

Economics

(Micro-economics)

Chapter 1: INTRODUCTION TO MICRO-ECONOMICS



INTRODUCTION TO MICRO-ECONOMICS

Simple Economy

An individual performs many activities in his day-to-day life. For Example, going to office, spending time with children, watching TV, etc All the activities performed by an individual can be classified as economic activities and non-economic activities.

Microeconomics	Macroeconomics
Microeconomics studies economic relationships or economic problems at the level of an individual, an individual firm or household or consumer.	Macroeconomics studies economic relationships or economic problems at the level of the economy as a whole.
It is basically concerned with the determination of output and price for an individual firm or industry.	It is basically concerned with determination of aggregate output and general price level in the economy as a whole.

Positive economics study the problem and its related issues which are subject to verification. The positive statements describe what was, what is and what would be under the given set of situations.

Normative economics offers suggestions to solve the problem. The normative statements describe what ought to be.

Economy and its Central Problems

Economy is a system spread over a particular area which reveals the nature and the level of economic activities in that area. It shows how people of the concerned area earn their living.

Types of Economy

Market Economy

Market economy is a free economy. It means that producers are free to decide what, how and for whom to produce. Their decision is based on the demand and supply forces in the market. Self-interest is the prime consideration, and hence there is profit motive behind every economic activity in a market economy.

Centrally Planned Economy

Centrally planned economy is an economy in which all economic decisions are taken by the government or by the central authority. Economic resources are owned by the society and are used in public interest. The social welfare or collective welfare is the prime consideration behind allocation of resources to the production of different goods and services in a centrally planned economy.

Mixed Economy

Mixed economy combines the merits and avoids the demerits of market economy and centrally planned economy. They decide what, how and for whom to produce on the basis of market forces and also on the basis of social considerations.

Economic Problem

Economic problem is the problem of choice arising from the use of limited means to satisfy the various wants.

Central Problems

In every economy, there are three economic problems, they are:

- What to produce?
- How to produce?
- For whom to produce?

What to produce?

Land, labour, capital, machines, equipments and natural means are limited. All demands, of every individual in the economy cannot be satisfied, so society has to decide the commodities which are to be produced and the quantities in which they are to be produced. If we produce one commodity, it could lead to neglecting the production of another commodity. If we assume all factors of production in the economy to be fully absorbed, and still want to increase the production of one commodity, then we need to withdraw resources from the production of other commodities.

How to produce?

'How to produce' means how to organise production. It is the second basic economic problem of resource allocation. It is the central problem concerned with the choice of technique of production. In a developing country such as India, there is always a choice between labour intensive technology and capital intensive technology.

Under labour intensive technology, labour is used more than the capital. It ensures greater employment and social justice. Under capital intensive technology, capital is used more than the labour. It ensures greater efficiency and productivity.

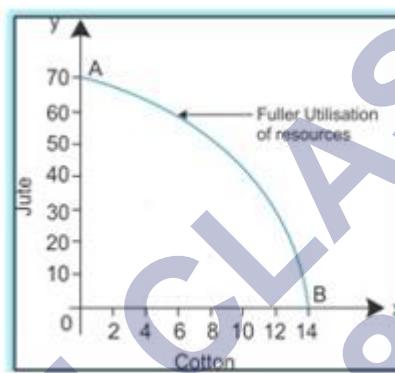
Hence, there is a central problem between the social justice and efficiency in productivity. This problem is concerned with the efficient use of resources which implies more production with low cost. Thus, one needs to decide the efficient technique of production which uses the least amount of scarce resources to provide the same amount of output.

For whom to produce?

'For whom to produce' is the third problem of allocation of resources. This relates to the

distribution of national products among the various individuals. It is true that sharing of national product is directly influenced by the income of an individual. People having higher income will definitely possess higher purchasing capacities. Therefore, for proper and equal distribution of goods and services, there should be equality of income among all the people of the society. To achieve this situation, Karl Marx suggested that the distribution of national income should be according to the contributions made by each individual to the total production i.e. the individual must receive income exactly equal to what she produces. Thus, we can see that every economy faces the problem of allocating its national resources to the production of different goods and services and of distributing the produced goods and services among the individuals within the economy.

Production Possibility Curve



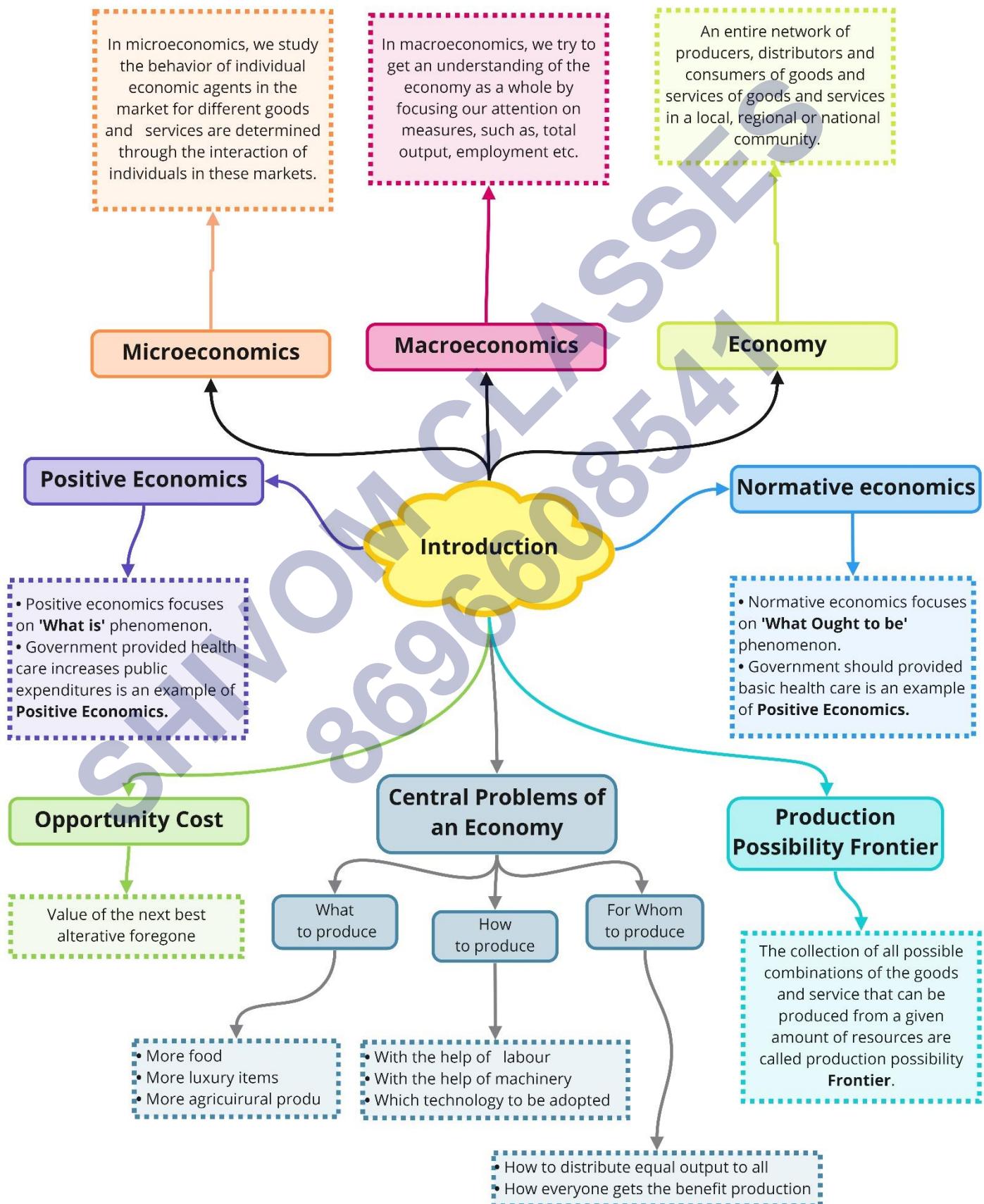
Production possibility curve is a curve which shows different combinations of two goods that can be produced with the given amount of resources and a given stock of technology in the economy.

Characteristics of PPC

- Slopes downwards to the right: PPC slopes downwards from left to right. It is because in a situation of fuller utilisation of the given resources, production of both the goods cannot be increased simultaneously. More of commodity A can be produced only with less production of commodity B.
- Concave to the point of origin: It is because to produce each additional unit of commodity A, more and more units of commodity B will have to be sacrificed. Opportunity cost of producing every additional unit of commodity A tends to increase in terms of the loss of production of commodity B. Production will act upon the law of increasing marginal opportunity cost.

The Marginal Opportunity Cost (MOC) is the rate at which the quantity of output of one commodity is sacrificed to produce one more unit of the other commodity. Hence, MOC is calculated in terms of the loss of output of Y for every additional unit of X produced when resources are shifted from A to B.

$$\text{MOC} = \text{Unit of one good sacrificed} / \text{More units of other good produced} = \Delta A / \Delta B$$



Important Questions

Multiple Choice Questions-

1. Which Economist divided Economics in two branches of micro and macro on the basis of economic activity?
 - (a) Marshall
 - (b) Ricardo
 - (c) Ragnar Frish
 - (d) None of these
2. Which of the following is studied under Micro Economics ?
 - (a) Individual unit
 - (b) Economic Aggregate
 - (c) National Income
 - (d) None of these
3. Which of the following economic activities are included in the subject-matter of Economics?
 - (a) Economic Activities related to Unlimited Wants
 - (b) Economic Activities related to Limited Resources
 - (c) Both (a) and (b)
 - (d) None of these
4. On which base structure of economic problems has been installed?
 - (a) Unlimited Wants
 - (b) Limited Resources
 - (c) Both (a) and (b)
 - (d) None of the above
5. 'Micros', which means 'Small' belongs to:
 - (a) Arabian word
 - (b) Greek word
 - (c) German word

(d) English word

6. Which of the following statement is true?

(a) Human wants are infinite

(b) Resources are limited

(c) Scarcity problem gives birth to choice .

(d) All of these

7. Which of the following is the salient feature of factors (or resources) ?

(a) These are limited as compared to wants

(b) These have alternative uses

(c) Both (a) and (b)

(d) None of the above

8. Which is a central problem of an economy ?

(a) Allocation of Resources

(b) Optimum Utilisation of Resources

(c) Economic Development

(d) All of these

9. Which of the following Is a type of economic activities ?

(a) Production

(b) Consumption

(c) Exchange and Investment

(d) All of these

10.To which factor, economic problem is basically related to:

(a) Choice

(b) Consumer's Selection

(c) Firm Selection

(d) None of these

11.Economy may be classified as:

(a) Capitalist

(b) Socialist

(c) Mixed

(d) All of these

12. Which economy has a co-existence of private and public sectors ?

(a) Capitalist

(b) Socialist

(c) Mixed

(d) None of these

13. The main objective of a socialist economy is.....

(a) Maximum production

(b) Economic freedom

(c) Earning profit

(d) Maximum public welfare

14. In which economy decisions are taken on the basis of price mechanism ?

(a) Socialist

(b) Capitalist

(c) Mixed

(d) All of these

15. The slope of a production possibility curve falls:

(a) From left to right

(b) From right to left

(c) From top to bottom

(d) From bottom to top

Very Short:

1. What are the three central problems of Economy?

2. Give two examples of Micro and Macro Economy.

3. Define Scarcity.

4. A growth of resources in an economy is shown in PP by.

5. What is Production Possibility Frontier?

6. Define marginal rate of transformation.

7. What are the three central problems of an economy?
8. What is the opportunity cost?
9. What do you mean by economizing of resources?

Short Questions :

1. From the scheduled PP evaluate MRT of good X.

Product Possibility	Production of good X units	Production of good Y units
A	0	14
B	1	13
C	2	11
D	3	8
E	4	4

2. Define Normative Economics.
3. What does the problem for whom to produce refer to?
4. What does the opportunity cost mean? Explain with a numerical example.

Long Answer Questions:

1. What is the difference between the planned economy and market economy?
2. Explain the central problem of the choices of products to be produced.

Case Study Question:

1. Read the following hypothetical text and answer the given questions:

Each economy has scarce resources and will have possibility of being exhausted gradually after a continuous use. Growth of resources, therefore, become a basic problem of the economy. It can achieve this objective through technological advancement. Under-developed countries like India, Pakistan, Thailand etc. have remained poor because of poor growth of their resources. Besides fuller utilization of resources, these countries should try to raise their productive capacities, by

exploring further availability of natural resources and discovering better techniques for their use. Moreover, full use of productive capacity is also indispensable for the growth of the economy.

Since economic theory is classified into Micro and Macro Theory. Microeconomic theory deals with the allocation of resources in the market economy. In this theory, decisions regarding 'what', 'how' and 'for whom' to produce are decided on the basis of price mechanism. Goods are freely bought and sold in the market economy on an agreed price.

Macroeconomic theory deals with the fuller and efficient use of resources. It also deals with the growth of resources and problems relating saving, investment, inflation, unemployment etc. Development economics deals with the problem of growth of resources.

1. Which is a central problem of an economy?

- (a) Allocation of resources
- (b) optimum utilisation of resources
- (c) Economic development
- (d) all of these

2. To which factor, economic problem is basically related to:

- (a) Choice
- (b) Consumer selection
- (c) firm selection
- (d) none of these

3. What measures have been followed by India to raise its productive capacities by exploring:

- (a) Technique
- (b) Natural resources
- (c) Discovering better technique
- (d) all of these

4. Macro Economics deals with the _____

- (a) Allocation of resources
- (b) Aggregate use of resources
- (c) both (a) & (b)
- (d) none of these

2. Read the following hypothetical text and answer the given questions:

In reality, all economies are mixed economies where some important decisions are taken by the government and the economic activities are by and large conducted through the market. The only difference is in terms of the extent of the role of the government in deciding the course of economic activities. In the United States of America, the role of the government is minimal. The closest example of a centrally planned economy is China for the major part of the twentieth century. In India, since Independence, the government has played a major role in planning economic activities. However, the role of the government in the Indian economy has been reduced considerably in the last couple of decades.

1. Whether the following statement is True or false:

"A centrally planned economy has been followed by India in the last two decades".

2. Economy may be classified as:

- (a) Capitalist
- (b) socialist
- (c) mixed
- (d) all of these

3. Which economy has a co-existence of private and public sectors?

- (a) Capitalist
- (b) Mixed
- (c) Socialist
- (d) none of these

4. In the USA, the role of the government is minimal, due to:

- (a) Capitalist economy
- (b) socialist economy
- (c) mixed economy
- (d) all of these

Assertion Reason Question:

1. In these questions, a statement of assertion followed by a statement of reason is given. Choose the correct answer out of the following choices.
 - (a) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A)
 - (b) Both Assertion (A) and Reason (R) are true, and Reason (R) is not the correct explanation of Assertion (A)
 - (c) Assertion (A) is true, but Reason (R) is false.

(d) Assertion(A) is false, but Reason (R) is true.

Assertion (A): 'Both, microeconomics and macroeconomics have same degree of aggregation'.

Reason (R): Micro economics involves limited degree of aggregation and Macroeconomics involves the highest degree of aggregation.

2. In these questions, a statement of assertion followed by a statement of reason is given. Choose the correct answer out of the following choices.

- (a) Both Assertion (A) and Reason (R) are true, and Reason (R) is the correct explanation of Assertion (A)
- (b) Both Assertion (A) and Reason (R) are true, and Reason (R) is not the correct explanation of Assertion (A)
- (c) Assertion (A) is true, but Reason (R) is false.
- (d) Assertion(A) is false, but Reason (R) is true.

Assertion (A): Utility is directly linked with the usefulness of a commodity.

Reason (R): A commodity may be useful, yet it may have utility for a particular person. For example, chewing tobacco is harmful for health, yet many people derive high degree of utility from it.

MCQ answers:

1. (d) None of these
2. (d) None of these
3. (c) Both (a) and (b)
4. (c) Both (a) and (b)
5. (b) Greek word
6. (c) Scarcity problem gives birth to choice
7. (c) Both (a) and (b)
8. (d) All of these
9. (d) All of these
10. (a) Choice
11. (d) All of these
12. (c) Mixed
13. (d) Maximum public welfare
14. (b) Capitalist
15. (c) From top to bottom

Very Short Answers:

1. The three central problems of Economy are.
 - What to Produce
 - How to Produce
 - For whom to Produce
2. The two examples of Micro economy are Individual supply and individual demand and the two examples of Macro economy are aggregate supply and aggregate demand.
3. Scarcity refers to the deficit of resources as compared to the demand.
4. Rightward Shift
5. Production Possibility Frontier is the curve that depicts the maximum output possibility for two combination goods that are produced when the resources are fixed at a given period of time.
6. Marginal Rate of Production MRT is the ratio of a particular product sacrificed to manufacture another product. $MRT = \Delta y / \Delta x$
7. The three central problems of an economy are (a) What to produce? (b) How to produce (c) For whom to produce?

8. Opportunity Cost is the next best alternative foregone.
9. Economizing means making the best of the available resources.

Short Answers :

1.

Production of good X units	Production of good Y units	MRT= $\Delta y / \Delta x$
0	14	-
1	13	1 : 1
2	11	2 : 1
3	8	3 : 1
4	4	4 : 1

2. Normative Economics is a theory that understands what an actual economy should be under an ideal circumstances as compare to what actually it is. It is mostly based on judgmental analysis and a statement 'what ought to be'.
3. The problem for whom to produce refers to a particular section of people who will consume the end product. Here, the problem of choices arises because the manufacturers are unable to produce each product in huge quantity to satisfy everybody's need. So, the consumers' have to make choices between which product is more important to them, so the limited resources can be distributed rationally.
4. Opportunity Cost is something when an individual has to give up something to achieve or acquire something else. In microeconomy, the opportunity cost is also known as alternative cost and is also used in calculating cost benefits or analysing a project in terms of best alternative while making a choice.

For example, Dev has three career offers to choose from. Job X has a salary offer of Rs 60000, job Y offer is Rs. 70000 and job Z offer is Rs. 80000. So, in this case, out of three offers, Dev has to choose what is best for him. If Dev opts for job offer Z the next best alternative not chosen is job offer Y and thus the opportunity cost is Rs 70000.

Long Answers:

1. Planned Economy – A planned economy has one person or a group who takes a decision on production, investment, pricing, and distribution, etc, and produces products and services that are pre-planned. The planned economy is a centrally planned economy and the decisions are basically taken by the government. In another term, the planned economy is also known as a command economy because everybody has to follow one person, his command and guidelines. The aim of the

planned economy is to increase production by making sure that everything required is manufactured and that everyone's requirements are fulfilled.

Most assets are controlled and owned by the state.

Market Economy- A market economy is controlled by external authority and may have one individual who might decide what to produce, whom to produce, and how to get the things done. This type of economy keeps changing according to the demand and supply and taste of a consumer. The main issue in the economy is that a company might refuse to manufacture goods if it's unprofitable for them. Most assets are controlled and owned privately.

Few differences between the planned economy and market economy are as follows.

- The planned economy operates according to the structure planned by the government. Whereas, the market economy operates based on market demand.
 - A decision on production, investment, pricing, and distribution, etc are taken by the government whereas in the market economy it is in the free market.
 - A planned economy doesn't identify consumer needs, supply, and shortages. Whereas, in a market economy, demand and supply are based on those factors.
2. The basic economic activities are based on the production, allocation, and distribution of goods and services. These are the major problem in the economy and other difficulties revolve around them. Allocation of goods and services relates to a problem of assigning the inadequate supplies in such a way so that it fulfills that maximum number of the consumer.

As the demand for the insufficient goods is more than that of the supply it is important to utilize it in the most effective way. In other words, an economy allocates its goods and resources and pick from a different possible package of goods (what to produce), select from various ways of production (how to produce), and therefore decide who will utilize the product (for whom to produce).

Case Study Answer:

1. Answer:

1. (d) 2. (a) 3. (d) 4. (b)

2. Answer:

1. False 2. (d) 3. (b) 4. (a)

Assertion Reason Answer:

1. (d) Assertion (A) is false, but Reason (R) is true.
2. (b) Both Assertion (A) and Reason (R) are true and Reason (R) is not the correct explanation of Assertion (A).