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QUESTION PAPER

(June – 2019)

(Solved)

ECONOMIC THEORY

Time: 2 Hours] *[Maximum Marks: 50*
[Maximum Weightage: 70%

Note: *This paper contains* ***three*** *sections:* ***A, B*** *and* ***C****. Instructions are given in each section along with marks.*

SECTION - A

Answer the following questions:

Q. 1. What are the various forms of economic system? Describe the features of a mixed economy.

Ans. Ref.: See Chapter-3, Page No. 17, 'Various Forms of Economic Systems' and Page No. 20, 'Features of a Mixed Economy'.

Q. 2. Explain the concept of consumer's surplus with the help of a diagram. What are its limitations?

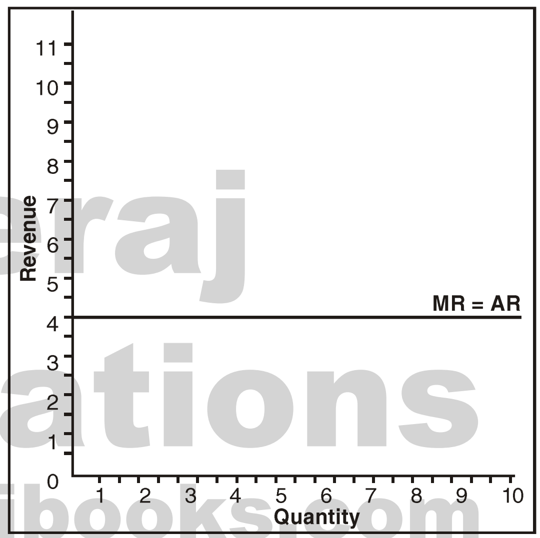
Ans. Ref.: See Chapter-4, Page No. 30, Q. No. 6.

Q. 3. What do you mean by Elasticity of Demand? How would you measure the price elasticity of demand?

Ans. Ref.: See Chapter-7, Page No. 51, 'Concept of Elasticity of Demand' and Page No. 53, 'Measurement of Price Elasticity of Demand'.

Q. 4. Explain the marginal and average revenues of a firm in both, perfect and imperfect competition.

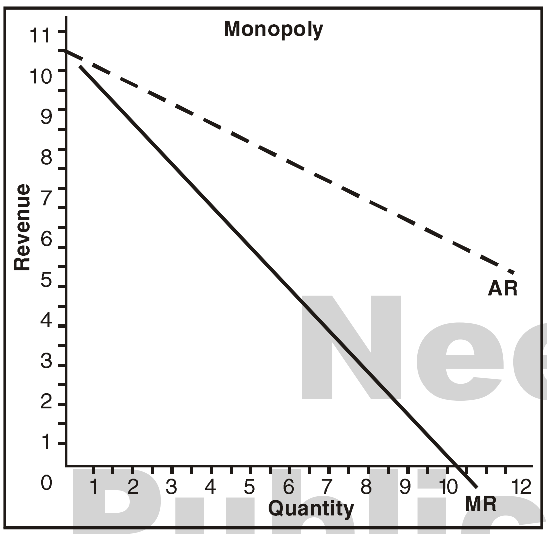
Ans. Marginal Equals Average: Perfect Competition: The equality between average revenue and marginal revenue occurs for a firm selling an output in a perfectly competitive market. This is illustrated by the exhibit to the right. This exhibit contains the average revenue curve and marginal revenue curve for zucchini sold by Phil the zucchini grower, a hypothetical firm in Shady Valley. Phil the zucchini grower is one of thousands of zucchini growers in the market, selling identical products. As such, Phil receives the going price for zucchini.



The primary observation from this exhibit is that (apparently) only one curve is displayed. This single horizontal line, labelled MR = AR, is actually two curves, the marginal revenue curve and the average revenue curve. They appear to be one curve because each overlays the other.

They coincide because marginal revenue is equal to average revenue at every output quantity. The equality between marginal revenue and average revenue is the result of perfect competition. Because Phil receives the same per unit price for every worker, incremental revenue is equal to the per unit revenue.

Marginal Less Than Average: Marginal revenue falling short of average revenue occurs for a firm selling an output in a monopoly market. This is illustrated by the exhibit to the right. This exhibit contains the average revenue curve and marginal revenue curve for medicine sold another hypothetical firm, Feet-First Pharmaceutical. By virtue of a government patent, Feet-First Pharmaceutical is the only producer of Amblathan-Plus, the only cure for the deadly (but hypothetical) foot ailment known as amblathanitis. As the only producer, Feet-First is a monopoly with extensive market control, and it faces a negatively-sloped demand curve. To sell more Amblathan-Plus, Feet-First Pharmaceutical charges a lower price.



The primary observation from this exhibit is that the negatively-sloped marginal revenue curve lies below the negatively-sloped average revenue curve. The juxtaposition of these two curves illustrates the marginal less than average relation. Because the marginal revenue is less than average revenue, the average revenue curve decreases.

SECTION - B

Answer the following questions:

Q. 5. What is long-run cost curve? Why is short-run Average Cost Curve 'U'-shaped?

Ans. Ref.: See Chapter-11, Page No. 89, 'Long Run Cost Curves' and 'Why U-shaped Short Run Average Cost'.

Q. 6. Differentiate between 'fixed' and 'variable' inputs. Explain their importance in theory of production.

Ans. Ref.: See Chapter-8, Page No. 65, Q. No. 5.

Q. 7. What is the meaning of the term 'Monopoly'? In what way does it differ from perfect competition?

Ans. Ref.: See Chapter-14, Page No. 116, Q.No. 1 (Terminal Question).

Q. 8. What are profits? Describe sources of profits.

Ans. Ref.: See Chapter-19, Page No. 156, 'Profits' and 'Sources of Profits'

SECTION - C

Q. 9. Write short notes on the following:

***(a)* Collective Bargaining**

Ans. Collective Bargaining is the process where representative of the employers and employees are meeting together to discuss about the term and condition of the employment. It established harmonious relationship between employer and employee. It also brings unity among the workers.

Objectives of Collective Bargaining

The following are the main objectives of collective bargaining:

- To increase mutual confidence between the employer and employees;
- To regulate terms and conditions of employment without intervention of a third party;
- To create cordial environment in the establishment;
- To protect the interest of the employees; through collective action and by preventing unilateral action on the part of the employer;
- To raise the socio-economic attributes of the employees.

***(b)* Competitive Wages**

Ans. Competitive wages refers more to the efforts of employers to attract workers through industry-standard wages. In some cases, industry employers must pay above-minimum wages to compete with others for the limited supply of workers. In a pure market economy, the level of worker supply and employer demand dictates the typical pay for a given job. In unskilled or less-skilled jobs in some sectors, the minimum wage is the standard starting pay for workers because employer competition isn't very high relative to the availability of labourers.

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The Chapter

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ECONOMIC THEORY

FUNDAMENTAL PROBLEMS OF ECONOMIC SYSTEM AND BASIC CONCEPTS

Fundamental Problems of Economic Systems 1

INTRODUCTION

Today in such a global scenario it is not so easy to grow at faster rate. Whether it is a developed economy or developing economy, all the economies are facing one or the other basic problems. So in this introductory chapter we will understand - what the basic problems of an economy are?

Starting from the basics of economics we will study all the concepts related to meaning of economics, what is economic system and their types? Along with these meaning and nature of different factors of production, how to take a rationale decision with the help of production possibility curve and last but not the least that how to allocate the resources in different types of economic systems so as to have maximum output with optimum utilization of resources will be a part of this chapter.

CHAPTER AT A GLANCE

AN ECONOMIC SYSTEM

Meaning of Economics: Economics is the social science that studies the production, distribution, and consumption of goods and services.

According to Robbins, "Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses."

Scarce Means and Unlimited Wants

Scarcity means that available resources are insufficient to satisfy all wants and needs. Economics examines how people use their scarce resources in an attempt to satisfy their unlimited wants.

Would you like a Grand Mercedes Benz, a sea-shore villa or a ocean journey? Would you like more free time, more sleeping time and more money to spend? Who wouldn't? The problem is simply that the resources available to satisfy these wants, or desires, are virtually limited. If there is absence of scarcity and alternative uses of available resources there is no economic problem.

There are only a limited number of resources such as workers, machines, factories, raw materials etc. Yet there are a number of different ways in which they could be used. Say water can be used for - gardening, washing, drinking, generating electricity etc.

Similarly people only have a limited amount of money. Yet they have lot of needs and wants to satisfy, say limited money can be used for shopping, holidays, investment and saving etc.

An important point to note out is that satisfaction of a want requires the use of some resources called the "Drivers to Satisfaction". Any specific want may be satisfied with various resources or a specific resource can be used to satisfy many wants. The basic fact is that available resources are never sufficient to satisfy all our recurring needs and ever increasing wants.

So what is the way out to come out of this problem?

Availability and supply of resources must be increased, although this option is possible up to a limited extent.

Priorities should be devised among the various needs in regard that which needs are more important to be satisfied and which can be forgone so as to allocate the limited resources in a more efficient and effective manner and to have maximum output.

An Economic System or Economy

An economic system refers to an organization which enables the individuals to get their livelihood. An economic system is identified in terms of modes of production, means of production, ownership of productive resources. There are basically three types of economic systems. They are:

- Capitalist Economy
- Mixed Economy
- Socialist Economy

As we say that each economic system comprises of many features and on the basis of these features only they are distinguished from each other. Even in all the economies their lies the problem of scarcity of resources and from the given resources only the producer has to take decision regarding production.

Economic Agents

As we say that economic system as a flow system, as flow system passes through various units of economy. All the units as an individual or as an institution like household, government, firms, companies take decisions with different capacities. So these decision-making units of an economy are called economic agents. The decision taken by these units depends upon the role played by these agents like it may be investor, saver, manufacturer, supplier, borrower or lender. These decisions by these agents are very crucial for the smooth flow of the economy because these agents are the persons who run this economy.

FACTORS OF PRODUCTION

Production refers to the economic process of converting of inputs into outputs. Production uses resources to create good or service that is suitable for exchange. Processes and methods employed in transformation of tangible inputs (raw materials, semi-finished goods, or sub-assemblies) and intangible inputs (ideas, information, know-how) into goods or services is called as production.

Factors of production (or productive inputs) are the resources employed to produce goods and services. They facilitate production, but do not become part of the product (as with raw materials).

Resources required for generation of goods or services, generally classified into four major groups:

1. Land (including all natural resources),
2. Labour (including all human resources),
3. Capital (including all man-made resources), and
4. Enterprise (which brings all the previous resources together for production).

These factors are classified also as management, machines, materials, and money.

Capital and labour are active factors while land is passive factor. One can only shift capital and labour rather than land which is limited, to get a production-factor combination.

Let us discuss about each of them in detail:

Land

Land is defined as everything in the universe that is not created by human beings. It includes more than the mere surface of the earth. Air, sunlight, forests, earth, water and minerals are all classified as land. Land is the passive factor of production. As such, land simply exists. To make the gifts of nature satisfy our needs and desires, human beings must do something with the natural resources. The payment for land use and the received income of a land owner is called rent.

Land is neither produced nor reproducible. Land as site is permanent and recyclable. Land supply is fixed.

Labour

Everything that people do, to convert natural opportunities into human satisfactions–whether it involves the exertion of brawn, or brains, or both–is labour. To make the gifts of nature satisfy our needs and desires, human beings must do something with the natural resources; they must exert themselves, and this human exertion in production is called labour. When the stuff of nature is worked up by labour into tangible goods, which satisfy human desires and have exchange value, we call those goods wealth. When labour satisfies desires directly, without providing a material good, we call that "services"; thus, economists say that labour provides the economy with "goods and services".

The payment for someone else's labour and all income received from ones own labour is wages. Labour can also be classified as the physical and mental contribution of an employee to the production of the good(s).

Supply of labour depends upon the size of the population, its geographical distribution, its level of education and training, its organization and its composition by age and sex.

Capital

When some of the wealth is used to produce more wealth, economists refer to it as capital. Capital increases labour's ability to produce wealth (and services too). It refers to machines, roads, factories, schools, infrastructure, and office buildings which humans have produced in order to produce goods and services.

The most common meaning refers to the equipments and structures used to produce goods and services, in conjunction with (or in replacement of) other inputs such as labour and land. The central characteristic of capital is that it is a durable stock—accumulating over time with investment decisions and depreciating as it becomes outdated or worn out. Thus capital is a produced factor of production—it is both a means of production and an output from another production process. A hammer, a screw-driver, and a saw are used by a carpenter to make a table. The table has exchange value. The truck which delivers the table to a retail store, the hammer and other tools and even the cash register are all forms of capital.

Goods with the following features are capital:

- It can be used in the production of other goods (this is what makes it a factor of production).
- It was produced, in contrast to "land," which refers to naturally occurring resources such as geographical locations and minerals.
- It is not used up immediately in the process of production unlike raw materials or inter-mediate goods.

Entrepreneurship

The fourth factor of production, involving human resources that perform the functions of raising capital, organizing, managing, assembling other factors of production, and making basic business policy decisions. The entrepreneur is a risk-taker.

Entrepreneurship is associated with the founding of new businesses or the introduction of new products and new techniques. But it means more than that, it also encompasses taking risks (possibly losing large sums of wealth on new ventures), inventing new methods of doing common things, and generally experimenting with any type of new thinking that could lead to monetary benefits.

Without entrepreneurship, virtually no large-scale business organizations could operate. Clearly, entrepreneurship as a human resource is scarce, not everyone is willing to take risks or has the ability for successful business decision-making. In markets entrepreneurs combine the other factors of production, land, labour, and capital in order to make a profit. Often these entrepreneurs are seen as innovators, developing new ways to produce and new products.

FUNDAMENTAL PROBLEMS OF AN ECONOMY

According to **Emerson:** "Want is a growing giant whom the coat of have was never large enough to cover." According to economists, why does "want" exceed "have"?

The economic problem, sometimes called the fundamental economic problem. It asserts that there is scarcity, or that the finite resources available are insufficient to satisfy all human wants. The problem then becomes how to determine what is to be produced and how the factors of production (such as capital and labour) are to be allocated. Because there is a scarcity of resources, our desires (wants) are greater than available resources. Therefore, economic issues spring from this fundamental problem of deciding:

- What to produce?
- How to produce?
- For whom to produce?

Let us discuss in detail about these problems which are central or basic to every economy:

What to Produce?

Since every economy faced with scarcity of resources. So it must decide that what to produce and what to forgo. Each country must decide what to produce to satisfy its needs and wants. They must decide how many resources they are going to devote to different products. All businesses must decide what to produce from given limited resources. While a society must decide how much food and shelter to produce to satisfy the population, a business must decide how much of each goods or services to produce.

Because of scarcity, by producing A, you must forgo the production of B, thus incurring an opportunity cost. You choose to produce, hopefully, the product or service that brings the highest benefits relative to costs.

How to Produce?

This problem is basically related to allocation of resources that is how the limited resources to be used for the production of various goods so as to maximum output and benefits. Goods and services can be produced in a variety of different ways. A country must decide how to put resources together in order to get the best product. There are many ways to produce a good or service of equal quality. As an entrepreneur, it is important to have a clear understanding of all your alternatives. Should the business produce all the goods and services it sells by itself or will it bring in outside contractors? Should the production take place domestically or should it be outsourced to another country? Should the production be labour-intensive or capital-intensive?

For Whom to Produce?

An economy is also to take decision about how to distribute the production or for whom to produce. This problem is basically related to distribution of total output among different sectors of economy. What should be the basis of distribution? Whether it should is needed basis or the contribution made by factors of production? Up to what extent the distributor will go for the equality in distribution? How the consumer goods are going to be distributed among different households, having different paying capacities?

In a free market, who gets what is determined by who is able to afford what at a price determined by supply and demand. As an entrepreneur, this question should be addressed that "Who are your customers?" "Will your targeted customers be able to afford the product?" "Are there enough of them to support your business?"

How to accelerate the rate of Growth?

One of the major problems faced by every economy is how to increase their production or how to go for economic growth. Every economy is keen to increase the standard of living of people especially in under-developed economies. In such countries this can be achieved by breaking the vicious circle of poverty, increasing population and unemployment. Along with these radical changes and developments are required in social, institutional infrastructure and technology.

THE PRODUCTION POSSIBILITY CURVE

As we know that with the availability of limited resources producing everything is not possible and it demands for setting of priorities regard to what to produce or not. The economy therefore has to choose between alternative combination of goods and services.

Let us learn how to production possibility curve helps in choosing out the best combination.

A production possibility frontier (PPF), or "transformation curve", is a graph that shows the different rates of production of two goods and/or services that can be produced efficiently during a given period of time with limited quantity of productive resources, or factors of production.

Assumptions: The concept of PPC is based upon the following assumptions:

The quantity of factors of production is fixed although they can be transferred from one good to another up to a limited extent.

Available factors are fully utilized in the economy or there is no wastage and underutilization of resources.

Technique of production is constant and is not possible to change it.

To make the study simple we assume only two goods or two sets of goods that are to be produced in economy.

Properties or Nature of Production Possibility Curve

PPC slopes downward: It slopes downward from left to right because under the given situation of full employment it is not possible to increase the production of both goods. Production of one good is compromised if the production of other is increased.

PPC is concave to the point of origin: This is because of existence of concept of opportunity cost and implication of phenomena of increasing opportunity cost. Opportunity cost of producing each additional unit of one good tends to increase in terms of loss of producing another good.

Illustration: Suppose an economy decides to produce only two goods namely petrol and diesel from its available resources. If all the factors of production are used for production of petrol only then 10,000 barrels can be produced and in the similar situation if only diesel be produced then 15,000 barrels can be produced. If economy produces both then various combinations of both can be produced with the available and limited resources. Given table shows the various combination of petrol and diesel.

Goods	Production Possibilities				
	A	B	C	D	E
Petrol (in barrels)	10000	8000	6000	3000	0
Diesel (in barrels)	0	5000	9000	13000	15000

The schedule shows that if production is carried out under combination 'A', then 10000 barrels of petrol can be produced alone and if production is obtained under combination 'E', then 15000 barrels of diesel can be produced. Besides these there are many other combinations of production of petrol and diesel.

The schedule shows that if production is carried out under combination 'A', then 10000 barrels of petrol can be produced alone and if production is obtained under combination 'E', then 15000 barrels of diesel can be produced alone. Besides these there are many other combination of production of petrol and diesel.

Allocation of Resources in Economic System

Economic System: An economic system is the system of production, distribution and consumption of goods and services of an economy. Alternatively, it is the set of principles and techniques by which problems of economics are addressed. 'System' refers to the