Introduction to Micro Economics. Micro

Set 1

1) Define Economics and Economy.

→ ~~Economy~~ Economics is a science of human behaviour concerned with allocation of scarce resources in which consumers can maximise their satisfaction, producer can maximise their profits and society can maximise ~~their~~ its social ~~welfare~~ welfare.

On the other hand an economy is a system spread over a particular area that reveals the nature and level of economic activities in that area.

2) Define an economic activity. Mention its types.

→ Economic activities are those activities which are related to the use of scarce resources. Economic activities can broadly be grouped into four categories as mentioned below:

(a) Production – It deals with those economic activities which are concerned with creation of utility. Eg: The creation of a building with the help of bricks, stone, iron rod etc.

(b) Consumption – It includes those activities which are concerned with destruction of utility of goods and services. Eg: To eat food for killing hunger.

(c) Distribution – It is related with the determination of prices of factors of production.

(d) Exchange – It is related to the sale and purchase of a commodity.

③ Define goods and services.

⟶ Goods are those tangible things which are having the power to satisfy human wants. On the other hand, services capture the intangible satisfaction of human wants.

④ Who is an individual and what is resource?

⟶ By individual we mean a single person, a single firm or an organisation.

By resource we mean those goods and services which are used to produce other goods and services. Eg: Labour, Land, Machines etc.

⑤ What is an economic problem?

⟶ It is the problem of making choices in the use of scarce resources to satisfy unlimited wants.

⑥ Why do economic problems arise?

OR

What are the causes of economic problem?

The three main causes of economic problem are below :—

(i) Unlimited human wants : Human wants appear one after another like the untiring waves of the sea. These wants are endless in the sense that they go on increasing with the increase in people's ability to satisfy them.

(ii) Limited resources : Production of various goods and services require resources like land, capital, machinery etc. However, compared to the unlimited wants for various goods and services, these resources seem to be insufficient.

(iii) Alternative use of resources : Resources are not only limited but also have alternative uses. Eg: A piece of land can be used for farming or for constructing a building. Thus every economy has to choose better alternative use of resources to which they can be put.

(7) Why the problem of choice arises?

→ The problem of choice arises because —

(i) Resources are scarce or limited.

(ii) Resources are having alternative uses.

(8) Explain how scarcity and choice go together.

.OR.

How are scarcity and choice inseparable?

→ Choice is the consequence of scarcity. Scarcity of resources having alternative uses compels us to make choices while using the resources. Thus scarcity and choice go together. Had resources been in abundance, there would have been no choice ~~Had resources~~ problem.

(9) Define opportunity cost with an example.

→ The opportunity cost of any good is the next best alternative good that is sacrificed. The production of a particular commodity involves sacrifice of another commodity which could have been produced using the same amount of resources.

Eg: A farmer having 1 bigha of land produces 30 kgs of wheat by using a given amount of resources. Further suppose he could also produce 40 kgs of rice on the same plot using the same amount of resources. Here, the opportunity cost of 30 kgs of wheat is 40 kgs of rice.

R 20 Jute 25

...scuss the subject matter of economics.

→ Traditionally the subject matter of economics has been studied under two broad branches — Micro economics and macro economics. Proff. Ragnar Frisch coined these terms for the first time in 1933.

Micro economics is that part of economic theory which deals with individual parts of an economy such as individual households, individual firms, individual industries etc. In other words, it studies the economic behaviour of individual decision making units of an economy. and not the economy as a whole. At the level of an individual economic unit, problem of choice is the basic problem. Thus, the central problems like what, how, and for whom to produce fall within the domain of micro economics. Moreover, Micro economic theory is also called 'Price theory' because it is primarily concerned with the determination of prices of individual commodities and factors of production.

On the other hand, in Macro economics, we are concerned with the determination of total output, total employment and general price level in the economy. Since, the subject matter of Macro

Economics revolves around determination of level of income and employment, it is also known as 'Theory of income and employment'.

(11) Distinguish between micro economics and macro economics.

→ The distinctions are as follows:

i. Micro economics studies individual economic units of an economy whereas macro economics studies the economy as a whole.

ii. Micro economics is primarily concerned with the allocation of resources and price determination whereas macro economics is concerned with the determination of level of income and employment.

iii. Micro economics is also called 'price theory' whereas macro economics is also called 'theory of income and employment'.

iv. Study of micro economics assumes that macro variables remain constant while study of macro economics assumes that micro variables remain constant.

(12) Distinguish between ~~po~~ positive economics and normative economics.

→ In economics we study not only the different issues and problems arising out of scarcity of but also try to find out solutions to the ...nomic problems. But when we are studying a problem which is subject to verification like the extent of poverty or unemployment, we are referring to positive economics. On the other hand when we are offering suggestions to solve the problem, we are referring to normative economics.

Infact, positive economics describes 'what was, what is and what would be' under the given set of circumstances. All these statements are capable of empirical verification and donot pass any value judgement. On the other hand, normative statements describe 'what ought to be'. These statements pass value judgement, i.e., opinions relating to right or wrong of a particular policy matter.

(13) Define an economy. Write a note on different types of economies of the world.

→ An economy is a system spread over a particular area that reveals the nature and level of economic activities in that area. Eg: When we talk of Indian Economy, we are referring to the nature and level of production, consumption, investment and exchange in India.

On the basis of nature of economic activities, economies of the world are classified as under :

i. Market Economy : Market economies are those economies in which economic activities are left to the free play of market forces of demand and supply. The government has no role to play in it. Self interest is the prime consideration under market economy (also called capitalism). Producers are free to produce those goods and services which are in high demand, so that they are able to maximise their profit. Likewise, consumers are free to buy goods and services in accordance with their choice, so that they are able to maximise their satisfaction.

ii. Centrally Planned ~~Econono~~ Economy : These are those economies in which all important decisions regarding production, consumption and exchange are taken by a Central Planning Authority or by the government. Under centrally planned economy social welfare is the prime consideration behind allocation of resources to the production of different goods and services.

iii. Mixed Economy : Mixed economy combines ~~the~~ the merits and avoids the demerits of market economy and centrally planned economy. Decisions

both basis

...ing 'what, how, and for whom' to produce are ...n both on the basis of market forces and on the basis of social considerations.

(14) Distinguish between a centrally planned economy and market economy. Also mention few features of a mixed economy.

→ The ~~dins disting~~ distinctions are :—

(i) Under market economy economic activities are regulated by the market forces of demand and supply while under centrally planned economy all decisions are taken by a central ~~pd~~ planning authority.

(ii) Under market economy, all means of production are owned by private individuals while under centrally planned economy, all means of production are owned by the government.

(iii) 'Self interest' is the prime objective under market economy but 'social welfare' is the prime objective under centrally planned economy.

(iv) Market economy is a free economy while centrally planned economy is under control of the government.

The features of mixed economy are as ~~follows~~ follows :

(i) Mixed economy combines the merits and avoids demerits of market economy and planned econ

ii. Means of production are partly owned by the government and partly owned by individuals.

iii. Price mechanism exists but it is not totally free.

iv. Individuals enjoy freedom of occupation and freedom of consumption.

(15) What are the two basic problems of an economy?

⟶ The two basic problems are :—

(i) Allocation of scarce resources.

(ii) The distribution of final goods and services.

(16) Discuss the central problems of an economy.

⟶ The central problems of an economy are normally summarised as follows :—

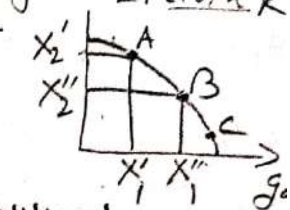
(i) What to produce : Every society has to decide which wants are to be taken on priority and which ones can wait.

(ii) How to produce : This problem is essentially the problem of choice of technique. Normally there are two techniques available, viz. (a) labour intensive technique and (b) Capital intensive technique.

(iii) For whom to produce : The third problem is the problem of distribution of the produce among various individuals in the ~~soc~~ society.

ine production possibility curve. (PPC). Point out its assumptions and characteristics.

(5) (PPC shows the different combinations of two goods which can be produced with the given resources and technology. The assumptions are —



(a) Resources available are fixed.

(b) Resources are fully and efficiently utilised.

(c) Technique of production remains constant.)

L K
100, 50

(6) (The features of PPC are as under :

i. PPC slopes downward from left to right. — It is because in a situation of fuller utilization of resources, production of both goods cannot be increased. More of good - X can be produced only with less of good - Y.

*ii. PPC is concave to the point of origin — It is because to produce every additional unit of good - X more and more units of good - Y will have to be sacrificed than before. The opportunity cost of producing every additional unit of good - X tends to increase in terms of loss of production of good - Y. In other words, there will be the operation of law of increasing marginal opportunity cost.)

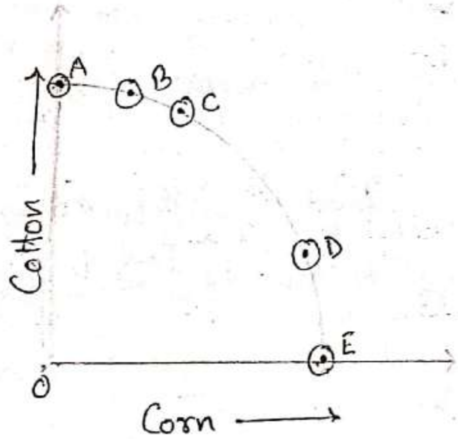
18. Explain the concept of Production Possibility Set and Production Possibility frontier.

→ Given the total amount of resources, it is possible to allocate the resources in different ways and thereby achieving different combinations of all possible goods and services. The collection of all possible combinations of the goods and services that can be produced from a given amount of resources and given stock of technological knowledge is called the Production Possibility Set of the Economy.

Let us consider an economy which can produce corn and cotton by using its resources. The following table gives some of the combinations of corn and cotton that the economy can produce.

Possibilities	Corn	Cotton.	
A	0	10	
			1
B	1	9	
			2
C	2	7	
			3
D	3	4	
			4
E	4	0	

It ~~is~~ ~~in~~ is seen that if all the resources are in the production of corn the maximum amount of corn that can be produced is 4 units and if all resources are used in the production of cotton, at the most 10 units of cotton can be produced. The economy can also produce 1 unit of corn and 9 units of cotton or 2 units of corn and 7 units of cotton, or 3 units of corn and 4 units of cotton. There can be many other possibilities. The following figure illustrates the production possibilities of the economy.



Any point on or below the curve represents a combination of corn and cotton that can be produced with the economy's resources. This curve (AE) is called The Production Possibility Curve (PPC) or Production Possibility Frontier (PPF).

19. What is the slope of PPC? What does it show?

→ The PPC is concave to the point of origin. It shows increasing slope, i.e., more and more units of good-y is to be sacrificed for every additional unit of good-x. In other words, the cost of producing additional X tends to increase in terms of loss of Y.

20. Define Marginal Opportunity Cost / Marginal Rate of Transformation (MRT).

→ Marginal Opportunity Cost / MRT is the loss of output of good-y when 1 unit more of good-x is produced by shifting the resources from Y to X.

21. What are the causes behind the operation of law of Increasing Marginal Opportunity Cost?

→ The causes are:

i. Resources are not equally efficient in the production of all goods. Therefore, as we draw more and more resources from the production of 'Y' to the production of every extra 'X', it implies that we have drawn those resources which are more suited to the production of 'Y' and thus the quantity of 'Y' sacrificed (i.e. the Marginal Opportunity Cost of producing 'X') increases.

Another reason for the opperation of this law is the Diminishing Returns. This law states that as more and more output of a commodity is produced, the marginal productivity of the factor gradually deminishes. As a result of it more quantity of the factor needs to be applied to produce the commodity.

22. How is PPC helpful in solving the central problems of the economy?

→ The usefulness of PPC in solving the central problems may be discussed as follows:

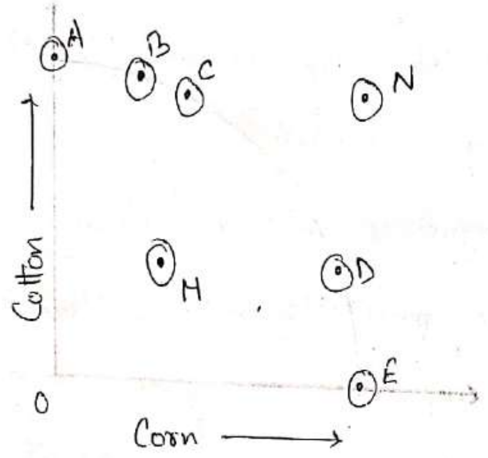
i. Problem of what to produce and in what quantities:
With the given resources and technology, the combinations of two goods that lie anywhere on the PPC can be produced. The problem of choice is indicated by the attainable points such as A, B, C, D and E as shown in the above figure. Thus, if the economy chooses combinations like B or C it implies that it has decided to produce more of cotton and less of corn. Contrary to it, If it chooses combination like E, it implies that the society intends to produce more of corn

2 = 10 kg
5 = 20 kg

ii. Problem of fuller utilisation of resources:
If all the resources are fully utilised, the production will take place at somewhere on the PPC. But if the economy is producing at any combination

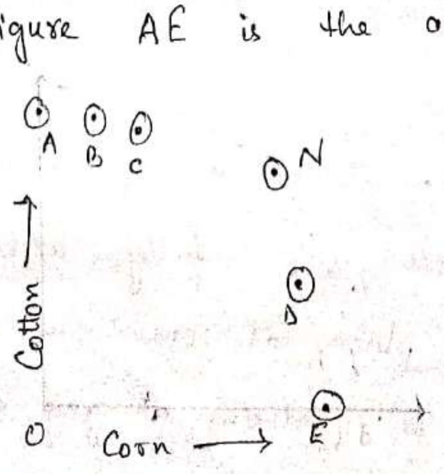
Scanned with CamScanner

lying inside/ below the PPC (such as point M as shown in the following figure) it would imply that some of the economy's resources are lying ~~ideal~~ idle or are not used efficiently. Contrary to it, all combinations of the two goods that lie outside the PPC (such as N in the following figure) are unattainable.



(iii) Problem of economic growth :

A point outside the PPC cannot attained with the given level of resources and technology. However, if an economy wants to achieve this point, it ~~would~~ would need to increase its resource base. In the following figure AE is the original PPC.



Point N in the above figure is unattainable as it lies outside the PPC – AE. ~~The outward moveme~~ However, the outward movement of the PPC from ~~AE to A_1E_1~~ AE to A_1E_1 shows an economy's resources. This results in an increase in the economy's production capacity. Hence, after growth of resources combination N becomes attainable.

23. What do you mean by shifting of PPC?

OR.

Under what conditions PPC may shift. or rotate.

→

~~24~~ 23. What does a point on PPC indicate?

→ It indicates fuller and efficient use of resources.

24. What does a point below PPC indicate?

→ It indicates inefficient/under utilisation of economy's resources.

25. What does a point above PPC indicate?

→ It ~~indicates~~ is normally unattainable but may be attained if there is growth of resources.

26. Why is PPC downwards sloping from left to right?

→ ~~Other~~ When the production ~~value~~ of one commodity ~~variable~~ rises production ~~value~~ of other should fall.

27. Why is PPC concave to the point of origin?

→ It is due to the operation of the law of Increasing Marginal Opportunity Cost.

28. Give one reason for rightward shift of PPC.

→ PPC may shift rightward either due to growth of resources or due to Improvement of technology for both commodities.

29. Give one reason for leftward ~~&~~ shift of PPC.

→ PPC may shift leftward either due to ~~decrease~~ditoriation of resources

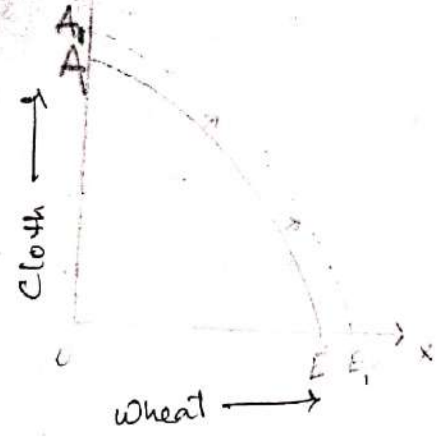
~~30~~. 30. What do you mean by shifting of PPC?

OR

Under what condition PPC may shift or rotate.

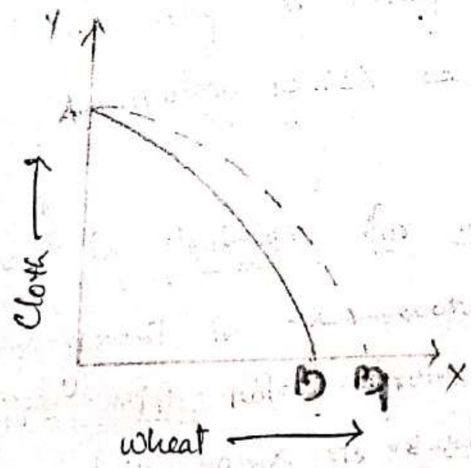
→ Production ~~Possibit~~ Possibility Curve is based on assumptions that resources available are fixed and technique of production remains constant. But if there is growth or decrease in resources or there is improvement or deterioration in technology the PPC will shift or rotate. Under the following conditions, PPC may shift or rotate :

(a) Growth of resources : Let us consider an economy which can produce wheat and cloth by using its resources. In the following diagram OE and OA shows the maximum amount of wheat and cloth which the economy can produce. Here, AE is the original PPC but when growth of resources take place in the economy, the PPC (A_1E_1) will shift rightwards.



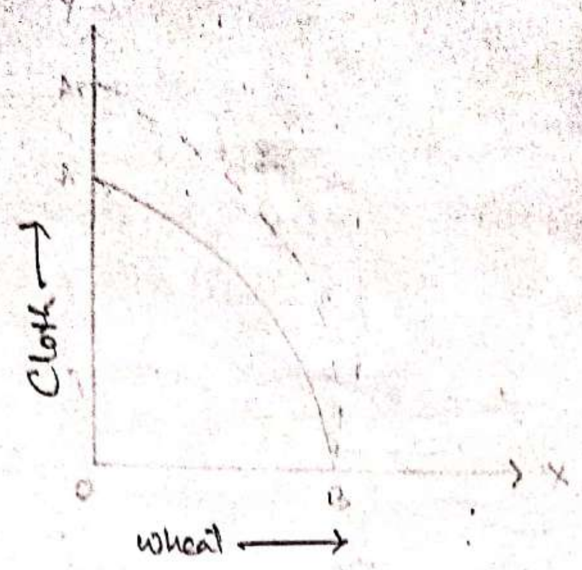
(b) Changes in technology : Change in technology implies improvement in technology ~~and~~ ~~&~~ or deterioration in technology. But normally by change in technology, we mean improvement in technology which can again be classified as :—

(i) Improvement in technique for wheat : If there is technological improvement in the economy for production of wheat, the PPC will rotate from OB to OB_1, keeping the production of cloth same as earlier :



(ii) Improvement in technology for production of cloth : If the technique of production for cloth is improved, the PPC will rotate from OA to OA_1 keeping the production of wheat ~~as~~ same as earlier.

Scanned with CamScanner



iii. Improvement in technique for both : when there is improvement in technique for both the commodities (i.e. wheat and cloth), the PPC will shift rightward from AB to A_1B_1 –