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Fundamentals of Economics

By: Vinita Jain
M.A. (Economics), Advanced Diploma (Chinese Language)

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CONTENTS

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Question Bank – (Previous Year Solved Question Papers)

S.No.	*Chapterwise Reference Book*	*Page*

■ ■

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QUESTION PAPER

(June – 2019)

(Solved)

FUNDAMENTALS OF ECONOMICS

Time: 3 Hours] *[Maximum Marks: 100*

Notes: *Answer questions from all sections as per instructions.*

SECTION-A

Q. 1. Define an indifference curve. What are its properties? Explain consumer's equilibrium with the help of indifference curves.

Ans. Ref.: See Chapter-5, Page No. 26, 'Ordinal Utility approach to Consumer Behaviour : The Indiference Curve Approach', Page No. 28, 'Consumer's Equilibrium With L-Shaped Indifference Curve'.

Q. 2. Explain the Keynesian theory of demand for money. How is it different from Friedman's version of demand for money?

Ans. Ref.: See Chapter-18, Page No. 132, 'Keynesian Theory fo demand for money' and Page No. 136, Q. No. 12.

Q. 3. Distinguish between price elasticity of demand and cross elasticity of demand. Discuss the factors determining price elasticity of demand. How is this concept helpful in price determination?

Ans. Ref.: See Chapter-4, Page No. 17, 'Price Elasticity of Demand', Page No. 19, 'Cross Elasticity Demand', Page No. 20, 'Factors on Which elasticity of Depend', Page No. 21, ' Importance of the Copncept of Elasticity of Demand'.

Q. 4. Explain the concept of balance of payments. What are its components? Explain why balance of payments always balances.

Ans. Ref.: See Chapter-20, Page No. 147, 'Balance of Payment', Page No. 147, 'The Current Account', 'The Capital Account', Page No. 150, Q. No. 20.

SECTION-B

Answer following questions from this section:

Q. 5. Explain briefly the law of variable proportions. In which stage does a business firm operate and why?

Ans. Ref.: See Chapter-6, Page No. 34, 'Fixed and Variables Proportions in Production', Page No. 34, 'Three stages of production'.

Q. 6. Describe the determination of equilibrium price and quantity under simple monopoly.

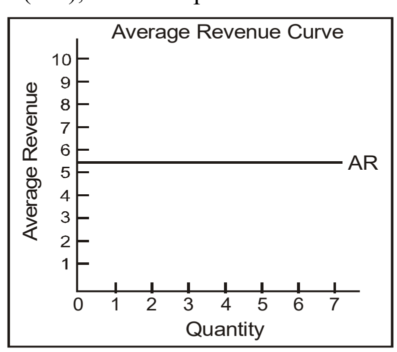
Ans. Monopoly refers to a market structure in which there is a single producer or seller that has a control on the entire market. This single seller deals in the products that have no close substitutes and has a direct demand, supply and prices of a product.

Therefore, in monopoly, there is no distinction between an one organization constitutes the whole industry.

Demand and Revenue under Monopoly

In monopoly, there is only one producer of a product, who influences the price of the product by making Change m supply. The producer under monopoly is called monopolist. If the monopolist wants to sell more, he/she can reduce the price of a product. On the other hand, if he/she is willing to sell less, he/she can increase the price.

As we know, there is no difference between organization and industry under monopoly. Accordingly, the demand curve of the organization constitutes the demand curve of the entire industry. The demand curve of the monopolist is Average Revenue (AR), which slopes downward.



Figure, it can be seen that more quantity (OQ2) can only be sold at lower price (OP2). Under monopoly, the slope of AR curve is downward, which implies that if the high prices are set by the monopolist, the demand will fall. In addition, in monopoly, AR curve and Marginal Revenue (MR) curve are different from each other. However, both of them slope downward.

The negative AR and MR curve depicts the following facts:–

(i) When MR is greater than AR, the AR rises.

(ii) When MR is equal to AR, then AR remains constant.

(iii) When MR is lesser than AR, then AR falls.

Here, AR is the price of a product, As we know, AR falls under monopoly; thus, MR is less than AR.

Q. 7. Explain the concept of consumption function and distinguish between Average Propensity to Consume (APC) and Marginal Propensity to Consume (MPC)

Ans. The difference between the average propensity and marginal propensity to consume?

Propensity to consume or consumption function expresses the function relationship between total consumption and total income. It refers to the consumption expenditure at various levels of income. Symbolically it is expressed as C=f(y). The consumption function has two technical attributes or properties (a) Average propensity to consume are (b) marginal propensity consume. Average propensity to consume and Marginal propensity to consume.

The concept of APC indicates the ratio of aggregate consumption expenditures to aggregate income, or in other words it is the ratio of absolute consumption to absolute income *i.e.,* it is the ratio of C to Y and is expressed as C/Y. Thus, it is found dividing consumption expenditure by income.

For example, at income 400 crores, the consumption expenditure is Rs. 360 crores, the APC=C/Y=360/400 – 9/10 = 0.9. The APC at various income levels is shown in the table given below. The APC declines income increases because the proportion of income spent consumption decrease.

Q. 8. Explain the theory of comparative cost advantage with a suitable example.

Ans. Ref.: See Chapter-20, Page No. 143, 'Comperative Cost Advantages: Why Trade takes place'?

Q. 9. What do you mean by public goods? Explain why is government intervention required for their efficient supply.

Ans. A public good is an item consumed by society as a whole and not necessarily by an individual consumer. Public goods are financed by tax revenues. All public goods must be consumed without reducing the availability of the good to others and cannot be withheld from people who do not directly pay for them. Law enforcement is also an example of a public good. Almost all public goods are considered to be non-rivalrous and non-excludable goods. Non-rivalry denotes any product or service that does not reduce in availability as people consume it. Non-excludability refers to any product or service that is impossible to provide without it being available for many people to enjoy. Therefore, a public good must be available for everyone and not be limited in quantity. A dam is another example of a public good. It is non-rivalrous and non-excludable in that all people within a society benefit from its use without reducing the availability of its intended function. While public goods are important for a functioning society, there is an issue that arises when these goods are provided, called the free-rider problem. This problem says a rational person will not contribute to the provision of a public good because he does not need to contribute to benefit. *For example,* if a person does not pay his taxes, he still benefits from the government's provision of national defense by free riding on the tax payments of his fellow citizens.

One of the core functions of government is to supply public goods that markets either fail to provide or cannot provide efficiently. The government intervention with public goods is required for overcoming the free-rider problem. Direct provision of a public good by the government can help to overcome the free-rider problem which leads to market failure. The non-rival nature of consumption provides a strong case for the government rather than the market to provide and pay for public goods. Many public goods are provided more or less free at the point of use and then paid for out of general taxation

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The Chapter

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FUNDAMENTALS OF ECONOMICS

INTRODUCTION TO ECONOMICS

Central Problems

1

INTRODUCTION

Resources are limited and people have choices, so they have to decide, what to take first? Central problems arise in an economy due to scarcity of resources having alternative uses in relation to unlimited wants. People cannot have everything they want. The purpose of this chapter is to clear the major problems of an economy to the students as well as the best method to deal with them.

CHAPTER AT A GLANCE

DEFINING ECONOMICS

What is Economics?

Economics is the study of how people choose to use resources. Economics is a social science which studies how human beings make choices to use scarce resources to satisfy their unlimited wants. Sometimes economics called the science of choices because scarcity forces people to choose.

According to **Lionel Robbins,** "Economics is a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses". According to this definition Robbins stressed that economics as a subject deals with human behaviour. There are other sciences such as political science, sociology, psychology etc., which also deal with human behaviour. But economics deals with the behaviour of people in the pursuit of economic activities. People use their talent with scarce available resources the land, buildings, equipment, and other tools on hand, and with best efforts to combine them to create useful products and services.

In short, economics includes the study of labour, land, and investments, of money, income, and production, and of taxes and government expenditures. Economists seek to measure well-being, to learn how well-being may increase overtime, and to evaluate the well-being of the rich and the poor.

Definitions of Economics

- Economics is the "study of how societies use scarce resources to produce valuable commodities and distribute them among different people."

  — Paul A. Samuelson

- "Economics is the study of people in the ordinary business of life."

  — Alfred Marshall

- "Economics is a science which studies human behaviour as a relationship between given ends and scarce means which have alternative uses."

  — Lionel Robbins

UNLIMITED WANTS AND LIMITED MEANS

Human wants are unlimited. Human beings live in a society. They want to have each and every thing that is available in the market. This whole concept is based on the two basic facts that are:

(a) Human wants are unlimited and

(b) Resources are limited.

If you want a dress for yourself, you will buy it from the market. The next day, if you want new shoes or you want to eat pizza you will satisfy it by buying it. But you will notice that no sooner does the first want gets satisfied that a new want takes it place. The chain process continues in an unending point. Your wants and needs occur daily and they keep on occurring again and again. Economics is concerned with human goals, objectives, ends to be achieved and realized through the use of certain means or resources at their disposal. For instance, if you want to drink a coffee, you have purchasing power to buy it. If you want to grow wheat you have to a piece of land, seeds, fertilizers and water to irrigate it. To build a house you need bricks, cement, steel, glasses and labour. Now it is clear that you must have resources to fulfil your wants.

SCARCITY AND CHOICE

Scarcity is the central economic problem in all societies, irrespective of the type of economic system. Scarcity is the inability to satisfy all your wants due to a lack in resources or supply, where human wants exceeds the output this can lead to something becoming scarce. Resources are the means which make a product; this can be natural resources such as land and raw materials, human resources, or manufactured resources such as factories and machines. We can say that scarcity and choices are inseparable. Scarcity means limited income and choice means allocation of income to the purchase of different goods and services in a manner that he maximizes his satisfaction. Economics not only deals with scarcity but also helps us to exercise meaningful choices, since scares means can be put to alternative uses. For instance, if you spend your income on rice and pulses, you forfeit the opportunity to spend your income on clothes; if an economy uses oil to run its factories it can't use the same for vehicles. Similarly, if you use your time to watch a movie, you can't use this to study your chapters.

Hence, Scarcity requires choice. People must choose which of their desires they will satisfy and which they will leave unsatisfied. Scarcity forces us to take less of something else. Economics is sometimes called the study of scarcity because economic activity would not exist if scarcity did not force people to make choices.

THE PROBLEM OF CHOICE: AN ILLUSTRATION

You want to have more clothes or want to buy a new car. Would you like to spend more money to get more goods and services? The answer will be yes. No matter how much you already have, there is always a want for more. In economics, human wants are assumed to be virtually unlimited. Consumers have limited means available to them (time, skills and money) to satisfy their needs and unlimited wants. They must use some means to satisfy their needs, which are essential for survival.

There are limited resources available to fulfil these wants. Only a finite amount of goods and services can be produced at any one time. After all, we only have so much resources available with us, whether these are natural resources (land and raw materials) such as gold, steel water etc., or human resources (labour), or human-made resources (capital) such as factories and machines.

Thus, the reason for scarcity is clear. Human wants are unlimited, yet the resources available to fulfil those wants are limited. This is further compounded by the fact that most resources have various uses. Already limited resources become even more limited if they have many alternative uses. For example, gold could be used to make jewellery as well as this can be used for electronic circuits, electroplating and coins. Thus, we have to decide it where to use it?

This leads directly to a well-accepted definition of scarcity: It is the excess of human wants over the actual amount of goods and services that can actually be produced.

However, with scarcity and limited means, consumers must choose how will they use their remaining means to satisfy their remaining needs through a decision-making process. Their decision will be influenced by tastes and preferences, personal values and the means available to them. Consequences of the decision will include the next best alternative foregone, known as the opportunity cost. Every economy face the three main problems: which goods are to be produced? How are they to be produced? And who should obtain them?

Production Possibility Curve

A production possibility curve shows the trend of production of goods. To understand this concept, assume that there are two goods X and Y that resources are fully employed and common to both goods, and that the technology is fixed. To produce more Y, resources (e.g. labour and capital) must therefore be moved from X to Y. This means that the production of more Y causes fewer Xs to be produced.

Table 1.1
Production Possibility Schedule

Goods	Production Possibilities				
	A	B	C	D	E
Rice (lakh tones)	100	90	70	40	0
Guns (units in thousands)	0	1	2	3	4

The above schedule shows that if production is carried out under combination 'A', then 100 lakh tones of rice alone will be produced without any production of gun. On the contrary, if production is obtained under `E' combination then four thousand of guns alone will be produced without any production of rice, besides these extreme limits, there are many alternative possibilities of production of rice and gun for instance, under B combination it is 90 lakh tones of rice and one thousand guns, under combination C it is 70 lakh tones of rice and 2 thousand guns, and so on in combination D. With this we can understand the first problem an economy i.e.,what to produce similarly, PPC can be use to illustrate the central problem of an economy–the problem of what to produce? how to produce? And for whom to produced? How resources are to combined to produce the goods that is the choice of method of production. The first and the foremost problem of an economy is that what goods and services are to be produced in an economy?According to the **Paul Samuelson** we can say that PPC describes the "Menu of Choice". Where 'Menu' means many possibilities and 'choice' means according to your wish and taste. Since, resources are limited the economy has to decide which of the consumer goods like sugar, wheat, ghee, cloth, toys etc. are to be produced and in what quantity? An economy has to make a choice between war time goods like guns, tanks etc. and peace time goods like bread and butter etc.which can be called producer goods and consumer goods etc.

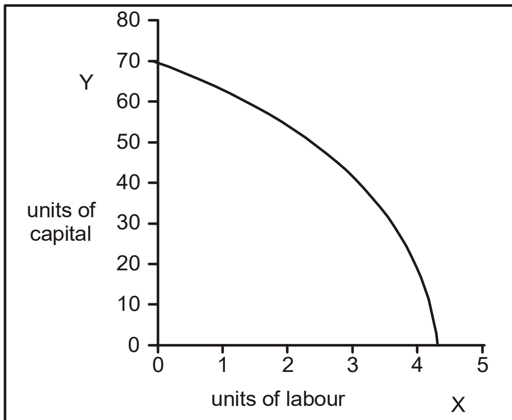

Fig. 1.1

we can have production of commodities with a combination of labour and machines. If we assume that X is labour and Y is capital intensive then at point A equilibrium of PPC is the best in concern with India because it is a combination of OX^1 of labour and OY^1 of capital units.

The second main problem of an economy is how to produce? It is a problem of making choice between which type of technology should be used for production i.e. labour intensive technology or capital intensive technology. Labour intensive technology means where more labour and less capital is used. Developing countries like India will use labour intensive technology because capital is an expensive choice and with more labour we can reduce the problem of unemployment also.Whereas developed countries like U.S.A. and Japan will use the capital intensive technology because they have less labour and more capital.

The third problem of an economy is For whom to produce? It is a problem relating to the selection of the section of the society for which the production is to be undertaken or the decision regarding the ditribution of the production. This problem has two aspects,viz.the decision regarding personal distribution and functional distribution.

Personal distribution: This aspect relates with the selection between the various sections of the society, i.e., the selection between the rich and the poor.

Functional distribution: This aspect relates with the selection between the various factors of production, i.e., the selection between land, labour, capital and enterpreneur. The main question arises here that what part should go as rent, wages, interest and profit to the factors of production respectively.

The production possibility curve shows the maximum amounts of production that can be obtained by an economy, given its technological knowledge and quantity of inputs available. The PPC represents the menu of goods and services available to society.

A Digression: Meaning of Goods in Economy

Goods, in economics, mean the means of satisfying human wants. These are the material commodities for example: butter, bread, scooter, soap, car, jewellery, watches, etc., which are consumed by the consumers. These are originally drawn from the nature and after changing their physical, chemical and biological characteristics are transferred to the people for the present or the future consumption. These are synonymously known as commodities, products. The classification of goods depends on the three factors: *(a)* their physical characteristics, *(b)* the way they provide utility to their consumers *(c)* the location of their availability.

Another Digression

According to **Lionel Robbins,** "Economics is the science which studies human behaviour as a relationship between ends and scarce means that have alternative uses" Robbins says, economics is a positive science but in reality it is not positive science it deals with material things, the results of which are certain but economics deals with human behaviour which is uncertain. Robbins has tried to explain economics a pure or positive science whereas it is a social science because it deals with the behaviour of the human being. Human behaviour keeps on changing from time to time so it cannot be evaluated on the scientific standard. **Marshal** defined Economics as an engine of social betterment. Thus; we can say that Marshall was more concerned with the welfare of the people.

POSITIVE VERSUS NORMATIVE ECONOMICS

In further chapters, we described two major kinds of economics: microeconomics and macroeconomics. Now we must consider another great dichotomy: Positive versus Normative economics.

According to **Friedman,** positive economics has to do with "what is," while normative economics has to do with "what ought to be." Positive economics is based on social science, and declares results on the basis of evidence as in any science. By contrast, normative economics has a moral or ethical aspect, and is based on 'should' or 'ought to' concept.

The positive economics describes what was, what is and what would be under the given set of circumstances. For example, 'Your salary is Rs.12, 000 a month.' This statement relates to the positive economics. 'Your salary should be Rs.15, 000 now.' This statement relates to the normative economics. On the basis of empirical verification of the statements, we can find out the degree of truth in such statements. The part of economics which deals with positive statements is called Positive Economics. But positive statements may not be the statements of the facts. Certainly, those statements are, however, verifiable for the facts. Normative statements cannot be empirically verified. That part of economics which deals with normative statements is we know that, in almost all the cases, economics cannot depend upon experimental methods to verify its hypotheses. Normative Economics is an observational science.

While both the statements above are part of the study of economics but they are fundamentally different from each other. The former is known as a positive statement, while the latter is known as a normative statement. As we can see that the first statement is the one that cannot be challenged as it is a factual statement. However, the second statement is normative and may be seen differently by different people; one may agree to it, the other may deny it. Thus, such a statement shall become a matter of discussion or difference.

CHECK YOUR PROGRESS

Q. 1. If you have Rs. 1000 income per month, name some biological needs that you will satisfy first, (In other words name some commodities which you regard essential for survival.)

Ans. Some essential commodities on which I would spend my income are:

- Rent of my house
- School fees of my children
- Some food items–cereals, oil, pulses, milk, wheat flour etc.
- Clothes.

Q. 2. If you want to grow sugarcane on a piece of agricultural land that you own, what are the resources that you will employ as means to achieve a certain level of output of sugarcane?

Ans. The resources to grow sugarcane are: seeds, fertilizers, labourers, water to irrigate and agricultural tools.