SUGGESTED SOLUTION

CA FOUNDATION

SUBJECT- ECONOMICS AND BCK

Test Code – JKN_ECO_02

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1. Capitalism is an economic system in which resources are privately owned and economic decisions are taken by the private sector (buyers & sellers) to address the problem of scarcity. One of the most important features of such a system is the presence of consumer sovereignty - the freedom to buy whatever the buyers wish and it is this freedom of choice that dictates what producers will ultimately produce. In this sense consumer sovereignty translates into 'consumer is the king of the market.'

[Ans. : B]

2. Here P_1 = Rs. 60; P_2 = Rs. 67

D_1 = Rs. 2035; D_2 = Rs. 1946

$\therefore \Delta$ D = 1946 – 2035 = (–) 89

Δ P = 67 – 60 = 7

The formula to calculate price elasticity of demand is,

$$e_p = \frac{\Delta D}{\Delta P} \cdot \frac{(P_1 + P_2)}{(D_1 + D_2)} = -\frac{89}{7} \times \frac{(67+60)}{(2035+1946)}$$

$$= \frac{(-89)(127)}{7(3981)}$$

$$= (-)\frac{11303}{27867}$$

= (–) 0.4

Negative Sign is to be ignored.

[Ans.: A]

3. MR = MC is equilibrium condition. When in equilibrium a firm in the short run will earn normal profit if AR = AC. It will earn supernormal profit if P (AR) > AC. The firm will make loss if P (AR) < AC.

[Ans.: B]

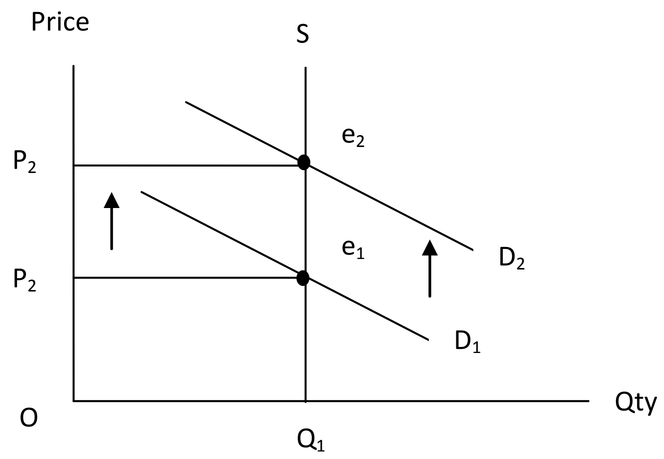
4. In the short run plant size of the firm cannot be changed because some factors are fixed. It has to operate on this plant size despite the fact that demand may be changing. If demand is increasing the firm will have to plan expansion of its plant size which will happen only in the long run when all factors become variable. On the other hand if the firm expects demand for its product to decline it will plan to decrease its plant size in the long run.

[Ans.: A]

5. An economy cannot grow endlessly due to scarcity of resources & constraints imposed by technology. Moreover during prosperity inflation becomes problems which leads to contraction.
An economy cannot contract endlessly because human wants can never become zero. Demand for basic necessities is always going to be there. So somewhere recession is going to get over. The most difficult thing in context of a business cycle is to predict its turning points.

[Ans.: D]

6. Perfectly inelastic supply means that the quantity supplied does not change at all despite change in price. Under this condition if demand increases, due to scarcity, only price increases. This situation can be better understood by the following diagram :



As demand increases from D_1 to D_2 price increases from P_1 to P_2

[Ans.: D]

7. Monopoly is defined as a market structure in which a single seller is selling a product having no substitutes. In such a market the firm itself is the industry. Demand for monopolist's product is inelastic but not perfectly inelastic.

[Ans.: D]

8. Isoquants show all possible combinations of two factors which can produce the same quantity of output. Isoquants are downward sloping, convex to the origin & they never touch either of the axes. They are also non – intersecting. If two isoquants intersect the that would mean that one combination of labour and capital can produce two different levels of output, which is not possible.

[Ans.: C]

9. Capitalism is an economic system in which resources are privately owned and economic decision are taken by the private sector (buyers & sellers), to address the problem of scarcity. In such a system resources are allocated by the price mechanism. Prices of goods, services and factors are determined by the interplay of demand & supply changes.

[Ans.: A]

10. Perfectly inelastic supply is a situation in which the quantity supplied does not change despite a change in the price of a commodity. So in terms of symbols, Δ q = 0.

[Ans.: D]

11. According to MR – MC approach there are two conditions for equilibrium of a firm –
    (i) MR = MC and
    (ii) MC curve should interest MR curve from below i.e. MC curve should have a positive slope.

    If MC curve intersects MR curve from above then it would mean that MC has a negative slope and that MR > MC so the firm would benefit by increasing output.

[Ans.: A]

12. A discriminating monopolist sells his product in different markets at different prices in order to maximize his total profit. When he sells his output in different markets price elasticity of demand is different in different markets. He is more likely to earn high profits in markets with inelastic demand. He need not be maximizing profit in all the markets.

[Ans.: C]

13. In ordinal / indifference curve approach, a consumer comes in equilibrium at a point where budget line is tanget to indifference curve. It is here that with given amount of money he maximizes level of satisfaction. If the two goods are x and y then this condition can be expressed as

$$MRS_{x,\,y} = \frac{MU_x}{MU_y}$$

[Ans.: D]

14. Fluctuations in economic activity around trend is business/ trade cycle. Over a period of time economy experiences ups and downs – periods of prosperity & recession. Many factors are responsible for these fluctuations. According to J.M. Keynes, most important factor determining business cycle is the change in aggregate effective demand. If aggregate effective demand increases, there will be prosperity & if aggregate effective demand decreases, there will be recession.

[Ans. A]

15. Price elasticity of demand measures responsiveness of demand for a commodity due to given change in its price. Many factors affect price elasticity. One of them is time element. In the short run demand tends to be less elastic as habits tends to take time to change & information about prices of related goods too cannot be obtained immediately. In the long run demand adjusts to change in conditions determining demand. It tends to become more elastic.

[Ans.: D]

16. Savings in an economy is done by three actors – individuals, business enterprises & government.

    In case of individuals & government, savings is the difference between their income & expenditure. In case of business enterprises, particularly joint stock companies, savings is undistributed profits. After tax is deducted from profits, the companies distribute a part of profit after tax to their shareholders in form of dividends. Now whatever is left over is retained earnings i.e. savings of the company.

[Ans.: B]

17. Short run supply curve in any market is based on the assumption of operation of law of diminishing marginal returns. This makes it slope upward from left to right. As more is produced due to increasing variable cost, total cost too increases which makes it imperative for the firm to change higher price to recover higher cost with increasing sales.

[Ans.: C]

18. Demand forecasting refers to the exercise of estimating demand for some commodity at some date in future based on past data & present trends. It is purely scientific in nature based on certain well established procedures. It is not purely guess work.

[Ans.: C]

19. Prefect competition and monopolistic competition are alike in the following respects :-
    (i) presence of large number of buyers & sellers
    (ii) free entry & exit of firms &
    (iii) firms are not price makers. Each firm takes prices of other firms as given

    These two markets differ in only one respect. In perfect competition products sold by all firms are identical and in monopolistic competition products sold are differentiated.

[Ans.: B]

20. There are three stages in the law of variable proportion. The second stage is known as the stage of diminishing marginal returns. In this stage output starts increasing at a decreasing rate and becomes maximum at the end of the stage. This means that marginal product starts decreasing but remains positive.

[Ans.: C]

21. Utility is want satisfying power of a commodity. It is also defined as the satisfaction derived by consuming a commodity. Utility is a subjective concept as the satisfaction derived from the same commodity differs from person to person. Based on utility to be derived consumer can make a choice regarding how many units to purchase at a given price.

    Utility cannot be measured accurately as it is an abstract concept.

[Ans.: C]

22. Monopolistically competitive firms in the long run earn only normal profit due to free entry and exit. When in long run equilibrium they operate on the falling portion of AC curve signifying the presence of excess capacity.
A monopolist earns abnormal profit in the long run due to the absence of competition.
Firms in perfect competition earn normal profits in the long run due to free entry & exit.

[Ans.: D]

23. Socialism is an economic system in which the fundamental problems of an economy - what, how & for whom to produce, are addressed by the government & not market forces. In such an economy government uses planning as a mechanism to solve the problem of scarcity. Rules and regulations are issued by the government from time to time to achieve the set goals.

[Ans.: B]

24. Different oligopoly settings give rise to different optimal strategies & diverse outcomes. In this context many oligopoly models have been advanced. In cournot's model, output is the firm's control variable whereas in Bertrand's model, price is the control variable for firms & each firm independently sets its price in order to maximize profits.

[Ans.: A]

25. AC is per unit cost of production. MC is the cost of producing an additional unit of output. It is MC that determines the direction in which AC will move. If MC > AC, then AC will increase. If MC < AC, then Ac will decrease. This automatically implies that MC curve will intersect AC curve at its minimum point.

[Ans.: C]

26. Business cycle refers to the fluctuations in aggregate economic activity (measured by GDP) around a trend (long term average). Distinct phases of a typical business cycle are - peak/ prosperity, contraction, trough (recession/ depression), recovery and expansion. Through is defined as that phase of business cycle when aggregate economic activity hits its lowest point. In this phase economic growth, is at its lowest adversely impacting employment, income, profits & living standards.

[Ans.: C]

27. Socialism is an economic system in which central problems of an economy (what to produce, how to produce, for whom to produce) are addressed by the government with the help of planning mechanism. The concept of socialist economy was propounded by Karl Marx and Frederic Engles in their work 'The Communist Manifesto' published in 1848.

[Ans.: D]

28. Main objective of firms in any market structure is to maximize profit. In the short run a firm will have to tolerate losses as some factors are fixed and so full adjustment cannot be done. In the long run the firm expects that it should atleast break – even i.e. (P = ATC). If P < ATC then the firm makes loss and decide to quit.

[Ans.: C]

29. Economic indicators are statistics that tell us about the health of the economy. Movements in these indicators are used as basis for forecasting the likely economic environment in the near future. There are three types of indicators
   (i) leading indicators – they move ahead of the level of economic activity.
   (ii) coincident indicators – they move simultaneously with the level of economic activity and
   (iii) lagging indicators – they move behind the level of economic activity.

[Ans.: A]

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(ii) coincident indicators – they move simultaneously with the level of economic activity and
(iii) lagging indicators – they move behind the level of economic activity.

GDP falls in the category of coincident indicator.

[Ans.: B]

31. Lionel Robbins has given the most acceptable definition of economics. He has defined economics as the 'science of scarcity'. His definition is based on the facts that –
(i) human wants are unlimited.
(ii) resources are limited (scarce) and
(iii) resources have alternative uses.

Due to limited resources individuals & societies face the problem of choice-making - deciding the best way to allocate resources.

[Ans.: C]

32. Cross elasticity of demand measures proportionate change in quantity demanded of a commodity due to a given change in price of its related good. If two goods are substitutes then cross elasticity will be positive. If two goods are complements then cross elasticity will be negative. Rye bread & wheat bread being substitutes, cross elasticity between them is positive.

If two goods are perfect substitutes then the value of cross elasticity of demand is infinity. This means that due to a given change in price of a product the demand for its substitute changes infinitely as these goods are perfect substitutes.

[Ans.: B]

33. Investment decisions are taken by businessmen on the basis of two important factors -
(i) rate of interest &
(ii) expected rate of profit.

Investments are undertaken with the only objective of maximizing profits. New inventions can raise profit by either decreasing cost or increasing sales. Similarly low interest rates too decreases cost and thereby increase profit.

[Ans.: D]

34. In perfect competition price of a product is determined jointly by industry/market demand and industry/market supply. This price is given as taken by the firm. In industry equilibrium price exists at a point where industry demand equals industry supply.

[Ans.: B]

35. When nothing is produced the only cost incurred is fixed cost. In the given table total fixed cost is Rs. 240. Now this cost remains the same.

Formula to calculate AFC is TFC ÷ Q.

Here AFC = 240/3 = Rs. 80.

[Ans.: C]

36. The formula to measure supply elasticity by –

(i) percentage method is $\frac{\Delta S}{\Delta P} \cdot \frac{P}{S}$

(ii) arc method is $\frac{\Delta S}{\Delta P} \cdot \frac{(P_1+P_2)}{(S_1+S_2)}$

(iii) point method is $\frac{dS}{dP} \cdot \frac{P}{S}$

Where S is quantity supplied & P is price. There is nothing like total outlay method of measuring elasticity of supply.

[Ans.: C]

37. Returns to Scale (RTS) are of 3 types :-

(i) Increasing RTS – proportionate increase in output is greater than proportionate increase in inputs

(ii) Decreasing RTS – proportionate increase in output is less than proportionate increase in inputs

(iii) Constant RTS – proportionate increase in output equals proportionate increase in inputs

From the data it is clear that the given case is of constant RTS.

[Ans.: A]

38. Science is of two types – Positive & Normative. Positive science answers the question- 'what it is'? and 'why it is?' It is based on facts/observations. It is also known as descriptive science.

Normative science answer the question – 'what it should be?' or 'what it ought to be ?' It is based on opinions/value judgements. It is also known as prescriptive science as it contains prescriptions given by economists on different issues.

[Ans.: B]

39. Market for a product can be classified in a number of ways. On the basis of whether government is regulating the market or not we have regulated and unregulated markets.

On the basis of volume of purchase, we have wholesale market (bulk purchase) and retail markets.

Consumers generally purchase their commodities from retail markets.

[Ans.: B]

40. A firms earns supernormal profit if AR > AC (AC is average cost).

A firm earns normal profits if AR = AC.

A firm makes losses if AR < AC but will not shut down till it is able to recover its day to day expenses i.e. AR = AVC.

A firm will have to shut down if it fails to recover AVC i.e. AR < AVC. In this situation if the firm continues to operate then it will end up in maximizing losses.

[Ans.: D]

41. Short run is a time period in which some factors are fixed & some are variable. A firm in any market structure will not be able to make full adjustments in the short run. As a result in the short run the firm can either earn normal profit (if P =AC); or earn supernormal profit (if P > AC); incur loss (if P < AC) or even face a shut down condition (if P < AVC) but cannot exit the industry.

[Ans.: B]

42. Alfred Marshall propounded total outlay method of measuring price elasticity of demand. In this method he compares changes in price to that in total expenditure and concludes the following :

(i) if with a change in price total expenditure does not change then it is a case of unit elastic demand.

(ii) if change in price and change in total expenditure move in opposite direction then it is a case of elastic demand.

(iii) if change in price and change in total expenditure move in the same direction then it is a case of inelastic demand.

Therefore total expenditure will increase if demand is elastic and price falls or demand is inelastic & price rises.

[Ans.: D]

43. Business cycle as five distinct phases peak, contraction, trough (recession/ depression),recovery & expansion.

Recession is a phase in which there is decrease in level of income, price, profit, interest rate, investment & employment. Most of the business run in losses and so the overall business environment is pessimistic. In absence of profitability prospects, investor confidence is very low & new investments are not undertaken.

[Ans.: D]

44. Paul Sweezy, an American economist propounded kinked demand curve model to explain price rigidity in oligopoly markets. He observed that there is a kink in the demand curve at the existing price because of a peculiar behavior of firms - all firms follow price cut by one firm but do not follow price increase.

[Ans.: B]

45. Consumer surplus is defined as the difference between willingness to pay for a commodity and the actual price paid.
Willingness to pay is determined by the marginal utility for different units of a commodity. This means that willingness to pay = MU.
Now consumer is in equilibrium when MU = Price. This means that when the consumer is in equilibrium, MU = P.

[Ans.: D]

46. In any market structure, firm determines the quantity of output to the produced. Total cost of production is positively related to the magnitude of output.
Marginal cost i.e. rate of change in total cost of production is determined by change in output level. Output plays an important role in determining the cost of a firm so it is a vital component of cost function.

[Ans.: D]

47. Macroeconomics studies the behaviour of aggregated economic variables. It studies the economy as a whole. Important topics covered under macroeconomics are-national income determination, employment, general price level (inflation) & business cycle. Microeconomics studies the behavior of individual economic variables. It is also known as price theory/value theory. Important topics covered under microeconomics are – product pricing, factor pricing, consumer behaviour, study of firms, etc.

[Ans.: B]

48. Price elasticity of demand is determined by a number of factors. One of them is the nature of the commodity. For necessities, demand tends to be less elastic as their demand cannot be postponed even if their price increases. But for luxury goods demand is relatively more elastic as their demand can be postponed if there is an increase in price.

[Ans.: C]

49. Marginal revenue (MR) is the change in total revenue (TR) due to an additional unit of output sold. MR is positive when TR is increasing ,MR is zero when TR becomes maximum & MR becomes negative when TR starts decreasing.

[Ans.: C]

50. Business cycle refers to the fluctuations of aggregate economic activity (measured by GDP) around a trend (long term GDP growth rate). When aggregate economic activity is increasing it is said to be an expansion, when it is declining it is said to be contraction. When aggregate economic activity hits its lowest then it is known as a through. Trough & Peak are two turning points.

[Ans.: A]

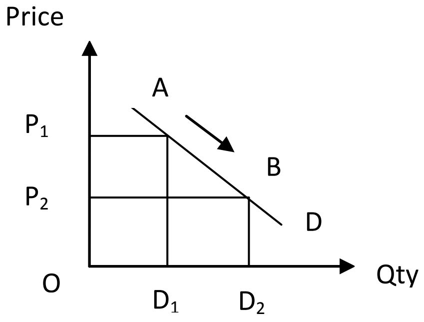
51. The law of diminishing marginal returns (also known as the law of variable proportion) explains short run output behavior when all inputs are fixed except one. It states that keeping the quantity of all factors fixed & increasing the quantity of one factor, a point will be reached when marginal product of variable input starts decreasing.

[Ans.: C]

52. Economics is defined as science of scarcity or choice-making. This is because of the fact that human wants are unlimited and resources or means to satisfy wants are limited or scarce.

[Ans.: B]

53. Expansion & contraction of demand refer to change in quantity demanded due to a change in its price, other factors remaining constant. Expansion refers to increase in quantity demanded due to decrease in price of a commodity shown by downward movement on the demand curve.



A to B $\rightarrow$ expansion
B to A $\rightarrow$ contraction

Contraction refers to decrease in quantity demanded due to increase in price of a commodity shown by upward movement on the demand curve shifts of demand curve reflect increase and decrease in demand.

[Ans.: C]

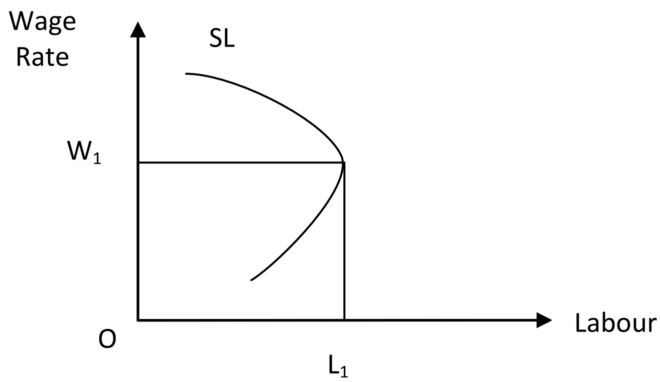
54. The kinked demand hypothesis was advanced by Paul Sweezy, an American economist to explain price rigidity that exists in oligopoly market. According to him the demand curve in oligopoly market has a kink at the existing price due to typical behaviour of the firms - all firms follow a price cut initiated by one firm but they do not follow a price increase initiated by one firm.

[Ans.: B]

55. Business cycle refers to the fluctuations in aggregate economic activity (measured by GDP) around a trend (long term average). Distinct phases of a typical business cycle are – peak/ prosperity, contraction, trough (recession/ depression), recovery and expansion. Through is defined as that phase of business cycle when aggregate economic activity hits its lowest point. In this phase economic growth, is at its lowest adversely impacting employment, income, profits & living standards.
When recession becomes severe it is known as depression.

[Ans.: B]

56. Supply of labour curve is backward bending.



This means that initially as wage rate increases, supply of labour too increases. People are willing to earn more with high wage rate. But beyond a very high wage rate (here W_1), supply of labour starts decreasing. This is because of trade-off between work (labour) & leisure. At very high wage rates laborers prefix more of leisure to work as at a higher wage rate they can earn more in absolute terms in less hours.

[Ans.: B]

57. Formula to calculate price elasticity of supply using arc method is

$$e_s = \frac{\Delta S}{\Delta P} \cdot \frac{(P_1+P_2)}{(S_1+S_2)}$$

Here $S_1 = 150$; $S_2 = 300 \Rightarrow \therefore \Delta S = 300 - 150 = 150$

$P_1 = 15$; $P_2 = 25 \Rightarrow \therefore \Delta = 25 - 15 = 10$

$\therefore e_s = \frac{150}{10} \times \frac{(15+25)}{(150+300)}$

$= \frac{150}{10} \times \frac{40}{450}$

$= \frac{60}{45}$

$= + 1.33$

[Ans.: B]

58. Economics is defined as the science of scarcity. This definition is premised on the facts that human wants are unlimited; resources are limited and resources have alternative uses. Therefore the central problem in economics is to allocate scarce resources in such a manner that society's unlimited wants are satisfied as well as possible. For this the society may adopt command economy (socialism) or market economy(capitalism). In market economy the emphasis is on producing output in the most efficient way and in command economy the emphasis is on guaranteeing a minimum level of income for every citizen.

[Ans.: D]

59. There are large number of buyers & sellers of agricultural goods selling more or less homogeneous products. There is free entry and free exit of firms. There is perfect mobility of factors and perfect knowledge of market conditions with both buyers & sellers. There are no transaction costs. All these are the features of perfect competition, so agricultural goods markets approximate perfectly competitive markets.

[Ans.: A]

60. Business cycle refers to fluctuation in aggregate economic activity (measured by real GDP) around a trend (Long – term average). There are five distinct phases of a business cycle – expansion, peak, contraction, trough (recession & depression) & recovery. Economy arrives at a peak when the expansion is over. And when peak is over economy starts contracting.

[Ans.: A]

61	B
62	A
63	B
64	D
65	B
66	A
67	C
68	B
69	D
70	B
71	C
72	B
73	C
74	A
75	A
76	B
77	A
78	B
79	B
80	D
81	B
82	C
83	A
84	B
85	B
86	B
87	C
88	A
89	D
90	D
91	C
92	C
93	A
94	B
95	A
96	D
97	B
98	C
99	C
100	B