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# **PRINCIPLES OF MICRO ECONOMICS**

**B.C.O.G.-171**

**B.Com. General - 5th Semester**

**Chapter Wise Reference Book  
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*Based on*

**C.B.C.S. (Choice Based Credit System) Syllabus of**

# **I.G.N.O.U.**

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*By: Somika Kapoor, M.Com*



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Mob.: 8510009872, 8510009878 E-mail: [info@neerajbooks.com](mailto:info@neerajbooks.com)

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**Sample Preview  
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# QUESTION PAPER

June – 2023

(Solved)

## PRINCIPLES OF MICRO ECONOMICS

B.C.O.G.-171

**Time: 3 Hours ]**

**[ Maximum Marks : 100**

**Note:** Answer any five questions. All questions carry equal marks.

**Q. 1. (a) What is an economic system? Explain the fundamental/central problems of an economy.**

**Ans. Ref.:** See Chapter-1, Page No. 6, Q. No. 1, Page No. 2, 'Fundamental/Central Problems of An Economy'.

**(b) Explain the law of demand with the help of demand schedule and demand curve.**

**Ans. Ref.:** See Chapter-3, Page No. 18, 'The Law of Demand'.

**Q. 2. (a) What is supply? How is it different from stock?**

**Ans. Ref.:** See Chapter-5, Page No. 38, Q. No. 1.

**Also add:** Stock refers to the number of goods that is available to the producers at a particular point in time. Whereas supply is defined as the actual quantity of the goods that a seller is willing and able to sell to consumers at a given price and at a particular point in time. The stock for any commodity is measured at a specific point of time while supply for any commodity is measured over a particular period of time. The main purpose of stock is to fulfil any unexpected increase in demand for the product. The main purpose of supplying goods by any company is to sell them to generate revenue.

**Q. 2. (b) Explain the concept of consumer's surplus. What are its limitations?**

**Ans. Ref.:** See Chapter-7, Page No. 55, Q. No. 6.

**Q. 3. (a) What are the assumptions of an indifference curve?**

**Ans. Ref.:** See Chapter-8, Page No. 66, Q. No. 1.

**Q. 3. (b) How the various tools of government intervention are applied while determining the price?**

**Ans. Ref.:** See Chapter-6, Page No. 45, Q. No. 2, and Page No. 48, Government Intervention'.

**Q. 4. What is monopoly? How does it differ from perfect competition? Explain the determination of a monopolist's equilibrium in the long period.**

**Ans. Ref.:** See Chapter-14, Page No. 116, 'Concept of Monopoly', Page No. 118, Q. No. 5, and Page No. 120, Q. No. 4.

**Q. 5. (a) What is backward bending supply curve? Explain with an example.**

**Ans. Ref.:** See Chapter-17, Page No. 140, Q. No. 6.

**(b) Explain how wage rates and employment are determined in factor market.**

**Ans. Ref.:** See Chapter-17, Page No. 139, Q. No. 3.

**Q. 6. (a) Why is long-run average cost curve "U"- shaped? Explain with the help of a diagram.**

**Ans. Ref.:** See Chapter-11, Page No. 94, 'Long Run Average Cost Curve' and Page No. 95, 'Why Long-run Average Cost Curve is U-shaped?'

**(b) Distinguish between nominal and real rates of interest. How are these interest rates determined?**

**Ans. Ref.:** See Chapter-19, Page No. 149, 'Nominal and Real Rates of Interest', Page No. 153, Q. No. 3 and Page No. 154, Q. No. 4.

**Q. 7. Write short notes on any four of the following:**

**(a) Microeconomics and Macroeconomics**

**Ans. Ref.:** See Chapter-2, Page No. 12, 'Micro Economics and Macro Economics'.

**(b) Marginal utility of money**

**Ans. Ref.:** See Chapter-7, Page No. 49, 'Marginal Utility of Money'.

**(c) Oligopoly**

**Ans. Ref.:** See Chapter-16, Page No. 130, 'Introduction' and 'Characteristics and Kinds of Oligopoly'.

**(d) Price ceiling**

**Ans.** A price ceiling is a type of price control, usually government-mandated, that sets the maximum

amount a seller can charge for a good or service. Price ceilings are typically imposed on consumer staples, like food, gas, or medicine, often after a crisis or particular event sends costs skyrocketing. While they make staples affordable for consumers in the short term, price ceilings often carry long-term disadvantages, such as shortages, extra charges, or lower quality products.

**(e) Quasi rent**

**Ans. Ref.:** See Chapter-20, Page No. 158, Q. No 5. ■■

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# Sample Preview of The Chapter

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# PRINCIPLES OF MICRO ECONOMICS

## Fundamental Problems of Economic Systems

1

### INTRODUCTION

This introductory unit aims to familiarize you with essential questions and challenges that every economy encounters. Understanding these concepts will help you grasp economic reasoning and related theories. The unit covers topics such as the meaning of an economic system, fundamental economic problems, factors of production and their characteristics, production possibility curve, and resource allocation in various economic systems. By studying these concepts, you'll gain insights into the nature of economic issues and the solutions used to address them.

### CHAPTER AT A GLANCE

#### AN ECONOMIC SYSTEM

An economic system refers to the way a society organizes production, distribution, and consumption of goods and services.

#### Concept of Scarcity

Scarcity drives economic activity due to unlimited wants and limited resources.

**(a) Unlimited Wants or Ends:** Human wants are endless, leading individuals to seek satisfaction through goods or services, but resources are limited, causing scarcity. Priorities vary among individuals based on circumstances and changing needs.

**(a) Scarce Means or Resources:** Scarcity of resources is a universal reality, compelling individuals and societies to prioritize wants and allocate resources efficiently. The challenge lies in increasing resource availability and wisely regulating their usage.

#### An Economic System or Economy

An economy encompasses the setup to tackle the imbalance between unlimited wants and scarce resources. Factors like resources, institutions, and historical forces shape each country's unique economy. Economies are classified based on ownership, productive resources, and development levels. The fundamental problem of scarcity exists in all

economies, necessitating efforts to increase resources and prioritize wants.

#### Economic Entities

Economic entities, like individuals, firms, and institutions, make decisions that shape the economy and influence its efficiency.

#### FACTORS OF PRODUCTION

Production transforms inputs into outputs, increasing their utility. Utility means consumer satisfaction. Inputs include land, labour, capital, and entrepreneurship.

#### Land

Land, in the economic sense, includes all natural resources like water, minerals, and climate. Its supply is fixed by nature, making it scarce, and its ownership generates rent.

#### Labour

Labour refers to human effort undertaken for payment. It cannot be separated from the worker and its performance is immediate, affecting workers' bargaining power.

**Size of Labour:** Labour in economics comprises various types of workers, skilled and unskilled, with diverse productive capacities and efficiencies. The size and quality of the labour force impact economic outcomes.

**Quality of Labour:** Labour's role in production involves two aspects: the intensity of work and the maximum efficiency a worker can achieve. Efficiency depends on education, training, health, and other factors. Land and labour are primary factors essential for production.

#### Capital

Capital refers to man-made productive resources like machinery and equipment. Capital formation adds to the capital stock, increasing productivity and future consumption goods.

#### Entrepreneurship

Entrepreneurship is the fourth factor of production, coordinating land, labour, and capital to yield output, assuming risk and seeking profit.



## FUNDAMENTAL/ CENTRAL PROBLEMS OF AN ECONOMY

Allocation of the scarce resources and the distribution of the final goods and services are the fundamental problems of every economy, as given here under:

### What to Produce?

An economy does not have sufficient resources to produce all the goods and services required and it has to decide what to produce and what not to produce. When some goods are not produced, some wants of the people remain unsatisfied. The decision involves allocation of resources. So, the economy chooses the product/service that brings highest benefits relative to its cost of production.

### How to Produce?

This problem is concerned with deciding about how much resources to be used in the production of different goods and services. After deciding about the goods and services to be produced, the economy has to decide as to in what quantities the chosen goods are to be produced. Different techniques/methods of production use different quantities of the different factors of production and the society has to choose the appropriate technique. Production can be alongside, every what and how to produce every economy has also to decide-how to distribute resources or how the total output will be divided amongst different consumers by using labour intensive techniques or capital intensive techniques.

### For Whom to Produce?

After deciding what and how to produce, the next problem is for whom to produce. Every economy has also to decide about how to distribute the production or the total output will be divided among different consumers. Distribution of national product depends on the distribution of national income and people having large incomes will get a larger share of the produce. In a free market economy, productive resources are privately owned and the question of who gets what is decided by who can afford what goods and services at the price decided by the demand and supply forces and the socialistic principle is from each according to his ability to each according to his needs.

### The Problem of Growth

In order to generate income, every economy seeks to increase its production capacity. The generated income in an economy has two alternative uses, consumption expenditure (C) and saving (S). Thus:

$$Y = C + S.$$

There is a need to reduce the share of consumption expenditure (and thereby increase investment); this helps in capital formation.

## Choice Between Public and Private Goods

**1. Private Goods:** Goods which can be priced and whose use can be restricted to selected persons are called private goods. These goods need not necessarily be produced by private sector of the economy, it may be a product of the public sector or of a unit owned jointly by private and public sectors. A product may be priced so that only those who can pay and are ready to pay its price can have it and others are prevented, a characteristic which is called principle of exclusion.

**2. Public Goods:** Public goods are goods which cannot be priced in way to prevent some persons from using. Example: Defence of the country from enemy attack, it cannot be said that only persons would be protected who pay a particular price and others would be left unprotected. However, it does not mean that every member of the public will also get equal share in it. Practically, there are no pure public or pure private goods and most of the goods available have a mixture of both in them. Goods which are pre-dominantly public in character, must be produced by the public sector and the private goods can be provided by both the private and public sectors.

### The Problem of Merit Goods

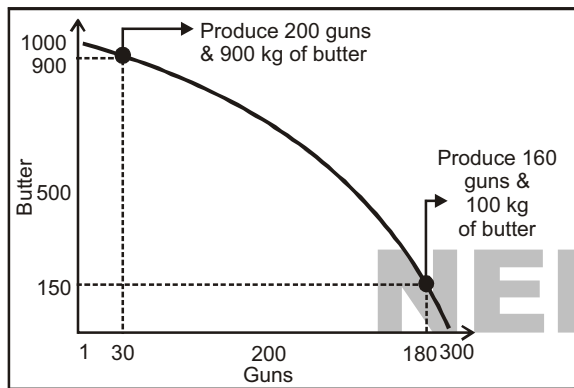
Merit goods, such as education facilities, are the goods and services that are regarded by the government as extremely important for the people, its use is promoted by the government because it wants people to consume these to ensure their welfare. The government provides these at free of costs or at subsidized prices because, if left to the private enterprises, it may not be provided to all the persons and a number of poor children may not be able to study which will adversely affect the people and the society. Consumption of merit goods help the entire society and also improve efficiency and well being of the people.

## PRODUCTION POSSIBILITY CURVE

The scarce resources have alternative uses and the society decides about the extent of resources to be put to use in producing different goods and services and also determine the pattern of allocation of resources towards different goods and services. Such allocation of resources brings about a particular combination of different goods and services. Given the total resources, the economy can allocate them in a number of ways and get different combinations of all possible goods and services. Such a collection of the possible combinations of goods and services that can be produced from a particular part of the resources available is called the production possibility curve of the economy.

FUNDAMENTAL PROBLEMS OF ECONOMIC SYSTEMS / 3

PPC explains the possible combinations of two goods that a society can produce in a particular time by efficiently utilizing its resources and it shows all the combinations of two goods that can be produced with the given resources. The PPC slopes downwards from left to right. This is because the production of one good is to be compromised when the production of the second good/service is to be increased. The second characteristic of PPC is that it is concave to its point of origin, which means that the opportunity cost of producing one additional unit of one product increases in terms of loss of producing the other unit.



Goods	Production Possibilities				
	A	B	C	D	E
Guns (No.)	10000	8000	6000	3000	00
Butter (Kgs.)	00	5000	9000	13000	15000

The above table shows that the combinations A, B, C, D and E give the production of the two commodities (butter and guns) by utilizing same amount of resources. The PPC curve shows different combinations of guns and butter that can be produced with the available resources.

**Characteristics of PPC**

**1. Downward sloping from left to right:** To produce more of one thing, you must give up some of another due to limited resources.

**2. Concave to the origin:** A concave downward sloping curve indicates increasing marginal rate of transformation (MRT) and underlies the PP curve.

**Can PP curve be a straight line?:** Yes, the PP curve can be a straight line if the MRT (marginal rate of transformation) is constant.

**Does production take place only on the PP curve?:** No, production can occur anywhere inside the PP curve (inefficient) or on the curve (efficient).

**Can the PP curve shift?:** Yes, the PP curve can shift due to changes in resource availability or technological advancements.

**Extension of the Production Frontier:** The PPC shifts outward over time as the economy gains more resources and efficiency, producing more goods.

**ALLOCATION OF RESOURCES**

Capitalistic economy and socialistic economy are two types of economic systems. All the countries in general have adopted a mixed economy system.

**Resource Allocation in a Capitalist Economy**

A capitalist or market economy has privately owned means of production. Prices are determined by the price mechanism through demand and supply interactions. Labour is treated as a commodity, and individuals act in their self-interest. Income is determined by the resources supplied and the prices received. The price mechanism guides resource allocation, prioritizing profitable goods.

**Resource Allocation in a Socialist Economy**

Socialism features state or cooperative ownership of means of production. The focus is on welfare, reducing inequalities. Central planning authority controls resource allocation, price decisions. Rational profit maximization is not allowed. It may reduce work incentives.

**Resource Allocation in a Mixed Economy**

Mixed economy has features of both capitalist economy and the socialist economy. In this system, the means of production are partly owned by the private and partly by the government. (A mixed economy has both the public sector and the private sector). Economic activities are allowed to play freely in the market but at the same time, the government regulates some of the segments of the economy. In India, we have both public sector and private sector and hence, mixed economy represents a mixture of capitalism and socialism. In some areas where there is no interference by the government, in some areas, the government regulates all the work and in selected areas all economic activities are reserved for government to encourage a balanced development of the economy.

**CHECK YOUR PROGRESS**

**Q. 1. State two important characteristics of wants which make them unlimited in number.**

**Ans.** Two important characteristics of wants that make them unlimited are:

1. Human desires and needs are diverse and ever-changing, driven by factors like culture, trends, and social influences, leading to an endless variety of wants.

2. As one want is fulfilled, new wants emerge due to human nature and the desire for improvement and progress, making wants limitless in number.

**Q. 2. What is an economic system?**

**Ans.** An economic system is a comprehensive framework that governs the production, distribution, and consumption of goods and services in a society. It includes the set of institutions, rules, and arrangements through which resources are allocated to meet the needs and wants of the population while addressing the problem of scarcity.

**Q. 3. State whether the following statements are True or False.**

- (i) All the human beings have limited wants.
- (ii) All persons have identical wants.
- (iii) In some economic systems, it is possible to satisfy all wants of all persons.
- (iv) Wants of a person depend entirely upon his income.
- (v) A given want can be satisfied once, though it may emerge again.
- (vi) Wants and means of their satisfaction can be combined in alternative ways.
- (vii) Majority of individuals try to reduce their wants in line with the availability of means of satisfaction.
- (viii) Economic entities are like commission agents who help others in activities like buying and selling.

**Ans.** (i) False, (ii) False, (iii) False, (iv) False, (v) True, (vi) True, (vii) False, (viii) False.

**Q. 4. List the major factors of production.**

**Ans.** The major factors of production are land, labour, capital, and entrepreneurship. Land encompasses all natural resources like minerals, water, and climate. Labour refers to the human effort and skills involved in production. Capital represents man-made resources such as machinery and buildings. Entrepreneurship involves organizing and managing these factors to create goods and services.

**Q. 5. State whether each of the following statements are True or False.**

- (i) Utility is the same thing as satisfaction.
- (ii) Utility is the want-satisfying capacity of a thing.
- (iii) Production is the creation of utility.
- (iv) Availability of land to a country can be increased.
- (v) A factor of production consists of various items which can be substituted for each other without affecting total output.

**Ans.** (i) False, (ii) True, (iii) True, (iv) False, (v) True.

**Q. 6. Fill in the blanks:**

- (i) ..... and ..... are two primary factors of production.
- (ii) In a production process, inputs are the items which go into it while output are the items which .....
- (iii) Capital is the means of production meant for .....
- (iv) While land is a free gift of nature, capital is.....

**Ans.** (i) Land, labour, (ii) come out of it, (iii) further production, (iv) created by man.

**Q. 7. What are the fundamental problems of an economy?**

**Ans.** The fundamental problems of an economy are scarcity, choice, and efficiency. Scarcity arises due to limited resources and unlimited wants. The society must make choices about what to produce, how to produce, and for whom to produce. Efficiency involves utilizing resources to maximize output and meet the most urgent needs effectively.

**Q. 8. What is capital formation?**

**Ans.** Capital formation refers to the process of increasing the stock of capital goods in an economy over time. It involves the accumulation of physical and human capital through investments in machinery, equipment, infrastructure, and education. Capital formation is vital for economic growth as it enhances production capacity and improves overall productivity and living standards.

**Q. 9. What is a technique of production?**

**Ans.** A technique of production refers to the method or process used to transform inputs, such as labour, capital, and raw materials, into finished goods or services. It encompasses the specific technology, machinery, and organization employed in the production process. Different techniques can result in varying levels of efficiency, productivity, and cost-effectiveness. For instance, a production technique could involve labour-intensive processes, relying heavily on human effort, or capital-intensive methods, utilizing advanced machinery and automation. Selecting an appropriate technique is crucial for businesses to optimize production and maintain competitiveness in the market.

**Q. 10. What are merit goods?**

**Ans.** Merit goods are products or services that are considered beneficial for society and are typically under-consumed in a free market due to individuals' limited knowledge or ability to assess their true value.