J.K. SHAH TEST SERIES
Evaluate Learn Succeed

SYJC PRELIMINARY PAPER – 2

ECONOMICS

MARKS : 80 **TIME : 3 Hrs**

SET B - SOLUTION

Q.1. (A) Fill in the blanks using proper alternative given in the brackets. (5)

1. Micro economics is a **Partial** equilibrium approach.
   (Partial / general / Total / multi – variable)

2. The demand for salt is **inelastic**.
   (Elastic / inelastic / infinitely elastic / unitary elastic)

3. Investment made by the government is **autonomous**.
   (Unplanned / gross / autonomous / induced)

4. A bank is an institute which deals in money and **credit**.
   (Commodity money / credit / barter / standard money)

5. During depression **deficit** budget is preferable.
   (Balanced / surplus / deficit / zero)

B. Match the following (5)

	'A'	'B'
1	Tea & coffee	Substitute goods
2	Stock	Potential supply
3	Labour	Wages
4	National income	Flow concept
5	Clearing house system	Central bank

C. State whether the following statement are true or false. (6)

1. Perfectly inelastic demand curve is parallel to 'Y' axis.

Ans. True

2. Supply is inversely related to price.

Ans. False

3. Price discrimination is possible under monopoly.

Ans. True

4. In case of token coin intrinsic value is less than their face value.

Ans. True

5. Credit money is **controlled** by the central bank of country.

Ans. True

5. Credit money is **created** by the central bank of country.

Ans. False

6. The main objective of the central bank is to earn profit.

Ans. False

Q.2. (A) Define or explain the following concept: (Any 3) (6)

1. Slicing method

Ans. Microeconomics splits the economy into small individual units. Then it studies the economic behaviour of each individual unit separately in detail. Thus, microeconomics uses slicing method for its analysis.

2. Total output

Ans. Total cost is the total expenditure incurred by a firm on the factors of production required for the production of goods and services. Total cost is the sum of total fixed cost and total variable cost. For example, if a producer incurred ₹ 50 in the form of fixed cost and ₹ 150 in the form of variable cost for producing 10 units of a good, the total cost can be calculated as follows:
TC = TFC -f- TVC = ₹ 50 + ₹ 150 = ₹ 200

3. Pure competition

Ans. (1) A market with features of large number of buyers, large number of sellers, free entry and free exit, homogeneous product and single price is known as pure competition.

(2) Pure competition is a part and parcel of perfect competition, so pure competition is a narrower concept.

4. Entrepreneur

Ans. (1) The factor which co-ordinates land, labour and capital is called entrepreneur. He not only combines all factors of production, but also organizes and supervises the production by undertaking all risks.

(2) According to **F. H. Knight**, "an entrepreneur is a person who performs the dual function of risk taking and control." According to Schumpeter, "Entrepreneur is associated with innovation".

5. Macro economics

Ans. (1) The word macro is derived from the Greek word 'makros', meaning large or aggregate (total). Macroeconomics therefore is the study of aggregates covering the entire economy. It is also known as Theory of Income and Employment or simply as Income Analysis.

(2) In the words of **Prof. Kenneth Boulding**, "Macroeconomics deals not with individual quantities as such but with the aggregates of these quantities; not with the individual income, but with the national income; not with the individual prices but with the price level; not with individual output but with the national output."

6. Repo rate

Ans. Repo Rate or Purchase Rate, i.e. Liquidity Adjustment Facility (LAF) is that rate at which commercial banks borrow money from the Central Bank for short period by selling their securities to the Central Bank, with an agreement to repurchase them at a future date at predetermined price. To control inflation, the repo rate is increased and to control deflation, the repo rate and bank rate is decreased.

(B) Give reasons or explain the following: (Any 3) (6)

1. Theories of micro economics are based on certain assumption.

Ans. (1) Microeconomics analyses the equilibrium positions of individual economic units by isolating them from other forces of an economy on the assumption of "Ceteris Paribus", i.e. "other things remaining the same".

(2) Microeconomics also assumes conditions of full employment, pure capitalism, laissez-faire policy of government, perfect competition, etc. in an economy. Therefore, microeconomic theories are based on certain assumptions.

2. Utility is a relative concept.

Ans. Utility changes from time to time and from place to place. For example, woollen clothes possess more utility during winter and less utility during summer. Similarly they possess more utility in Kashmir and less utility in Mumbai.

3. Demand for the commodity having multiple uses is elastic.

Ans. (1) When the price of commodity having multiple uses rises, consumers restricts its uses and therefore its demand falls. Similarly, when the price of such a commodity falls, consumers use it for various purposes and therefore its demand rises.

(2) Thus, the demand for the commodity having multiple uses changes as a response to the change in its price. Therefore, the commodity having multiple uses has elastic demand.

4. Old age pension is transfer income.

Ans. (1) The income which a person receives without carrying out any economic productive activity is called transfer income.

(2) Government levy a variety of taxes on the incomes of the working people. The revenue collected through taxes is utilized for giving pensions to old people. Thus, old age pension is not earned but it is received out of government's expenditure. Therefore, old age pension is transfer income.

5. The propensity to save depends upon the level of income.

Ans. (1) The propensity to save is the functional relationship between the saving and the income. Algebrically, $S = f(Y)$.

(2) The propensity to save and the level of income have direct relation. As the level of income rises, the propensity to save rises and vice versa.
Thus, the propensity to save depends upon the level of income.

6. Central bank acts as a lender of the last resort of commercial banks.

Ans. (1) The commercial banks operate on the basis of low cash reserve system. If there is a great demand for cash by depositors, even a well-managed commercial bank can run into difficulty.

(2) In such a financial crisis, the Central Bank is the ultimate source of financial assistance to commercial banks. Commercial banks gets loans from the Central Bank to overcome their financial crises.
Thus, the Central Bank acts as a lender of the last resort.

Q.3. (A) Distinguish between. (Any 3) (6)

1. Individual demand and Market demand

Ans.

Individual demand	Market demand
(a) Individual demand refers to total quantities of a commodity demanded by an individual or household at a given price during a period of time.	(a) Market demand refers to the total quantities of a commodity demanded by all the individuals in the market at a given price, during a given period of time.
(b) It is basically micro or narrow concept and not very useful in framing business, production and price policies.	(b) It is a macro or broader concept and is very useful in framing, business, production and price policies. Even the law of demand is based on market demand.
(c) Individual demand depend on the price of goods, disposable income credit facilities, taste preference, etc.	(c) Market demand depends on size of population, social customs, distribution of income, etc.
(d) It can be presented with the help of individual demand schedule and individual demand curve.	(d) It can be presented with the help of market demand schedule and market demand curve.

2. Increase in supply and Decrease in supply.

Ans.

Increase in supply	Decrease in supply
(1) Meaning	
A rise in supply caused by favourable changes in other factors than price is called Increase in supply.	A fall in supply caused by unfavourable changes in other factors than price is called Decrease in supply.
(2) Causes	
Increase in supply is caused by: (1) Fall in the cost of production (2) Reduction in taxes (3) Use of modern technology (4) Availability of speedy transport facilities	Decrease in supply is caused by: (1) Rise in the cost of production (2) Raise in taxes (3) Use of traditional technology (4) Lack of speedy transport facilities.

3. Partial equilibrium and General equilibrium.

Ans.

Partial equilibrium	General equilibrium
(a) Micro economics uses Partial Equilibrium analysis based on the assumption, other things remaining constant.	(a) Macro economics uses general equilibrium. It is not based on assumption.
(b) Partial Equilibrium studies the equilibrium of a consumer, a firm, an industry or a market.	(b) It deals with the Equilibrium position of the economy as a whole.
(c) It deals with one or two variables at a time. So it is a simple method. It is independent.	(c) It deals with all the variables of the Economic System simultaneously. So it is sophisticated There is inter dependence.
(d) Partial Equilibrium is regarded as a worm's eye-view.	(d) General Equilibrium is a bird's eye-view.

4. Gross domestic product at market price and Gross domestic product at factor cost.

Ans.

Gross domestic product at market price	Gross domestic product at factor cost.
(1) Meaning	
Gross Domestic Product at Market Price is the gross money value of all final goods and services produced annually in a country which is estimated according to price prevailing in the market.	Gross Domestic Product at Factor Cost is the gross money value of all goods and services produced within the domestic territory of a country and accruing to the various factors of production during a period of one Year.
(2) Formula	
GDP(mp) = C + I + G + (X-M)	GDP (FC) = = C + I + G + (X-M)-IT + S

5. Legal tender money and Non – legal tender money.

Ans.

Legal tender money	Non – legal tender money
(1) Meaning	
Money which is backed by law and can’t be refused by anybody on any gound is called Legal tender money.	Money which is generally used by people in payments, but has no legal compulsion of acceptance is called non-legal tender money.
(2) Examples	
In India, all coins and all currency notes are legal tender money.	Cheques, bills of exchange, etc. are non-legal tender money.

6. Surplus budget and Deficit budget.

Ans.

Surplus budget	Deficit budget
(a) A surplus budget is a budget in Which estimated revenue are greater than estimated expenditures.	(a) A deficit budget is one in which estimated expenditure exceeds estimated revenue.
(b) It leads to flow of money from economy to government and lead to decrease in aggregate demand	(b) It leads to flow of money from government to the economy and increases aggregate demand.
(c) It is suitable for individuals and families but not favoured for government.	(C) It is suitable for government especially when the economy sufferes from depression.
(d) The policy of Surplus budget would lead to unemployment and recession due to low investment.	(d) The policy of deficit budget would lead to employment and revival of economic activities.
(e) Surplus budget is advocated during inflation to reduce demand and prices by imposing high taxes.	(e) Deficit budget is not desirable during inflation.

(B) Write short notes. (Any 2) **(6)**

1. Subject matter of Macro Economics.

Ans. i) **Theory of Income and Employment:** Macro-Economics analysis explains what determines the level of national income and employment, and what causes fluctuations in the level of income, output and employment.

To understand how the level of income and employment is determined, wc have to study the determinants of aggregate supply and aggregate demand and further we have to study consumption function and investment function. The analysis of consumption function and investment function are the important subjects to Macro-Economic Theory. Theory of Business Cycles is also a part and parcel of the theory of income. This theory also examines inter-relation between income and employment, and suggests policies to solve the problems related to these variables.

ii) **Theory of General Price Level and Inflation:** Macro-Economics analysis shows how the general level of prices is determined and further explains what causes fluctuations in it. The study of general level of prices is significant of account of the problems created by inflation and depression. The problems of inflation and depression are the serious economic problems faced these days by most of the countries in the world. Theory of price level studies causes and effects of inflation and depression, and suggests economic policies to tackle these problems.

iii) **Theory of Growth and Development:** Another important subject matter of Macro-Economics is the theory of economic growth and development. It

studies the causes of under development and poverty in poor countries and suggests strategies for accelerating growth and development in them. Growth Theory also, deals with the problems of full utilization oil increasing productive capacity in developed countries and explains how the higher rate of growth with stability can be achieved in these countries.

iv) Macro Theory of Distribution: Still another important subject matter of Macro-Economics is, to explain what determines the relative shares from the total national income of the various classes, especially a workers and capitalist. Ricardo and Karl Marx propounded theories, explaining the determination of relative shares of various social classes in the total national income. Afterwards, Kalecki and Kaldor also explained determination of relative shares of wages and profits in the national income. Macro theory of distribution thus deals with the relative shares of rent, wages, interest and profits in the total national income. In addition to this, study of public finance, international hade, monetary and fiscal policies are also a subject matter of Macro-Economics.

2. Significance of price elasticity of demand.

Ans. 1) **Monopoly and Elasticity of Demand:** The objective of a seller in monopoly market is profit maximization. Since he is a single seller in monopoly, market having total control over supply and price, he can take decisions about price policy and get more profit. If demand is inelastic for the product sold by monopolist, he will raise the price of that commodity and earn more profit.

2) Taxation Policy and Elasticity of Demand: The concept of Price Elasticity' of Demand is useful to the government in the determination of taxation policy. The finance minister considers the Elasticity of Demand, while selecting goods and services for taxation. If government wants more revenue, those goods will be taxed more, for which demand is inelastic. Therefore, generally heavy taxes are imposed on goods like cigarettes, liquors and habitual goods for which demand is inelastic.

3) **Fixation of Wages and Elasticity of Demand**: The concept of Elasticity of Demand is useful to trade unions in collective bargaining, for wage determination. When trade union leaders know that demand for the product produced by labour is inelastic, they will insist for more wages to workers.

4) **International Trade and Elasticity of Demand:** The concept of Elasticity of Demand is useful to determine norms and conditions in international trade. The countries exporting commodities for which demand is inelastic can raise their prices. For instance, Organization of Petroleum Exporting Countries (OPEC) has increased the prices of oil several times. The concept is also useful in formulating export and import policy of a country.

5) **Public Utilities**: In case of public utilities like railways which have an inelastic demand, government can either subsidise or nationalise them to avoid consumer's exploitation.

3. Types of monopoly.

Ans. 1) **Natural monopoly:** Natural monopoly emerges due to availability of natural resources. A particular type of natural resource is available, therefore that region enjoys monopoly in the product which requires that natural resource. Natural advantages like good location, confirm natural monopoly e.g., tea from Assam.

2) Public monopoly: Public monopoly refers to sole ownership of the supply of goods or services by the government. Such monopoly functions with the primary motive of providing maximum welfare to the society, thus, it is also known as welfare monopoly. It is not based on profit motive, e.g., Indian Railway.

3) Private monopoly: Private monopoly refers to sole ownership of the supply of goods or services by the private firm or individual. The main objective of private monopoly is profit maximization, for e.g. Tata group and Reliance group.

4) Legal monopoly: When monopoly is created by law, it is known as legal monopoly. Legal provisions like patents, trademarks, copy rights etc. give rise to legal monopolies e.g. some producers use a particular trademark for their product and they take legal permission from the government for that brand, thus law forbids the potential competitors to imitate the design, form and shape of product If any firm tries to violate the rights action can be taken against them e.g., Parle-G etc.

5) Simple monopoly: It is that organization which charges a simple uniform price for all consumers. There is no price discrimination among the consumers.

6) Discriminating monopoly: When different prices are charged to different customers for the same product or services, it is known as price discrimination or discriminating monopoly. e.g., a doctor or a lawyer may charge different fees to the people.

7) Voluntary monopoly: When number of big business companies acquire monopoly through voluntary agreement, business firms join together through trusts, cartels, syndicates etc. They are called joint monopolies. Mergers and amalgamations may also lead to monopoly e.g., OPEC (Oil Producing and Exporting Countries). This is also known as Joint Monopoly.

4. Types of capital.

Ans. The capital can be classified mainly into four groups:

1) On the basis of ownership:
   a) Private capital or Personal capital
   b) Public capital or Social capital

2) On the basis of durability:
   a) Fixed capital
   b) Working capital or Circulating capital

3) On the basis of mobility:
   a) Sunk capital
   b) Boating capital

4) On the basis of nature
   a) Real capital
   b) Money capital

1) **On the basis of Ownership:**

a) **Private or Personal Capital**: It is that capital which is owned by individual or institute that is group of individuals, e.g., a firm owned by individual, machinery etc.

b) **Public or Social Capital**: When capital is owned collectively by the society or the government, it is public or social capital, e.g., municipal school, municipal hospital, railways etc.

2) **On the basis of Durability:**

a) **Fixed Capital**: It is that capital which is used in a production process again and again. It is durable in nature, e.g., machinery, factory building etc.

b) **Working or Circulating Capital**: It is that type of capital which is used in a production process only once. It is also known as variable capital, e.g. raw material, power fuel.

3) **On the basis of Mobility:**

a) **Sunk Capital**: When the capital is used for specific purpose, it is sunk capital. e.g., xerox machine, road rollers, railway lines. It cannot be used for any other purpose.

b) **Floating Capital**: It is that capital which has several alternative uses, e.g. electricity, coal, petrol, etc.

4) **On the basis of Nature:**

a) **Real Capital**: It is a physical capital used in the production process, e.g. machinery, raw material, equipments etc. It is used to produce other goods.

b) **Money Cap**ital: It is a capital in the form of money. Real capital like raw material, machinery can be purchased with the help of money capital.

Q.4. Write short answer for the following questions: (Any 3) (12)

1. Explain the types of utility.

Ans. Various types or forms of utility are as follows-

1) **Form utility** - When utility increases due to the change in the shape or structure of existing material, it is called form utility.
Toys made out of clay, making furniture from wood, a dress from fabric, etc., are some examples of form utility.

2) **Place utility** - When utility of a commodity increases due to the change in the place of utilisation, it is also created with the transfer of goods from the place of production to the place where they are consumed, e.g. Sea sand has more utility in construction work than along the sea shore.

3) **Time utility** - When utility of a commodity increases with a change in the time of utilisation, it is called time utility. e.g. Umbrellas have greater utility during rainy season than in winter.
Time utility also refers to storing of goods and using at the time of need or scarcity.

4) **Service utility** - It arises when personal services are rendered by various professionals in the society to others. Services provided by doctors to patients, knowledge given by teachers to students, suggestions by lawyers to his clients, etc., are examples of service utility. In this case, production and consumption both take place at the same time.

5) **Knowledge utility** - It increases when a consumer acquires knowledge about a particular product. e.g. Utility of a mobile phone or computer increases when a person knows about its various functions.

6) **Possession utility** - It arises when the ownership of goods is transferred from one person to another. e.g. Possession utility is enjoyed by the consumers when they purchase goods from sellers.

2. Explain the features of monopolistic competition.

Ans. 1) **Fairly large number of buyers:** In this market, there are fairly large number of buyers. Consequently, no single buyer can influence the price of the product by changing his individual demand.

2) **Fairly large number of sellers**: The number of sellers in a monopolistic competition is large. It is still smaller than that in a perfectly competitive market. Since the number of sellers is large. Each seller has a limited control over supply. The seller has complete control over his brand. This control is possible because of patents, trade mark, copyrights etc.. that the producer possesses. Thus, each producer enjoys an element of monopoly on one hand and on the other they have to face competition from sellers selling close substitute in the market.

3) **Product differentiation:** The most important feature of Monopolistic Competition is product differentiation. Each product in this market is different from other product in some form or the other. The differences could be in its colour, shape, wrapper, after - sales services etc. Their products, though different, are close substitute to each other e.g., Hamam soap is close substitute to Lux soap. Producers also adopt various techniques such as discounts, gifts, advertisements etc. to attract the consumers. This is known as product differentiation. In this market producers compete with each other on the basis of product differentiation and not on the price differentiation. Therefore, Monopolistic Competition is also known as non-price competition.

4) **Close Substitute:** In Monopolistic Competition goods have close substitute to each other. For e.g. Goldspot is close substitute to Limca.

5) **Selling cost:** The uniqueness of this market lies in the fact that a difference is made between cost of production and selling cost. Product differentiation leads to emergemce of selling cost. Thus, the cost that producer have to incur, in order to differentiate their product is known as selling cost. Hence, medium such as television, radio, newspaper, magazine, exhibitions, incentives and salaries of sales representatives etc., are used by firms to increase the sales. The price of the product includes cost of production as well as selling cost.

6) **Free entry and exit:** Under Monopolistic Competition, there is freedom of entry and exit i.e. new firms are free to enter the market, if there is super normal profit. Similarly, they can leave the market, if they find it difficult to survive.

7) **Demand curve of the firm:** Due to product differentiation and availability of close substitute, demand curve of the seller is highly price elastic and downward slopping. It means a slight change in price of the product will bring about a change in quantity demanded.

8) **Concept of group:** Chamberlin introduced the concept of group as the substitute for industry concept. The firm producing identical product, are clubbed together in one industry under perfect competition. However, in the Monopolistic Competition the products are differentiated. All the firms producing close substitutes are taken together in a 'group concept'. For example - group of firms producing medicines, cement etc.

3. Explain the Historical review of macro economics.

Ans. Macro approach to study economy is comparatively new and is of a recent origin. Though it is a modern approach, this does not mean that it did not exist in the past. It is true that Macro-Economics did not exist as a separate branch of economic analysis in the past, but this approach did prevail even before the evolution of Micro-Economics.

In the 16th and 17"1 century, advisors advocated policies to the government which were based on macro approach. These people were the followers of merchantilist (a group of English merchants) school of thought. In the 18th century Physiocrats (French Thinkers) tried to analyse the concept of national income and wealth, and discussed relative share of landlords, tillers of the soil and unskilled workers in the flow of income. Even the Classical economic theory of Prof. Adam Smith, Prof. Ricardo and Prof. J.S. Mill also discussed the determination of national income and wealth, and die division of national income into total wages, total rent and total profit. But their macro analysis was combined with micro analysis. Thus, from the beginning, some thinking was being done on macro economic level. The neo-Classical economists, Specially Prof. Marshall and Pigou, relegated Macro-Economics to the background. There micro analysis ruled the world of economics till the great depression of 1930's.

After the great depression, we find revolutionary and fundamental changes in economic thinking. Lord John Maynard Keynes published his very famous book "General Theory of Employment. Interest and Money" published in 1936. Keynes used macro approach to analyse economic problems. After the publication of Keynesian theory, macro economic analysis became more important and popular approach to economic analysis. Hence, credit for the development of Macro-Economic approach goes to Lord Keynes. Besides Keynes, Malthus, Karl Marx, Wicksell, Walrus, Irving Fisher are the other economists who have participated in the development of macro economics. After Keynes, Harrod and Domar used macro analysis to develop Theory of Growth and many post Keynesian economists developed it as a policy oriented science.

4. Explain the determinants of aggregate demand.

Ans. The determinants of aggregate demand are expressed as AD = C + I + G + (X - M). They are as follows:

(**1) Consumption Expenditure (C):** Consumption expenditure refers to the expenditure incurred on those goods and services which satisfy the wants of private individuals and institutions directly. Consumption expenditure is directly related to the aggregate demand.

(2) Investment Expenditure (I): An addition to the country's physical stock of capital is called investment. Expenditure incurred on forming the capital is called

investment expenditure. Investment expenditure is directly related to the aggregate demand.

(3) Government Expenditure (G) : The consumption expenditure and investment expenditure incurred by the government for the purpose of maximising welfare and promoting maximum growth and development is called government expenditure. Government expenditure is directly related to the aggregate demand.

(4) Net Earnings from Foreign Transactions (X — M): The difference between the export value and the import value is known as net earnings from foreign transactions. Positive net earnings increases the aggregate demand, negative net earnings decreases the aggregate demand and zero net earnings does not affect aggregate demand.

5. Explain the agency function of commercial banks.

Ans. Banks perform certain functions on behalf of their customers. The bank acts as an agents while performing these functions for their account holders. Some of these functions are:

1) **Collection of money**: The commercial banks accept standing instructions from customers regarding collection of money such as cheques, drafts, interest, dividend, bills, promissory notes, rents, demand drafts, etc. The bank charges a small commission for rendering such services.
2) **Payments/Periodical payments:** The banks can also make payments on behalf of their customers, such as payment of insurance premium, rent, electricity bill, telephone bill, taxes etc. A commission is normally charged for such services.
3) **Purchase and sale of securities:** The commercial banks can undertake buying and selling of securities, debentures, shares as per the instructions and authority given by the customer. Commercial banks on the basis of its expert knowledge can help its customers in this regard.
4) **Acting as Trustee. Executor, Administrator or Attorney:** As a trustee, the bank is the custodian of the customer's fund. The bank also act as the executor of the customers will, in case of death. As an attorney, the banks signs the documents on behalf of the customer's. Commission is normally charged for such services.
5) **E-Banking (Electronic Banking):** Through electronic banking, a customer can operate his bank account through internet. He can transfer money from one place to another. He can also make payments of various bills like telephone bills. E-banking helps businessmen, traders, merchants. Banking transactions can be carried out safely and with total confidentiality with the help of E-banking.
6) **Dematerialization Account**: **(D-mat) account**
   Some commercial banks provide D-mat facility to their customers. D-mat account is useful to investors who deal in shares. Each investor has to open a separate D-mat account. The transactions relating to buying and selling of shares are recorded. Periodically statements about buying and selling of shares are given by commercial banks to each investor.

7) **Other functions:** Commercial banks can work as an agent for any government or local authority or any other persons i.e. clearing and forwarding of goods.

6. Explain the budget expenditure of the government.

Ans. Budget expenditure refers to the estimated expenditure of the government during a given fiscal year.

Budget expenditure includes

i) **Plan expenditure** - it is the expenditure incurred on various programmes in the plan. For example, expenditure on irrigation, transport, energy, agriculture allied activities, general economic social services, communication etc.

ii) **Non-plan expen**diture - it is the expenditure that is incurred on other activities, which is out of the scope of government plans. For ex. expenditure incurred for rescue of people affected by various calamities

iii) **Development expenditure** - which is directly related to economic and social development of the country. For example, expenditure on health, education, industrial development, social welfare, scientific research etc.

iii) **Non-Development expenditure -** is incurred on the essential services of the government. For example, expenditure on administrative services, defence, judiciary, police etc.

Budget expenditure may be further classified as: 1) Revenue Expenditure. 2) Capital Expenditure.

I) **Revenue Expenditure**

Expenditure, which neither creates any asset nor causes reduction in any liability of the government, is known as revenue expenditure. Revenue expenditure is for the normal running of government departments and various services.

Revenue expenditure includes

1) **Expenditure on general services** - includes defense services, collection of taxes, police, judiciary and interest payments.
2) **Expenditure on social and community services -** such as medical and public health, education, labour and employment.
3) **Expenditure on economic services** - such as agriculture, industries, trade, transportation etc.
4) **Grants** - all grants given to state government by Union.

The expenditure, which is met out of the revenue receipts, is called revenue expenditure.

II) **Capital Expenditure**

Expenditure, which either creates an asset or causes a reduction in the liabilities of the government, is known as capital expenditure. Capital expenditure includes:

1) Expenditure on land and building
2) Expenditure on machinery and investment
3) Investment in shares
4) Loans granted by Central Government to state governments, government companies.

5) Loans to the corporations and other parties. Most of the capital expenditure is developmental in nature. The expenditure, which is met out of capital receipts, is called capital expenditure.

Q.5. Explain with reasons whether you agree or disagree with the following statements (Any 3) (12)

1. The law of Diminishing Marginal Utility is important in practice.

Ans. Yes, I agree with this statement.

Reasons:

1. **To the consumer**-The law of diminishing marginal / utility guides the consumer in planning their budget, so as to achieve maximum satisfaction from the resources available.
2. **To the producer** -The law is important to the producer in determining price and sales policy. It helps to maximise his profits.
3. **To the monopolist** -The law of DMU is helpful to the monopolist to practise price discrimination, i.e., charging different prices to different consumers for the same product.
4. **To the government** – The law of diminishing marginal utility is useful to the government to implement various economic policies like public distribution system, social justice, etc. It helps to improve the welfare of the people in the society.
5. **To the finance minister**-The law of diminishing marginal utility guides the finance minister to frame progressive taxation policy. It helps to reduce economic inequality. The law is also useful to economic experts, bankers and modern economists.
6. **To understand paradox of value** - The law explains 'value paradox' by showing the difference between value in use and value in exchange. Value-in-use refers to usefulness of a commodity. Whereas value-in-exchange means rate of exchange of one commodity in terms of another Some commodities have high value-in-use but low exchange value, for example water. Whereas some commodities have low value in use but high exchange value due to its scarcity. For example diamonds. Higher TU determines greater value in use and higher MU denotes greater value in exchange of a commodity.

2. Price is the only determinant of demand.

Ans. No, I do not agree with this statement.

Reasons:

Demand is affected by the following factors.

1. **Price**: Price is one of the most important factors that affect demand. When price rises demand falls and when price falls demand rises. T
2. **Income**: Income is yet one more important factor that affects demand. Demand depends upon income of individuals in the society. Normally. Demand rises with increasing income of the society.
3. **Population**: An increase in population leads to an increase in market demand for goods and services.
4. **Tastes, Habits and Fashions**: Some factors such as taste, habit of consumers affect demand, in the market.
5. **Prices of Substitute and Complementary Goods**: Demand changes due to changes in the prices of substitute and complementary goods. For

example demand for tea changes because of change in the price of coffee. Similarly, demand for motor cars changes because of change in the price of petrol.

6. **Distribution of Income**: Unequal distribution of income and wealth would lead to less demand for goods and services i.e. demand depends on the distribution of National Income and Wealth.
7. **Expectation about Future Prices**: If consumers expect a fall in the price of a commodity in the near future, they will demand less at present price and vice versa. It shows that expectations about the future prices affect demand.
8. **Advertisement**: The goods which are advertised powerfully on radio, television and newspapers, etc., push up demand. Advertisement is an important factor today that affects demand.
9. **Taxation Policy**: Government's taxation policy affects demand. For example, a change in income tax will change consumer's disposable income and therefore demand.
10. **Other Factors**: Change in any climatic conditions, traditions, political and social factors also affects demand.

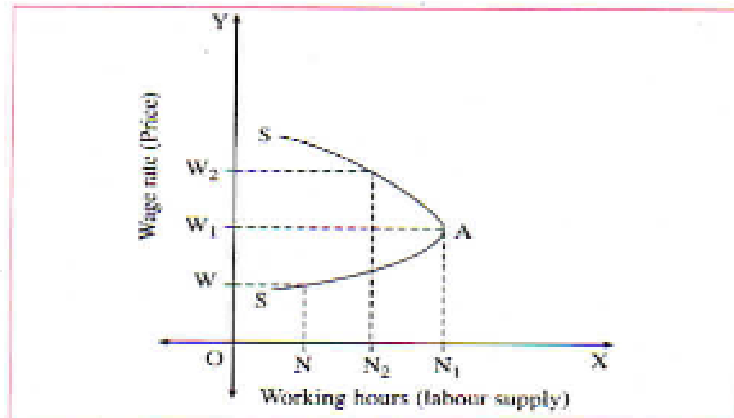
3. Supply curve of labour bends backwards.

Ans. Yes, I agree with this statement.

Reasons:

(1) In the initial stages, labour supply increases as wage rate increases. However, at a later stage, workers would prefer leisure to work. They prefer to earn same amount of income by working for less hours.

(2) Therefore, in the initial stages, the labour supply curve slopes upwards from the left to the right. However, in the later stage, the labour supply curve bends backward.



(3) From the above diagram it can be seen that in the initial stages as wage rate rises from OW to OW_1 the supply of labours also rises from ON to ON_1. However, when the wage rate rises from OW_1 to OW_2 the supply of labours do not rise further; rather it is reduced from ON_1 to ON_2.

(4) Thus, after the wage level OW_1, the supply curve slopes backwards from the point A towards Y-axis indicating that at higher prices fewer labour hours are supplied.

Therefore, the backward sloping supply curve shows the inverse relationship between supply of labour and wage rate.

4. Money also performs contain contingent functions.

Ans. Yes, I agree with this statement.

Reasons:

According to Prof. Kinley, money in modem times also performs certain contingent functions.

Following are some contingent or incidental functions of money.

i) Measurement and Division of National Income: Money facilitates estimation and distribution of national income. Numerous goods and services are produced in a country during a period of time. When these goods and services are converted in terms of money, calculation of national income becomes possible. Factors of production like land, labour, capital and organisation contribute to national income. All these factors get their respective rewards like rent, wages, interest and profit in terms of money. Thus, total production and factor prices are easily expressed in terms of money.

ii) Basis of Credit - Modern economy is based on credit. Commercial banks create credit on the basis of their cash holdings. Without the use of money, credit instruments cannot operate. One cannot issue cheque without having a bank balance. Money provides the liquid base of the banking system.

iii) Imparts liquidity to wealth - Money is called the most liquid asset. Money can be easily converted into any asset and any asset can be converted in to money e.g. a person can purchase gold and if he wants, he can sell it and can purchase government bonds, securities etc. Liquidity of money has improved the mobility of capital from a business in loss lo a profit making business. It also facilitates transfer of capital from less productive use to a more productive use.

iv) Equalization of marginal utilities and marginal productivities with Price - Prices of goods, services and prices of all factors of production are expressed in terms of money. It helps the consumers to compare marginal utilities of goods with their prices. Based on this comparison consumers can allocate their income on various goods, in such a way that the price of each commodity is equal to its marginal utility.

Producers compare factor prices like rent for land, wages for labour, interest for capital, with marginal productivity (contribution made by additional factor unit to total productivity) of factors of production. The producers try to maximize their profits by equalizing marginal productivity of a factor with its price.

v) Estimation of Macro Economic Variables - Macro Economic variables like Gross National Product, total savings, total investment etc. can be easily estimated in monetary terms. It also facilitates government tax collection, budget etc.

Thus, in modem monetized economy money has facilitated production, distribution, saving etc. It encourages international trade, transport, formation of capital market and other financial institutions.

Along with these functions money also performs some other functions like

(a) It helps in the maintenance of the repaying capacity which is called 'guarantee of solvency".

(b) Money can be used for any purpose according to the priority of an individual or an organization e.g. Money saved by a person to

purchase a house in future can be used for higher education of children. Prof. Graham has called this function of money as 'bearer of option".

(c) It is the base of price mechanism - Prices of all goods and all factors of production are expressed in terms of money. Price mechanism guides important decisions like what to produce how much to produce, how to distribute etc.

When money performs various functions, different qualities or characteristics of money help it lo perform these functions. Let us discuss qualities of good money.

5. A commercial bank cannot create credit money.

Ans. **No, I disagree** with this statement.

Reasons:

(1) Primary deposits refer to money deposited by the people in the form of cash with the banks. By keeping some part of primary deposits in the form of cash reserve, the rest of the primary deposits are used for lending loans.

(2) When a bank grants loan to a borrower, the bank opens a deposit account in the name of the borrower and the money transferred on the account of the borrower creates secondary deposits.

(3) When the borrower withdraws money from his loan account by a cheque, it is deposited by the payee in some other bank.

(4) Other banks again create credit on the basis of fresh deposits received after keeping the required reserves.

Thus, a commercial bank can create credit on the basis of primary deposits.

6. Cash reserve ratio is a quantitative measure of credit control.

Ans. **Yes, I agree** with this statement.

Reasons:

By the Banking Act. commercial banks have to maintain a certain amount of cash with Central Bank (for e.g. RBI) as reserves against their demand and lime deposits. (Under the RBI Act of 1935 every commercial bank has to keep certain minimum cash reserves with the RBI. It can vary C.R.R. between 3% and 15% of total time and demand deposits.)

This amount cannot be used by banks for lending activities. Therefore, the amount available for lending gets reduced to the extent of Cash Reserve Ratio.

This reserve ratio is changed to regulate credit. It directly affects the lending capacity of banks and the rate of interest charged by banks.

An increase in Cash Reserve Ratio leads to a contraction of credit, increase in lending interest rates and a reduction in money supply in the economy. This can reduce inflationary pressures.

A decrease in Cash Reserve Ratio leads to an expansion of credit, a decrease in lending interest rates and an increase in money supply in the economy.

When Central Bank wants to reduce money supply, the C.R.R. will be raised, and it will be reduced to expand the quantity of money. It is a very effective instrument as it affects the base of credit creation.

Q.6. Write explanatory answers: (Any Two) **(16)**

1. Explain the types of elasticity of demand.

Ans. Following are three types of elasticity of demand.

1) Price Elasticity of Demand: prof. Marshall has defined price elasticity of demand as below:

"Price elasticity of demand is a ratio of proportionate change in the quantity demanded of a commodity to a given proportionate change in its price." Thus, price elasticity is responsiveness of change in demand due to a change in price only. Other factors such as income, population, tastes, habits, fashions, prices of substitute and complementary goods are assumed to be constant. Therefore, price elasticity of demand is written as:

$$Ed = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}}$$

$$Ed = \frac{\Delta Q/Q}{\Delta P/P} \quad \text{or} \quad e = \frac{\Delta Q}{Q} \times \frac{P}{\Delta P}$$

Where Q = Original demand.

P = Original price.

ΔQ =Change in quantity demanded. It is measured as the difference between new quantity demanded (Say Q1) and old quantity demanded (Q)

Thus ΔQ = Q1 - Q

ΔP = Change in price. It is measured as the difference between new price (P1) and old price (P)

Thus ΔP = P1 - P

Price elasticity of demand may have five values infi nite. zero. unit, greater than one and less than one.

2. **Income elasticity of demand:** Income elasticity of demand may be defined as the "degree of responsiveness of quantity demanded to change in income only, other factors including price remain unchanged." It is written as-

$$Ey = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in income}}$$

Symbolically, $Ey = \frac{\%\Delta Q}{\%\Delta Y}$ (Here Q means quantity demanded, Y means income, Δ delta stands for a change). Income elasticity of demand is positive, when demand increases with increasing income. Income elasticity of demand is negative when, quantity demanded decreases with increase in income. In case of normal goods income elasticity of demand is positive, whereas in case of inferior goods, income, elasticity of demand is negative. Income elasticity of demand can be zero, one, greater than one and less than one.

3. **Cross elasticity of demand:** Cross elasticity of demand is found in case of substitute goods as well as complimentary goods and non-related goods. In the case of substitute goods change in the price of one good, affects the demand tor another good. For example, if the price of tea rises, the demand for coffee will rise. So. "cross elasticity of demand refers to

change in quantity demanded of one commodity, due to change in the price of another commodity." Symbolically

$$Ec = \frac{\text{Percentage change in the demand of commodity A}}{\text{Percentage change in the price of commodity B}}$$

Ec = %ΔA/%ΔB (Here A is original commodity and B is price of another related substitute commodity)

2. Explain any 'two methods of measuring price elasticity of demand.

Ans. i) Ratio or Proportionate Method: This ratio method of measuring elasticity of demand is also known as Arithmetic or Percentage method. This method is developed by Prof. Fluck's. In this method we consider percentage change in quantity demanded and divide it by percentage change in the price of the commodity.

Thus

$$Ed = \frac{\text{Percentage change in demand}}{\text{Percentage change in price}}$$

Numerical Illustration –

Ratio or Proportionate Method

Price of X	**Demand (Units)**
200	1000
100	1500

$$Ed = \frac{\%\,\Delta Q}{Q} \times \frac{P}{\%\,\Delta P}$$

$$Ed = 1$$

Price of commodity X falls from Rs. 200/- to Rs 100/- and quantity demanded increases from 1000 units to 1500 units. Here percentage change in demand is 50, whereas percentage change in price is also 50. Therefore, 50%,/ 50% = 1, which means Ed is unitary or one, in this example.

2) Total Expenditure Method

The name of Prof. Marshall is associated with this method. This method is also known as Total Outlay Method. In this method, statistics of total expenditure is used to find out elasticity of demand. When total expenditure at the original price and the total expenditure at new price is compared, it indicates the elasticity of demand.

When price falls or rises, total expenditure does not change or remains constant, demand is unitary elastic.

When price falls, total expenditure increases or price rises and total expenditure decreases, demand is elastic or elasticity of demand is greater than one.

When price falls and total expenditure decreases or price rises and total expenditure increases, demand is inelastic or elasticity of demand is less than one. Measurement of elasticity of demand with the help of total expenditure method can be better understood with the help of the following example.

Total Expenditure Method

	Price (₹)	Demand (Units)	Total Outlay(₹)	Elasticity of Demand
A	10 8	12 15	120 120	Unitary or **1**
B	10 8	12 20	120 160	Elastic or >1
C	10 8	12 14	120 112	Inelastic or <1

In example A, original price is ₹ 10 per unit and demand is 12 units. Therefore total expenditure incurred is ₹ 120/-. Price falls to the level of ₹8/- and demand rises up to 15 units. But total expenditure is still ₹ 120/-. In this case, total outlay does not change even though there is change in price. Therefore, demand is unitary elastic.

In example B, at the price ₹ 10/-, 12 units are demanded. So total original expenditure is ₹120/-. Price falls to ₹ 8/- per unit and demand rises to the level of 20 units. Therefore, total expenditure incurred on commodity rises to ₹160/-. Total expenditure under this new condition of change in price, is greater than original expenditure. Hence, in this example, demand is elastic or elasticity of demand is greater than one.

In example C, original total outlay is ₹120/- with a change in price to ₹. 8/- per unit, demand expands to the extent of 14 units. Nevertheless, total expenditure ₹ 112/-, which is less than original expenditure. Therefore, in this example demand tends to be inelastic or elasticity of demand is less than one.

3) Point Method or Geometric Method

The proportionate method and total outlay meihod enable us to measure elasticity of demand at a given point on the demand curve. Therefore. Prof. Marshall has developed yet another method to measure elasticity of demand, which is known as Point or Geometric method. At any point on demand curve elasticity of demand is measured with the use of the following formula

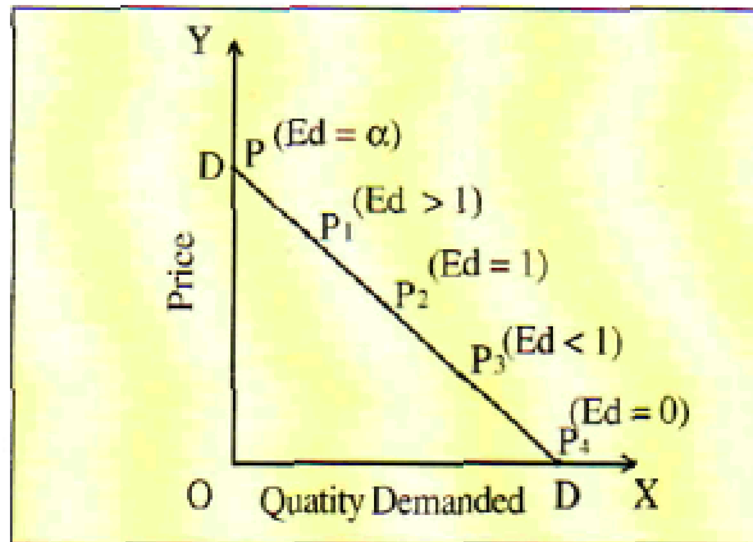
$$\text{Point Elasticity of demand} = \frac{\text{Lower segment of the demand curve below the given point}}{\text{Upper segment of the demand curve above the given point.}}$$

$$\text{Or Price Elasticity of demand} = \frac{L}{U}$$

$$\text{or Point Ed} = \frac{L}{U}$$

With the help of the following example, we can understand how to measure elasticity of demand at a point on linear demand curve.

Linear Demand Curve

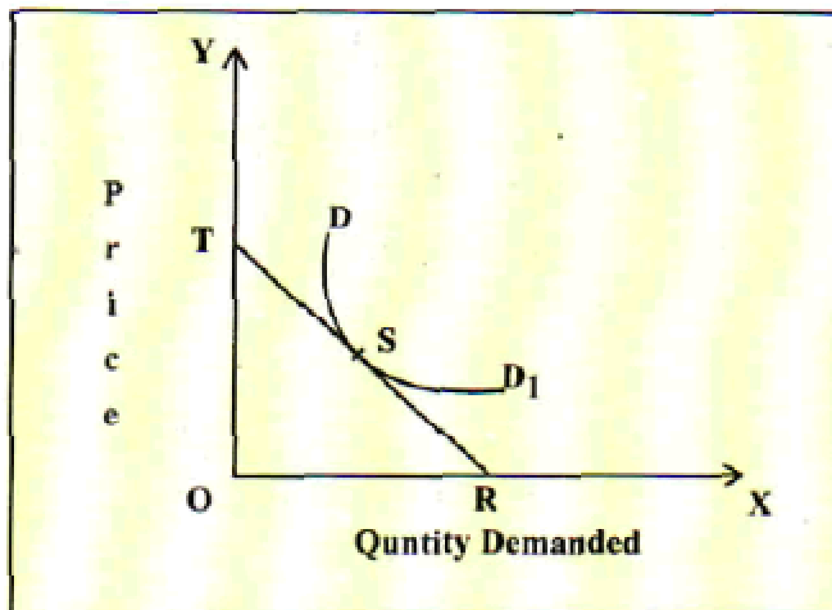


In the above figure, DD is, demand curve and we assume that its length is 4 cm. At point P. demand is infinite elastic, whereas at point P_4 elasticity of demand is zero. Therefore, we have to measure elasticity of demand on points, P_1, P_2 and P_3.

At point P_1, elasticity of demand = lower segment of the demand curve below the given point $P_1 P_4$ ÷ Upper segment of the demand curve above the point is P_1P. Therefore, Ed = $P_1P_4 \div P_1P$. ED> 1. It means demand is elastic or elasticity of demand is greater than one at point P_1.

Similarly, by using the above given formula, we can measure elasticity of demand at point P_2 and P_3 At point P_2 , demand is unitary elastic. It means elasticity of demand is equal to one, whereas at point P_3 demand is less than one.

Non-Linear Demand Curve.



If the demand curve is non-linear, then a tangent is drawn to the demand curve at the given point 'S'. The tangent should touch both the axes - OX axis and OY axis. The price elasticity is measured by the ratio of lower segment to the upper segment.

$$\text{Elasticity} = \frac{SR}{ST}$$

$$Ed = \frac{L}{U}$$

3. Explain the statistical difficulties involved in the measurement of national income.

Ans. In practice, a number of difficulties arise in the collection of required statistics in estimating national income, some of these are:

1) **Problem of double counting:** The greatest difficulty in calculating the national income is of double counting. It arises from the failure to distinguish properly, between a final and an intermediate product. It so happens, the national income would work out to be many times the actual. For example, flour used by a bakery is an intermediate product and that by a household the final product.

2) **Existence of non-monetized sector:** There is a large non-monetized sector in the developing economy like India. Agriculture, still being in the nature of subsistence farming in the developing countries, a major part of the output is consumed at the farm itself and a part of production is partly exchanged for other goods and services. Such production and consumption cannot be calculated in national income.

3) **Lack of occupational specialization:** There is the lack of occupational specialization, which makes the calculation of national income by product method difficult. For instance, besides the crop, farmers in a developing country are engaged in supplementary occupations like dairy farming, poultry farming, cloth making etc. But income from such productive activities may not be revealed and thus is not included in the national income estimates.

4) **Inadequate and unreliable data**: Adequate and correct production and cost data are not available in a developing country, such data relate to crops, fisheries, animal husbandry, forestry, the activities of petty shopkeepers, construction workers, small enterprises etc. That is why, national income of a country will not show at its actual.
For estimating national income by income method, data on unearned incomes and on persons employed in the service sector are not available. Data on consumption and investment expenditures of the rural and urban population are also not available for die estimation of national income. Moreover, there is no machinery for the collection of data in such countries.

5) **Capital gains or losses:** Capital gains or losses, which accrue to the property owners by increases or decreases in the market value of their capital assets or changes in demand, are not included in the gross national product, because these changes do not result from current economic activities.

6) **Depreciation**: The calculation of depreciation on capital consumption is one more difficulty. Depreciation refers to wear and tear of capital assets, due to their use in the process of production. Depreciation of capital assets

will depend on technical life of the asset, the intensity of its use, nature of the asset, regular and careful maintenance etc. There are no uniform, common or accepted standard rates of depreciation applicable to the various capital assets. In case of depreciation, one has to make many reasonable assumptions, which involve an element of subjectivity. So it is difficult to make correct deductions for depreciation.

7) **Valuation of inventories:** Raw materials, intermediate goods, semi-finished and finished products in the stock of the producers are known as inventory. All inventory changes, whether negative or positive, are included in the gross national product. Any mistake in measuring the value of inventory, will distort the value of the final production of the producer. Therefore, valuation of inventories requires careful assessment.

8) **Illiteracy and Ignorance:** Majority of the small producers in developing countries are illiterate and ignorant, and are not in a position to keep any account of their productive activities. So they cannot give information about the quantity or value of their output. Hence, the estimates of production and earned income are simply guesses.

4. What is 'Consumption function'? Explain the institutional factors which determine consumption function.

Ans. (1) Consumption function explains the functional relationship between the consumption and the income. J. M. Keynes states that other things being equal consumption is a function of income.

(2) Algebraically, the relationship between consumption as a dependent variable and aggregate income as the independent variable is expressed as: C = f (Y), where, C = Consumption, f = functional relationship, Y= Aggregate income.

(3) Consumption function has two technical attributes, viz. the Average Propensity to Consume (APC) and the Marginal Propensity to Consume (MPC).

These factors are called exogenous or external factors as they are external to the individual's behaviour, which, in turn, has a strong bearing on their consumption expenditures.

These are:

(1) Changes in Wage Rate: If income in terms of wage rate increases, consumption expenditure increases. A change in income distribution will cause change in expenditure on consumption.

(2) Change in Disposable Income: Consumption expenditure depends upon disposable income. If there is a change in disposable income there will be a change in expenditure on consumption.

(3) Change in the Rate of Interest: Change in the rate of interest is likely to affect consumption function. An increase in the rate of interest may have a dampening impact-on consumption. On the other hand, a fall in the rate of interest may encourage people to consume more.

(4) Change in Capital Value (Windfall Gains or Unexpected Gains): Capital gains are due to sudden change in money value of wealth. The consumption expenditure of wealthy classes is likely to be

extremely susceptible to unforeseen change in the value of their wealth. During the period of prosperity, huge unexpected gains or windfall gains may accrue to the capitalist class, and as a result their consumption may increase. Some examples of windfall gains are unexpected rise in profits caused due to unexpected upswing in business. Unexpected rise in the rate of return on investment in some company's shares or debentures is also an example of windfall gain. All these windfall gains may cause increase in consumption.

(5) **Fiscal Policy**: Changes in fiscal policy of the government affects consumption. Certain type of changes in fiscal policy adversely affect consumption. For example, increase in income tax, capital gains tax, excise duty etc. On the other hand, increase in government spending in various ways (including deficit financing) would increase propensity to consume.

(6) **Expectations about the Future Income:** If future income is expected to increase people are likely to save less and consume more. On the contrary, if future income is expected to fall, people may save more for the future and spend less on present consumption.

(7) **Changes in Depreciation Allowances:** Increase in depreciation allowance would reduce income of shareholders and consequently, their consumption may decrease.

(8) **Demographic Factor**: Size of population, family size would affect consumption. Keynes, who was concerned with the problem of unemployment, was of the opinion that the above subjective and objective factors will not have very great influence on saving function in the short period. Keynes, therefore, believed that in the short period of time, consumption function and the saving function would be fairly stable.