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CLASS: XII ECONOMICS

Solution of Central Problems in Different Types of Economy.

Different economies solve the central problems differently, as under:

Market Economy/ Capitalist Economy

A Market economy is a free economy. It means that producers are free to decide 'what, how and for whom to produce'. On what basis do they take their decisions? It is on the basis of supply and demand forces in the market.

What to Produce? The producers will produce those goods which are more in demand and less in supply. Such goods offer a high price and high profit to the producers.

How to Produce? The producers will use those inputs which keep their cost of production as low as possible. So that their profits are maximised.

For whom to Produce? In a free economy, the producers will produce goods for those people who can afford to pay the high price. Poorer sections of the society are often ignored. It causes the problem of Economic Divide, as noted above.

Centrally Planned Economy/ Socialist Economy

In a centrally planned economy, decisions related to 'what, how and for whom to produce' are taken by some central authority appointed by the government of the country.

All decisions are taken with a view to maximising social welfare. Unlike the market economy, profit maximisation is not the consideration. Those goods and services will be produced which the central authority or the government finds as the most useful for the society. That technique of production is adopted which is socially more useful. In a situation of mass unemployment, for example, labour intensive technology will be preferred rather than capital intensive technology, so that unemployment is reduced. Enough goods will be produced for poorer sections of the society even when production of such goods does not yield a profit. Priority is given to social welfare than profit maximisation.

Mixed Economy

Mixed economy shares the merits of both capitalist economy and socialist economy. Decisions regarding 'what, how and from whom to produce' are taken on the basis of market forces as well as on the basis of social consideration. In certain areas of production, producers are free to take their decisions with a view to maximising profits. In certain other areas, decisions are taken entirely on the basis of social consideration. For example - In India producers are free to produce cloth or steel to maximise their profits. But 'Railways' are the monopoly of the government. The government provides transport services at nominal rates so that poorer section of the society can avail them. Thus, India is an example of Mixed Economy.

Types of Costs

Fixed Costs (FC) -The costs which don't vary with changing output. Fixed costs might include the cost of building a factory, insurance and legal bills. Even if your output changes or you don't produce anything, your fixed costs stays the same.

Variable Costs (VC) - Costs which depend on the output produced. For example, if you produce more cars, you have to use more raw materials such as metal. This is a variable cost.

Semi- Variable Cost. Labour might be a semi-variable cost. If you produce more cars, you need to employ more workers; this is a variable cost. However, even if you didn't produce any cars, you may still need some workers to look after empty factory.

Total Costs (TC) = Fixed + Variable Costs

Marginal Costs – Marginal cost is the cost of producing an extra unit. If the total cost of 3 units is Rs.1550, and the total cost of 4 units is Rs.1900. The marginal cost of the 4th unit is Rs.350.

Opportunity cost – Opportunity cost is the next best alternative foregone. If you invest Rs.1 crore in developing a cure for pancreatic cancer, the opportunity cost is that you can't use that money to invest in developing a cure for skin cancer.

Economic Cost. Economic cost includes both the actual direct costs (accounting costs) plus the opportunity cost. For example, if you take time off work to a training scheme. You may lose a weeks pay Rs 5000, plus also have to pay the direct cost of Rs.1200. Thus the total economic cost = Rs. 6200.

Accounting Costs – This is the monetary outlay for producing a certain good. Accounting costs will include your variable and fixed costs you have to pay.

Sunk Costs. These are costs that have been incurred and cannot be recouped. If you leave the industry you cannot reclaim sunk costs. For example, if you spend money on advertising to enter an industry, you can never claim these costs back. If you buy a machine, you might be able to sell if you leave the industry.

Money Cost:

'Money Cost' is the monetary expenditure on inputs of various kinds. It is the total money expenses incurred by a firm in producing a commodity. They include wages and salaries of labour; cost of raw-material, expenditure on machines and equipment, depreciation and obsolescence charges on machines, building and other capital goods; rent on building; interest on capital invested and borrowed ; normal profits of business, expenses on power, light, fuel, advertisement and transportation, insurance charges and all types of taxes.

Unit I

Introduction

Q. 1 Defend or refute the following statements. Give reasons also

1)Microeconomics does not deal with aggregates.
2)Opportunity cost refers to explicit cost of production.
3)Production possibility curve may sometimes be convex to the origin.
4)Central problems of an economy are found only in those economies which are not governed or regulated by the government.
5)Scarcity exists even when certain goods are available at zero price.
6)Marginal opportunity cost falls as resources are shifted from Use-1 to Use-2
7)PPC is drawn on the assumption of constant technology.
8)Economising the use of resources means saving the resources for future use

Q.2 Write your comment on each of the following statements in a sentence or two:
1)Choice between consumer goods and capital goods refers to the problem of 'how to produce'.

2)Choice between labour intensive technology and capital intensive technology refers to the problem of 'what to produce'.
3)Choice between 'production for the poor' and 'production for the rich' refers to the problem of what to produce
4)In a market economy, the central problems are solved by the central authority of the government
5.In a centrally planned economy, the central problems are solved by the forces of supply and demand.
6)In a mixed economy, only public sector is engaged in the process of production.
7)Problem of resource allocation is automatically solved in a mixed economy
8)Production possibility curve shows possibilities of production when different technologies are used
9)Economic activity would not exist if resources were not scarce
10) A point below PPC points to under utilisation of resources.

Q.3 Complete the following sentences:
1.Mixed economy is the one in which____
2.In a capitalist economy, the problem of resource allocation is solved by____
3. .Marginal opportunity cost refers to the loss of output of Good-1 when____
4.Growth of resources causes a shift in PPC to the________________________________
5.When an economy is operating inside the PPC, it is a situation of ____________________.
6. In a state of economic slowdown (or recession) when there is massive unemployment and the economy fails to operate on the PPC, it tends to operate_____________________________
7.Destruction of resources causes a shift in PPC to the____________________________
8.Discovery of resources (or new technology) causes a shift in PPC to the_________________

HOTS (Higher Order Thinking Skills)

Write 'true' or 'false' with a reason:
1.With an efficient utilisation of resources, an economy can shift to point beyond the PPC.
2**.** When output of Good-1 increases from 200 units to 210 units and output of Good-2 decreases from 400 units to 350 units, marginal opportunity cost = 50 units.
3. When an economy moves from a situation of underemployment to full employment, PPC curve shifts to the right.

4. Marginal rate of transformation refers to the slope of PPC.
5. Convexity of PPC to the origin points to increasing slope of PPC and increasing marginal opportunity cost.
6. Problem of resource allocation would not arise if resources had no alternative uses.

7. If a country is operating inside the PPC, it is saving its resources for future growth. 8. If an economy is operating inside the PPC, it is possible to increase the production of Good-1 without any decrease in the production of Good-2
8. Opportunity cost is an avoidable cost
9. Even when resources and technology are constant, an economy may not operate on the PPC.

Unit II

Consumer Equilibrium and Demand

QUESTION SET–I

Defend or refute the following statements. Write 'yes' or 'no' with reason:

1. All attainable combinations of Good-X and Good-Y are below the budget line of a consumer.
2. Demand for a commodity can exist independent of its price.
3. Quantity demanded is a specific amount of a commodity that the consumer is ready to buy against a specific price, while demand is not.
4. Demand for a commodity refers to the entire demand schedule.
5. It is quantity demanded (and not demand for a commodity) that changes with respect to its own price.
6. Marginal utility of each unit of a commodity adds up to total utility.
7. Total utility will increase even when marginal utility decreases.
8. . Total utility is maximum when marginal utility starts declining.
9. . Increase in demand refers to extension of demand
10. . Decrease in demand refers to contraction of demand.
11. . In case of inferior goods, law of demand fails.
12. . Giffen goods must be inferior goods, while inferior goods, may or may not be giffen goods.
13. . In case of substitute goods, a fall in price of Good-X causes a fall in demand for Good-Y.
14. . In case of complementary goods, a rise in price of Good-X causes a rise in demand for Good-Y
15. Indifference curve is not convex to the origin.
16. MRS (marginal rate of substitution) along an indifference curve tends to diminish.
17**.** A consumer strikes his equilibrium when: MUX/ PX= MUM.
18. A consumer strikes his equilibrium when: MUX/PX =MUY /PY= MUM
19. A consumer strikes his equilibrium when: MRS = PX/PY.
20. A situation when MRS > PX/ PYis better than when MRS = PX /PY.
21. A situation when PX/PY > MUX/ MUYis better than when PX/PY = MUX/ MUY

QUESTION SET–II

Write your comment on each of the following statements in a sentence or two

1. MU must diminish as more and more standard units of a commodity are continuously consumed.
2. Cross price effect occurs in case of substitute goods, and not in case of complementary goods.
3. In an indifference curve map, higher IC always points to higher level of satisfaction.

4. Changes in income causes a shift in demand curve, while change in price does not.
5. Even when PX remains constant, QX may increase or decrease.
6. Elasticity of demand refers to change in quantity consequent upon change in price of the commodity.
7. When total expenditure on the commodity remains constant, price elasticity of demand also remains constant, no matter what the change in price is.
8. Elasticity of demand (with respect to price of the commodity) is constant along a straight line demand curve.
9. If price elasticity of demand is zero, it means expenditure on the commodity does not change with change in price of the commodity.
10. A commodity showing high elasticity of demand often has a large number of close substitutes in the market.
11. Elasticity of demand tends to be high over a short period of time than the long period.
12. Complementary goods often exhibit low elasticity of demand.
13. Luxuries of life often exhibit low elasticity of demand.
14. Higher the price level, higher should be the elasticity of demand.
15. A horizontal straight line demand curve shows zero elasticity of demand.
16. A vertical straight line demand curve shows that demand rises to infinity even when price remains constant.
17. Price elasticity of demand is identical with slope of demand curve.
18. From a point of intersection, a flatter demand curve shows greater elasticity of demand than a steeper demand curve.
19. In case of normal goods, income effect is positive, while in case of inferior goods, it is negative
20**.** In case of giffen goods, income effect is always greater than the substitution effect.

QUESTION SET–III Complete the following sentences:

1. When price of the commodity increases, demand for the commodity ______________________
2. When demand for the commodity increases, demand curve curve________________________
3. When demand curve shifts, price of the commodity____________________________________
4. In case of normal goods, there is a positive relationship between_________________________
5. Moving along an indifference curve, we find that MRS tends to__________________________
6. Moving along a price line, we find that price ratio (PX/PY) remains______________________
7. In case of IC analysis, a consumer strikes his equilibrium when_________________________
8. In case of utility analysis (and one-commodity case) a consumer strikes his equilibrium when ____
9. In case of utility analysis (2-commodity case) a consumer strikes his equilibrium when ____.
10. Demand curve slopes downward because of the law of________________________________
11. Downward sloping demand curve shows the law of___________________________________
12. Convexity of IC to the origin shows____
13. Elasticity of demand (with respect to price of the commodity) shows____________________
14. Law of demand fails in situations of (*i*) ____
ii) ______________________________________and (*iii*) ____________________________ .
15. Demand curve shifts to the right because of (*i*) _____________________________________, (*ii*) ____, and (*iii*) _____________________________.
16. When price of tea increases, demand for sugar will tend to _____________________________
17. Even when price of the concerned commodity remains constant, people tend to buy less of it, because(*i*) ___________________________, (*ii*) ____________________________, and

(*iii*) ________________________________
18. If demand curve is a rectangular hyperbola, elasticity of demand = ____________________
19. At the mid-point of straight line downward sloping demand curve, elasticity of demand = ___________________________________ .
20. In case of a perfectly elastic demand, demand curve for the concerned commodity is____ .
21. In case of a perfectly inelastic demand, demand curve for the concerned commodity is ____ .

HOTS (Higher Order Thinking Skills) **Write 'true' or 'false' with a reason**

1 If 5% increase in PX causes 5% increase in expenditure on Good-X, elasticity of demand = 1

2 If 5% increase in PX is accompanied with constant expenditure on the commodity, elasticity of demand.

3 When slope of demand curve = 0, price elasticity of demand = infinity.

4.A consumer consumes only two goods X and Y and is equilibrium Price of X falls.Explain the reaction of consumer through the utility analysis.5.Ms Pratima was hungry ,hence she decided to eat bananas However after eating 2 bananas,she suddenly realized that now she is enjoying less.Hence she decided to eat rest of the bananas later on .Identify the reason behind the above case.Also state the underlying assumptions.6. What price a consumer is willing to pay for a commodity in state of equilibrium?