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SUGGESTED ANSWERS

CA INTER

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Answers

Section A - Financial Management

Q.1

(a)

Working Note:

(1) F.L. = $\frac{\text{EBIT}}{\text{EBIT-I}} = \frac{\text{EBIT}}{\text{EBIT-300}} = 4$

$\therefore$ 4 EBIT – 1200 = EBIT

$\therefore$ EBIT = 400

(1 Mark)

(2) O.L. = $\frac{\text{Contribution}}{\text{EBIT}} = 400$ Contribution $= 5$

Contribution = 2000

(1 Mark)

(3) P/v Ratio = $\frac{\text{Contribution}}{\text{Sales}} \times 100$

$25\% = \frac{2000}{\text{Sales}}$

Sales = 8000

(1 Mark)

Income Statement

Particulars	Amount (₹)
Sales	8,000
(-) Variable Cost (?)	(6,000)
Contribution	2,000
(-) Fixed Cost (?)	(1,600)
EBIT	400
(-) Interest (10% 3,000)	(300)
EBT	100
(-) Tax (45%)	(45)
PAT	55
÷ No. of Equity Shares	10
EPS	5.5

(1 Mark)

$\therefore$ Market Price per share = EPS x P/E Ratio

= 5.5 x 8 times

= 44/ share

(1 Mark)

(b)

	(1 Mark)	(1 Mark)	(1 Mark)
	20% Debt	**30% Debt**	**50% Debt**
EBIT	4,00,000	4,00,000	4,00,000
(-) Interest	(24,000)	(36,000)	(60,000)
	(6% 4,00,000)	(6% 6,00,000)	(6% (10,00,000)
Net Income	3,76,000	3,64,000	3,40,000
			(1 Mark)
Value of Firm V = EBIT/K_o	40,00,000	40,00,000	40,00,000
(-) Debt	(4,00,000)	(6,00,000)	(10,00,000)
Equity	36,00,000	34,00,000	30,00,000
$K_e = \frac{NI}{Equity}$	$= \frac{3,76,000}{36,00,000}$	$= \frac{3,64,000}{34,00,000}$	$= \frac{3,40,000}{30,00,000}$
	10.44%	10.71%	11.33%
			(1 Mark)

(c)

(a) Optimum Cash Balance as per Baumol's Model.

$$= \sqrt{\frac{2.F.T.}{r}}$$

$$= \sqrt{\frac{2.12,00,000,300}{5\%}} = \boxed{1,20,000}$$

(3 Marks)

(b) Opportunity Cost

	Amount (₹)	
Total Transaction Cost $= \frac{F}{Q} \times T = \frac{12,00,000}{1,20,000} \times 300$	3,000	**(1 Mark)**
Total Interest Cost $= \frac{Q}{2} \times r = \frac{1,20,000}{2} \times 5\%$	3,000	**(1 Mark)**
	6,000	

(d)

NPV

Plant-A

Year	C.F.	DF @ 11%	PV
1-3	(2,50,000)	2.4437	(6,10,925)
		(-) PVCO	(10,00,000
		NPV	**(16,10,925)**

(1 Mark)

Plant-B

Year	C.F.	DF @ 11%	PV
1-2	(4,00,000)	1.7125	(6,85,000)
		(-) PVCO	(7,00,000)
		NPV	**(13,85,000)**

(1 Mark)

$$\text{Annualized NPV} = \frac{\text{NPV}}{\text{Cumulative DF}}$$

$$\text{Plant-A} = \frac{(16,10,925)}{2.4437} = 659216 \text{ p.a.}$$

(1 Mark)

$$\text{Plant-B} = \frac{(13,85,000)}{1.7125} = \boxed{(808759)\text{ p.a.}}$$

(1 Mark)

Advice: It is advisable for Sanitizer Ltd. to consider Plant-A as it will be cost effective.

(1 Mark)

Q.2

(a)

(a) Price of Shares

(i) If Dividend paid

$P_1 = P_o (1+K_e - D_1$

$= 20 (1.15) – 2$

$\boxed{P_1 = 21}$

(1 Mark)

(ii) If Dividend not paid

$P_1 = P_o (1+K_e) – D_1$

$= 20 (1.15) – 0$

$\boxed{P_1 = 23}$

(1 Mark)

(b) Number of new equity shares to be issued

	Dividend Paid
Net Income	1,75,000
(-) Dividend Paid (60,000 x 2)	(1,20,000)
Retained Earnings	55,000
Investment target	3,70,000
Required Amount to be raised	3,15,000
÷ Market Price (P_1)	21
Number of new equity shares to be issued	**15,000**

(3 Marks)

(b)

NPV @ 4%

NPV (x)	**Prob**	**Exp. NPV**	$P\left(x-\bar{x}\right)^2$
1773	0.10	177.50	123210
1220	0.20	244	61605
665	0.40	266	0
110	0.20	22	61605
-445	0.10	-44.50	123210
		665	**369630**

(0.5 Mark)

(a) Expected NPV = 665

(1 Mark)

(b) Standard Deviation $= \sqrt{\Sigma p\left(x-\bar{x}\right)^2}$

$= \sqrt{369630}$

$\boxed{= 608}$

(1 Mark)

NPV @ 10%

NPV (x)	**Prob**	**Exp. NPV**	$P\left(x-\bar{x}\right)^2$
1487	0.10	148.70	99002
989	0.20	197.80	49402
492	0.40	196.80	0
-5	0.20	-1	49402
-503	0.10	-50.30	99002
		492	**296808**

(0.5 Mark)

(a) Expected NPV = 492

(1 Mark)

(b) Standard Deviation $= \sqrt{\Sigma p\left(x-\bar{x}\right)^2}$

$= \sqrt{296808} = \boxed{545}$

(1 Mark)

Q.3

Ratios	**Year-2**	**Year-3**	
(1) Fixed Assets Turnover Ratio $= \frac{\text{Sales}}{\text{Average Fixed Cost}}$	$= \frac{2000}{350}$ $\boxed{= 5.71 \text{ times}}$	$\frac{3000}{450}$ $\boxed{= 6.67 \text{ times}}$	**(2 Marks)**
(2) Return on Proprietory Fund $= \frac{NP\,(PAT)}{\text{Average proprietory Fund}} \times 100$	$= \frac{150}{345} \times 100$ $\boxed{= 43.48\%}$	$= \frac{200}{535} \times 100$ $\boxed{= 37.38\%}$	**(2 Marks)**
(3) Gross Profit Ratio $= \frac{\text{Gross Profit}}{\text{Sales}} \times 100$	$= \frac{1150}{2000} \times 100$ $\boxed{= 57.50\%}$	$= \frac{1500}{3000} \times 100$ $\boxed{= 50\%}$	**(2 Marks)**

(4) Current Ratio $= \frac{\text{Current Assets}}{\text{Current Liabilities}}$	$= \frac{300}{120}$ $\boxed{= 2.5:1}$	$= \frac{350}{150}$ $\boxed{= 2.33:1}$	**(2 Marks)**
(5) Working Capital Turnover Ratio $= \frac{\text{Sales}}{\text{Average Working Capital}}$	$= \frac{2000}{140}$ $\boxed{= 14.29 \text{ times}}$	$= \frac{3000}{190}$ $\boxed{= 15.79 \text{ times}}$	**(2 Marks)**

Working Note:

	Year-2	**Year-3**
Average Fixed Assets	$= \frac{300+400}{2}$ $\boxed{= 350}$	$= \frac{400+500}{2}$ $\boxed{= 450}$
Average Proprietory Fund	$= \frac{250+440}{2}$ $\boxed{= 345}$	$= \frac{440+630}{2}$ $\boxed{= 535}$
Average Working Capital	$= \frac{100+180}{2}$ $\boxed{= 140}$	$= \frac{180+200}{2}$ $\boxed{= 190}$

(1 Mark)

Q.4

I. Capital Asset Pricing Model

- K_D = I (1-t)
  = 10% (1-0.40) $\boxed{= 6\%}$

(1 Mark)

Note: As Debt is risk free so interest rate will be same as return on government securities.

-K_e = R_F + B [R_m – R_F]
= 10% + 1.6 [15-10] $\boxed{= 18\%}$

(1 Mark)

WACC

Debt (2)	40	6%	2.40
Equity (3)	60	18%	10.80
	100		**13.20%**

(3 Marks)

II. Gordon's Approach:

$K_e = \frac{D_1}{P_0} + 9$

Where,

$D_o = \frac{8,00,000}{1,00,000}$ $\boxed{= 8 / \text{ share}}$

(1 Mark)

9 = 12%

P_o = 80/share

$\therefore K_e = \frac{8 + 12\%}{80} + 12\%$

$K_e = \frac{8.96}{80} + 12\%$

$\boxed{K_e = 23.20\%}$

(1 Mark)

WACC

Debt (2)	40	6%	2.40
Equity (3)	60	23.20%	13.92
	100		**16.32%**

(3 Marks)

Q.5

Particulars	Present units = 60000 (5000 x 12)	Proposed = 45000 (60,000 – 25%)	**(2 Marks)**
Sales @ 200	1,20,00,000	90,00,000	**(1 Mark)**
(-) Variable cost @ 150	(90,00,000)	(67,50,000)	**(1 Mark)**
(-) Bad Debts	(12,00,000)	-	**(1 Mark)**
(-) Agency fees	-	(5,00,000)	**(1 Mark)**
(-) Cost of Investment in Debtors	18,00,000 (3,37,500) (90,00,000 x 3/12 x 15%)	17,50,000 (2,53,125) (67,50,000 x 3/12 x 15%)	**(2 Marks)** **(1 Mark)**
Net Benefit	**14,62,500**	**14,96,875**	

Advice: It is advisable to consider proposal of credit agency as it will give higher net benefit.

(1 Mark)

Q.6

(a)

1. Securitisation:

(a) Securitisation is the process by which financial assets (e.g. Loan Receivables, Mortgage backed receivables, Credit Card balances, Hire Purchase Debtors, Trade Debtors, etc.) are transformed into securities. Securitisation is different from Factoring since the latter involves transfer of debts without transformation thereof into securities.

(1 Mark)

(b) Securitisation is a mode of financing, wherein securities are issued on the basis of a package of assets (called Asset Pool). In this method of recycling funds, assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued.

(2 Marks)

2. Securitisation Process:

(a) Initial Lending / Origination Function: Originator gives various Loans to different Borrowers (Obligors). Borrowers have to repay the loans in EMI's (Interest + Principal). These EMI's constitute financial assets /receivables for the Originator.

(b) Securitisation Function: Financial Assets / Receivables or defined rights therein, are transferred, fully or partly, by the Originator to a SPE. SPE pays the Originator immediately in cash or in any other consideration for taking over the financial assets. The assets transferred are termed' Securitised Assets' and the assets or rights retained by the Originator are called 'Retained Assets'.

(c) Financing Function: SPE finances the assets transferred to it by issue of securities such as Pass through Certificates (PTCs) and / or debt securities to Investors. These are generally sold to Investors (Mutual Funds, LIC, etc.), through Merchant Bankers.

(b)

	Financial Accounting	Financial Management	
1.	Financial Accounting generates information relating to operations of the Entity.	Financial Management seeks to use the information generated by the accounting function, for decision-making.	**(1 Mark)**
2.	Financial Accounting is past-oriented, in the sense that transactions/ events which happen, are recorded.	Financial Management is future-oriented, i.e. to guide the Entity in future course of action.	**(1 Mark)**
3.	Measurement, Recognition and Disclosure are the dominant aspects considered in accounting.	Procurement of Funds and their Effective Utilisation are the dominant aspects of Financial Management.	**(1 Mark)**
4.	Measurement of Funds (i.e. Revenue, Expenses, etc.) is largely based on the accrual concept.	Decision-making requires the analysis of funds in terms of Cash Inflows and Cash Outflows.	**(1 Mark)**
5.	Accounting is guided by principles, standards, legal requirements, etc.	Financial Management is guided by tools and techniques for decision-making.	**(1 Mark)**

(Any 3 points 1 point 1 Mark)

(c)

The Capital Budgeting Process consists of the following stages –

Stage	Procedure
Planning	* Identity various possible investment opportunities. * Determine the ability of the management to exploit / utilize the opportunities * Reject opportunities which do not have much merit, and prepare Proposals in respect of investment opportunities which have reasonable value for the Firm, **(1 Mark)**
Evaluation	* Determine the inflows and outflows relating to various proposals. * Use appropriate technique (like NPV, IRR, MIRR. PI, etc.) to evaluate the proposals. **(0.5 Mark)**

Selection	* Weigh the risk-return trade-off relating to various investment proposals. * Compare W ACC or Cost of Capital with the Return (ROCE) from various proposals. * Choose that project which will maximize the Shareholders' wealth. **(0.5 Mark)**
Execution	* After deciding on the project to be implemented, obtain the necessary funds for the project * Establish the infrastructure (assets, equipments, etc.), acquire the resources, and implement the project, according to the stipulated time-frame. **(0.5 Mark)**
Control	* Obtain Feedback Reports (Capital Expenditure Progress Reports, Performance Reports. Internal Audit / Inspection Reports, etc.) to monitor the implementation of the project. **(0.5 Mark)**
Review	* After the project is over, review the project- (a) to explain its success or failure, and (b) to generate ideas for new proposals to be undertaken in future. **(1 Mark)**

OR

(c)

OPERATING OR WORKING CAPITAL CYCLE

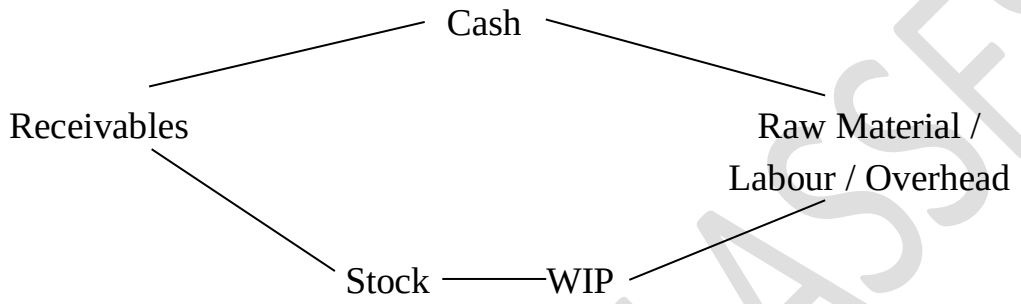
A useful tool for managing working capital is the operating cycle. The operating cycle analyzes the accounts receivable, inventory and accounts payable cycles in terms of number of days. For example:

- Accounts receivables are analyzed by the average number of days it takes to collect an account.
- Inventory is analyzed by the average number of days it takes to turn over the sale of a product (from the point it comes in the store to the point it is converted to cash or an account receivable).
- Accounts payables are analyzed by the average number of days it takes to pay a supplier invoice.

(2 Marks)

Operating/Working Capital Cycle Definition

Working Capital cycle indicates the length of time between a company's paying for materials, entering into stock and receiving the cash from sales of finished goods. It can be determined by adding the number of days required for each stage in the cycle. For example, a company holds raw materials on an average for 60 days, it gets credit from the supplier for 15 days, production process needs 15 days, finished goods are held for 30 days and 30 days credit is extended to debtors. The total of all these, 120 days, i.e., 60 - 15 + 15 + 30 + 30 days is the total working capital cycle.



The duration of working capital cycle may vary depending on the nature of the business. In the form of an equation, the operating cycle process can be expressed as follows:

Operating Cycle = R + W + F + D- C
Where,
R - Raw material storage period
W = Work-in-progress holding period
F = Finished goods storage period
D = Receivables (Debtors) collection period.
C = Credit period allowed by suppliers (Creditors).

(2 Marks)

Section B - Economics in Finance

Q.1

(a)

Sanitary and Phytosanitary (SPS) Measures: SPS measures are applied to product human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease – causing organisms and to protect biodiversity. These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirement, production processes, and associated compliance assessments. For example; prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc.

(2 Marks)

(b)

The labour and capital of a country acting on its natural resources produce annually a certain amount of goods and services. This is called national income of the country. National income of a country can be defined as the total market value of all final goods and services produces in the economy in a year.

(0.5 Marks)

Following are the Usefulness of estimating National Income:

1. National income estimates provide a comprehensive, conceptual and accounting framework for analyzing and evaluating the **Short-run performance** of an economy.
2. **The distribution pattern of Income** determines the pattern of demand for goods and services and enables businesses to forecast the future demand for their products.
3. Economic welfare depends to a considerable degree on the magnitude and distribution of national income, **size of per capita income** and the growth of these over time.
4. It shows the composition and structure National income in terms of different sectors of the economy, the periodical variation in them and the broad sectoral shift in an economy over time. Using these information, the **Governments can fix various sector- specific development target** for different sectors of the economy and formulate suitable development plans and policies to increase growth rates.

5. National income statistics also helps in assessing and selecting economic policies and for objective statement as well as **evaluation of governments' economic policies.**
6. The national income data are also useful to determine the **share of nation's contributions to various international bodies.** (which helps to determine Income, Standard of living and eligibility for loans)

(2.5 Marks)

(c)

Stabilization Function: Market economy does not automatically generate full employment and price stability and therefore the government should pursue deliberate stabilization policies. Business cycles are natural phenomena in any economy and they tend to occur periodically. In the absence of appropriate corrective intervention by the government, the instabilities that occur in the economy in the form of recessions, inflation etc. may be prolonged for longer periods causing enormous hardship to people especially the poorer sections of society. It is also possible that a situation of stagflation (a state of affair in which inflation and unemployment exist side by side) may set in and make the problem more severe.

The stabilization function is concerned with the performance of the aggregate economy in terms of:

- labour employment and capital utilization,
- overall output and income,
- general price levels,
- balance of international payments and
- The rate of economic growth.

(1.5 Marks)

Allocation function: A market economy is subject to serious malfunctioning in several basic respects. There is also the problem of nonexistence of market in a variety of situations. While private goods will be sufficiently provided by the market, public goods will not be produced in sufficient quantities by the market. Market failures which hold back the efficient allocation of resources.

In the absence of appropriate government intervention, market failures may occur and the resources are likely to be misallocated by too much production of certain goods or too little production of certain other goods. The allocation responsibility of the governments involves suitable corrective action when private markets fail to provide the right and combination of goods and services.

(1.5 Marks)

(d)

A recessionary gap, is said to exist if the existing level of aggregate production is less than what would be produced with full employment of resources. It is a measure of output that is lost when actual national income falls short of potential income, and represents the difference between the actual aggregate demand and the aggregate demand which is required to establish the equilibrium at full employment level of income. This gap occurs during the contractionary phase of business-cycle and results in higher rates of unemployment. In other words, recessionary gap occurs when the aggregate demand is not sufficient to create condition of full employment.

(2 Marks)

Q.2

(a)

(i)

The incentive to let other people pay for a good or service, the benefit of which are enjoyed by an individual is known as the free rider problem. In other words, free riding is 'benefiting from the actions of others without paying'. A free rider is a consumer or producer who does not pay for a nonexclusive good in the expectation that others will pay.

Public goods provide a very important example of market failure, in which the self-interested behaviour of individual does not produce efficient results. Consumers can take advantage of public goods without contributing sufficiently to their production.

The absence of excludability in the case of public goods and the tendency of people to act in their own self-interest will lead to the problem of free riding. If individual cannot be excluded from the benefit of a public good, then they are not likely to express the value of the benefit which they received as an offer to pay. In other words, they will not express to buy a particular quantity at a price.

(2.5 Marks)

On account of the free problem, there is no meaningful demand curve for public goods. If individual make no offer to pay for public goods, then the profit maximizing firms will not produce them.

(0.5 Marks)

(ii)

Market stabilization scheme (MSS):

1. Market stabilization scheme started in the year 2004
2. It is a program started by RBI & government, to absorb additional liquidity from the market due to huge foreign inflow of fund and the process is called as Sterilization.
3. later under this scheme Govt borrows money from RBI and issues treasury-bills which helps to absorb additional liquidity from the system,

(1 Mark)

Cash Reserve Ratio (CRR):

1. CRR refers to fraction of Total NDTL (Net demand and time liabilities) of commercial bank which it should maintain as cash deposits with RBI.
2. CRR is mandatory Reserve for all commercial bank.
3. Banks have to pay monetary penalty if they don't maintain CRR.
4. CRR is applicable only to commercial bank & not applicable to NBFC.
5. No interest is paid on CRR deposits kept with RBI. Since March 2007 as per current update CRR is 3%.

(1 Mark)

(b)

Liquidity aggregates determined by RBI are:

L1 = MN3 + all deposits with post office savings banks (Excluding National Saving Certificates)

L2 = L1 + Term deposits with term lending institutions and refinancing institution + Term borrowing by Financial Institution (FIs) + Certificates of deposits issued by FIs.

L3 = L2 + Public deposits of non – banking financial companies.

(2 Marks)

Thus,

i. L1 = 50 Lakhs + 11 Lakhs = ₹ 61 Lakhs

ii. L2 = 61 Lakhs + 20 Lakhs + 5 Lakhs + 2 Lakhs = ₹ 88 Lakhs

iii. L3 = 88 Lakhs + 4 Lakhs = ₹ 92 Lakhs.

(3 Marks)

Q.3

(a)

(i)

Explain Theory of Absolute Advantage

1. Concept:

a) Adam Smith propounded the Theory of Absolute Cost Advantage as the basis of Foreign Trade.

b) Under this theory, an exchange of goods will take place only if each of the two countries can produce one commodity at an absolutely lower production cost than the other country.

c) Each Country which has an absolute advantage over another Country in the production of an item, can trade such item, and hence gain in terms of International Trade.

d) Absolute Advantage refers to the ability of a Party (an Individual, or Firm, or Country) to produce more of a good or service than the Competitors, using the same amount of resources.

(1 Mark)

2. Explanation:

Consider two Countries (A and B), and two Products (X and Y). The Countries have different abilities to produce goods, and accordingly the Production varies as under –

	Product X	**Product Y**
Country A	30 units per hour	20 units per hour
Country B	5 units per hour	25 units per hour

- Here, Country A is better equipped to produce Product X (30 units vs 5 units), whereas Country B is better equipped to produce product Y (25 units vs 20 units).
- Both Countries will gain by trading with one another, by which Country A will specialize in Product X, and Country B will specialize in Product Y.
- If specialization takes place but there is international trade, residents of Country A will not have Product Y, and Residents of Country B will not Product X at all. This situation is avoided by engaging in International Trade.
- Gains may not always be distributed equally between Countries A & B, say if 1 unit of X is traded for 1 unit of Y.

3. Advantages:

a) Each country which has an absolute advantage over another Country in the production of an item, can trade such item, and hence gain in terms of International Trade. One Country's Gain need not be another Country's Loss.

b) This Theory recognizes the importance of division of labour, specialization, and consequent benefits.

c) Global Output is maximized, and all products are available to Consumers of all Countries.

4. Disadvantages:

a) It is simplistic a Model to consider. It does not recognize many practical barriers to International trade.

b) Labour is considered as the only Factor Input in the analysis of Absolute Advantage.

(2 Marks)

(ii)

GDPFC = GDPMP – Net Indirect Tax

Hence, Net Indirect Tax = ₹ 3,51,930 lakhs

(2 Marks)

(b)

(i)

Adverse selection is a situation in which asymmetric information about quality elimates high-quality goods from a market. Good quality products disappear because they are kept by their owners and sold only to their friends and relatives, eventually market may offer nothing but lemons

(0.5 Mark)

Moral hazard is opportunism characterized by an informed person's taking advantage of a less-informed person through an unobserved action. It arises from lack of information about someone's future behaviour. Moral hazard occurs when an individual knows more about his or her own actions than other people do. This leads to a distortion of incentives to take care or to exert effort when someone else bears the costs of the lack of care or effort.

(0.5 Mark)

(ii)

Bank rate:

1. Bank rate is also known as rediscount rate.
2. It is rate at which central bank rediscount the bill of commercial bank.
3. Rediscounting bills of exchange is discontinued after introduction of LAF
4. MSF now plays the role of bank rate.
5. Currently bank rate acts as a penalty interest rate on default in maintaining CRR SLR
6. Currently bank rate is 4.65%,

(1 Mark)

Open market operation (OMO):

1. It is a general term used for market operation.
2. It is an deliberate attempt for buying & selling government bonds in the open market.
3. It will lead to either absorption or injection of liquidity.
4. During inflation Selling of bonds will take place and during period of low growth Purchase of bonds will take place.
5. It is market operation conducted by RBI.

(1 Mark)

Q.4

(a)

(i)

The GATT lost its relevance by 1980s because

- it was obsolete to the fast evolving contemporary complex world trade scenario characterized by emerging Globalization
- international investments had expanded substantially
- intellectual property rights and trade in services were not covered by GATT
- world merchandise trade increased by leaps and bounds and was beyond its scope
- the ambiguities in the multilateral system could be heavily exploited
- efforts at liberalizing agricultural trade were not successful
- there were inadequacies in institutional structure and dispute settlement system

(2 Marks)

(ii)

Public expenditures are income generating and include all types of government expenditure such as capital expenditure on public works, relief expenditures, subsidy payments of various types, transfer payments and other social security benefits. Government expenditure is an important instrument of fiscal policy. It includes

governments' expenditure towards consumption, investment, and transfer payments. Government expenditures include:

1. current expenditures to meet the day to day running of the government,
2. capital expenditures which are in the form of investments made by the government in capital equipments and infrastructure, and
3. transfer payments i.e. government spending which does not contribute to GDP because income is only transferred from one group of people to another without any direct contribution from the receivers.

Government may spend money on performance of its large and ever-growing functions and also for deliberately bringing in stabilization. During a recession, it may initiate a fresh wave of public works, such as construction of roads, irrigation facilities, sanitary works, ports, electrification of new areas etc.

(1.5 Marks)

Public Revenue

Taxes form the most important source of revenue for governments. Taxation policies are effectively used for establishing stability in an economy. Tax as an instrument of fiscal policy consists of changes in government revenues or in rates of taxes aimed at encouraging or restricting private expenditures on consumption and investment. Taxes determine the size of disposable income in the hands of the general public which in turn determines aggregate demand and possible inflationary and deflationary gaps. The structure of tax rates is varied in the context of the overall economic conditions prevailing in an economy. During recession and depression, the tax policy is framed to encourage private consumption and investment. A general reduction in income taxes leaves higher disposable incomes with people inducing higher consumption. Low corporate taxes increase the prospects of profits for business and promote further investment

(1.5 Marks)

(b)

(i)

1) An important landmark in India's monetary history is the constitution of an empowered six-member Monetary Policy Committee (MPC) in September, 2016.

2) It consist of the RBI Governor (Chairperson), the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board and the remaining three central government nominees representing the Government of India.

3) The MPC shall determine the policy rate required to achieve the inflation target.

4) Fixing of the benchmark policy interest rate (repo rate) is made through debate and majority vote by this panel of experts.

5) With the introduction of the Monetary Policy Committee, the RBI will follow a system which is more consultative and participative similar to the one followed by many of the central banks in the world.

(2 Marks)

The new system is intended to incorporate:

- Diversity of views,
- Specialized experience,
- Independence of opinion,
- Representativeness, and
- Accountability.

(0.5 Mark)

(ii)

1) All states and union territories of India calculate state and district level income estimates

2) Net state domestic product (NSDP) measures (in monetary terms) the volume of all goods and services produced in the state within a given time period, accounted without duplication

$$\text{Per capita state income} = \frac{\text{NSDP}}{\text{Mid year population of state}}$$

3) These estimates are prepared by the state income units of the respective state Directorates of economics and statistics

4) Regional accounts help in decision making process at the regional level by providing comprehensive data base

5) However for certain sectors such as railways, communication etc business operations take place across various states. These are know as Supra regional sectors. For all such sectors estimates are Computed for the economy as a whole and then allocated to the states based on various parameters

(2 Marks)

Q.5

(a)

(i)

Precautionary motive:

It is necessary to be cautious about future which is uncertain. Uncertainity is an important element in Keynesian precautionary motive. An additional amount of money over and above for a known -requirement is held for **contingencies, sudden expenditure, illness, accident or to grab opportunity of advantageous purchase money may also be required at a time of temporary unemployment.**

Business people hold cash with them to meet any unforeseen expenditure or to take advantage of favourable market condition when price declines.

A firm's precautionary demand for money is influenced by political uncertainty. When political conditions are unstable business firms tend to be more cautious and hold larger amount of cash. The demand for money for transaction & precautionary motive is directly related to income.

(0.5 Mark)

Transaction motive

People require money to carry out transaction at all types but most of them receive income once is a month sometimes once in a week or even daily in case of daily wage earners.

There is a time gap between two successive Income receipts but not between the expenses incurred on various transaction. Transaction motive is divided in to two parts,

1) Income motive

2) Business motive

Income motive:

It refers to transaction demand for money by wages and salary earners. They receive their Income once in a month, in few cases weekly or daily. Money is required for these people to carry out transaction at all kind they may incur regular payment like Rent, electricity, glossary bill & other payments. Suppose the time interval between Income receipts is a month. People required to hold money with them to meet the daily payments. Money held for this purpose gradually decline over the period.

Business motive:

Business firms required to hold money to meet their day to day transaction. The time interval of a firm may be a month or two or even longer as there is always a time gap between production and realization of its value. Meanwhile they are required to keep money for payment of various bills such as electricity, rent, raw material, wages etc.

(0.5 Mark)

(ii)

Escalated tariff: Higher tariff will be charged when countries import Finished goods and lower tariff will be charged when countries import raw material, it protects domestic industries in importing countries

(1 Mark)

Mixed Tariffs: Mixed tariffs are expressed either on the basis of the value of the imported goods (an ad valorem rate) or on the basis of a unit of measure of the imported goods (a specific duty) depending on which generates the most income.

(1 Mark)

(b)

(i)

Effects of currency appreciation on the economy:

- Exports become more expensive. The price Exports will increase making exports more expensive. Therefore with a higher price, we would expect to see a fall in the quantity exports.
- Imports become cheaper: Domestic consumers will find that more goods can be purchased with the same amount of money. Therefore, with cheaper imports, we would expect to see an increase in the quantity of imports.
- Lower (X-M) with lower export demand and greater spending on imports, we would expect fall in domestic Aggregate Demand (AD), causing lower growth.
- Lower inflation. An appreciation tends to cause lower inflation because import prices are cheaper. The cost of imported goods and raw materials will fall after an appreciation, e.g. imported oil will decrease, leading to cheaper petrol prices.

(3 Marks)

(ii)

Pure Public Goods: In economics, a pure public good is a good that is both non-excludable and non-rivalrous in that individual cannot be effectively excluded from use and where use by one individual does not reduce availability to others. The concept of pure public good is often criticized by many who point out that such goods are not in fact observable in the real world. They argue that goods which perfectly satisfy non rivalrous and non- excludability are not easy to come across. For example, if the government provides law and order or medical care, the use of law courts or medical care by some individuals subtracts the consumption of others if they need to wait.

(1 Mark)

Impure Public Goods: There are many hybrid goods that possess some features of both public and private goods. These goods are called impure goods and are partially rivalrous or congestible. Because of the possibility of congestion, the benefit that an individual gets from an impure public good depends on the number of users. Consumption of these goods by another person reduces, but does not eliminate, the benefits that other people receive from their consumption of the same good. For example, open access Wi-Fi networks become crowded when more people access it.

(1 Mark)

OR

Following are some of the benefits of Foreign Direct Investments in the host country:

- FDI foster competition and generates a competitive environment in the host country. The domestic enterprises are compelled to compete with the foreign enterprises operating in the domestic market. This results in positive outcomes in the form of cost-reducing and quality-improving innovations, higher efficiency.
- FDI can accelerate growth and foster economic development by providing the much needed capital, technological know-how, management skills and marketing methods and critical human capital skills in the form of managers and technicians.

(1 Mark)

- Competition for FDI among national governments also has helped to promote political reforms important to attract foreign investors, including legal systems and macroeconomics polices.
- FDI generates direct employment in the host country. Subsequent FDI as well as domestic investments propelled in the downstream and upstream project that comes up in multitude of other services generate multiplier effects on employment and income.

(1 Mark)