ECONOMICS BASIC NOTES - PART 4

BASED ON: **CLASS XII- NCERT**
INTRODUCTORY MICROECONOMICS

1. Basic economic activities of life are production, exchange and consumption. As the resources are limited we need to make choice how to utilize resources and for what product or service to produce and how much to produce.

2. **PRODUCTION POSSIBILITY FRONTIER:** The resources of an economy as a whole are always limited in comparison to what the people in the economy collectively want to have.
The scarce resources have alternative usages and every society has to decide on how much of each of the resources to use in the production of different goods and services.
Every society has to decide/ determine how to allocate its resources which are scarce, to different goods and services.
Thus, society can have various combinations of different goods and services. Given the total amount of resources, it is possible to allocate the resources in many different ways and thereby achieving different mixes of all possible goods and services.

THE COLLECTION OF ALL POSSIBLE COMBINATIONS OF THE GOODS AND SERVICES THAT CAN BE PRODUCED FROM A GIVEN AMOUNT OF RESOURCES AND A GIVEN STOCK OF TECHNOLOGICAL KNOWLEDGE IS CALLED THE PRODUCTION POSSIBILITY CURVE OR PRODUCTION POSSIBILITY FRONTIER OR PRODUCTION POSSIBILITY SET OF THE ECONOMY.

PRODUCTION POSSIBILITIES
RESOURCE: LAND LABOUR

POSSIBILITIES	CORN	COTTON
ONE	0	10
TWO	1	9
THREE	2	7
FOUR	3	4
FIVE	4	0

Consider an economy which can produce corn or cotton by using its resources. The table above gives some of the combinations of corn and cotton that the economy can produce when its resources are fully utilized. If all the resources are used in the production of corn, the maximum amount of corn that can be produced is 4 units and if all resources are used in the production of cotton, at the most, 10 units of cotton can be produced. The economy can also produce 1 unit of corn and 9 units of cotton or 2 units of corn and 7 units of cotton or 3 units of corn and 4 units of cotton. There can be many other possibilities. The table illustrates the production possibilities of the economy.

If more of the scarce resources are used in the production of corn, less resources are available for the production of cotton and vice versa. Therefore, if want to have more of one of the goods, we will have less of the other good. Thus, there is always a cost of having a little more of one good in terms of the amount of the other good that has to be forgone. This is known as the opportunity cost of an additional unit of the goods.

Every economy has to choose one of the many possibilities that it has. In other words, one of the central problems of the economy is to choose from one of the many production possibilities.

PRODUCTION POSSIBILITIES
RESOURCE: STEEL. LABOUR

POSSIBILITIES	SCOOTER	CARS
ONE	10	0
TWO	8	1
THREE	6	2
FOUR	4	3
FIVE	2	3.5
SIX	0	5

3. ORGANISATION OF ECONOMIC ACTIVITIES OF A NATION:

TWO TYPES:

THE CENTRALLY PLANNED ECONOMY: In a centrally planned economy, the government or the central authority plans all the important activities in the economy. All important decisions regarding production, distribution and consumption of goods and services on behalf of the society are taken by the central authority.

For example: if it is found some goods or services which are considered good for the society but not being produced in enough quantity government either give directions to producers to produce that good or service by giving incentives of subsidy or tax concessions or government decides to produce that good or service to produce by itself. It happens generally with merit good like education and health services.

THE MARKET ECONOMY: In market economy, all economic activities are organised through the market.
A MARKET is an institution which organises the free interaction of individuals pursuing their respective economic activities.
In a market system, all goods or services come with a price (which is mutually agreed upon by the buyers and sellers) at which the exchanges take place.
The price reflects the society's valuation of the good or service in question.
If the buyers demand more of certain good the price of that good will rise.
This signals to the producers of that good that the society as a whole want more of that good than is currently being produced and the producers of the good, in their turn, are likely to increase their production.
So here, in the market system the issue of how much and what to produce are solved through the coordination of economic activities brought about by the price and demand signals.

INDIAN ECONOMY: Indian economy is a mixed economy where some important decisions are taken by the government and the economic activities are by and large conducted through the market. 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.

4. **MICROECONOMICS AND MACROECONOMICS**: The subject matter of economics has been studied under two broad branches:

MICROECONOMICS & MACROECONOMICS

In microeconomics, we study the behavior of individual economic agents in the markets for different goods and services. We study how prices and quantities of goods and services are determined through the interaction of individuals in the market.

In macroeconomics we try to understand of the economy as a whole by studying on aggregate measures such as total output, employment and aggregate price level. Here we are interested to know how the levels of these aggregate measures change over time.

CHAPTER 2
THEORY OF CONSUMER BEHAVIOUR

1. How a consumer/individual decide how to spend, how to choose different goods. Consumer goes for maximum satisfaction. The likes of the consumer are called PREFERANCES.
What the consumer can afford to buy depends on prices of the goods and the income of the consumer.

2. A consumer usually decides his demand for a commodity on the basis of utility or satisfaction that he drives from it. Utility of a commodity is its want-satisfying capacity. The stronger the desire to have it, the greater is the utility derived from the commodity.
Different individuals can get different levels of utility from the same commodity. Also, utility that one individual gets from the commodity can change with change in place and time.

3. **CARDINAL UTILITY ANALYSIS**: Cardinal utility analysis assumes that level of utility can be expressed in numbers.

Total Utility: total satisfaction derived from consuming the given amount of some commodity.
Marginal Utility: Marginal utility is the change in total utility due to consumption of one additional unit of a commodity. For example, suppose 4 bananas give us 28 units of total utility and 5 bananas give us 30 units of total utility. Clearly consumption of the 5th banana has caused total utility to increase by 2 units. Therefore, marginal utility of the 5th banana is 2 units.

LAW OF DIMINISHING MARGINAL UTILITY: Marginal utility from consuming each additional unit of a commodity declines as its consumption increases.
At one stage Marginal utility will become zero. Thereafter it goes even negative.

4. **DEMAND CURVE:** DEMAND FOR A COMMODITY- The quantity of a commodity that a consumer is willing to buy and is able to afford, at a given prices of goods and income of the consumer is called demand for that commodity
Demand curve is a graphic presentation of various quantities of a commodity that a consumer is willing to buy at different prices of the same commodity. It is presumed that prices of other commodities and his income remain constant.

The downward sloping demand curve shows that at lower prices, the individual is willing to buy more of that commodity. At a higher price he will be less willing to buy that commodity. Therefore, there is a negative relationship between price of a commodity and quantity demanded which is referred to as the LAW OF DEMAND.

5. **NORMAL GOODS**: The quantity of a good that the consumer demands can increase or decrease with the rise in income depending on the nature of the good. For most goods, the quantity that a consumer chooses, increases as the consumer's income increases and decreases as the consumer's income decreases. Such goods are called normal goods. Thus, a consumer's demand for a normal good move in the same direction as the income of the consumer.

6. **INFERIOR GOODS**: There are some goods the demands for which move in the opposite direction of the income of the consumer. Such goods are called inferior goods. As the income of the consumer increases, the demand for an inferior good fall, and as the income decreases, the demand for an inferior good rise. Ex. Low quality food items like coarse cereals.

   A GOOD CAN BE A NORMAL GOOD FOR THE CONSUMER AT SOME LEVELS OF INCOME AND AN INFERIOR GOOD FOR HER AT OTHER LEVELS OF INCOME. AT VERY LOW LEVELS OF INCOME A CONSUMER'S DEMAND FOR LOW QUALITY CEREALS CAN INCREASE WITH INCOME. BUT BEYOND A LEVEL, ANY INCREASE IN INCOME OF THE CONSUMER IS LIKELY TO REDUCE HER CONSUMPTION OF SUCH FOOD ITEMS AS SHE SWITCHES TO BETTER QUALITY CEREALS.
   OTHER EXAMPLE IS WALKING/ BUS RIDE/ SCOOTER RIDE/ AND TAXI RIDES

7. **SUBSTITUES AND COMPLMENTS**: The quantity of a good that the consumer chooses can increase or decrease with the rise in the price of a related good depending on whether the two goods are substitutes or complementary to each other.
   Goods which are consumed together are called complementary goods. Ex. Tea and sugar, shoes and socks, pen and ink, etc.

   Since tea and sugar are used together, an increase in the price of sugar is likely to decrease the demand for tea and decrease in the price of sugar is likely to increase the demand for tea. Similar is the case with other complements. IN GENERAL, THE DEMAND FOR A GOOD MOVES IN THE OPPOSITE DIRECTION OF THE PRICE OF ITS COMPLEMENTARY GOODS.
   In contrast to complements, goods like tea and coffee are not consumed together. In fact, they are substitutes for each other. Since tea is a substitute for coffee, if the price of coffee increases, the consumers can shift to tea, and hence, the consumption of tea is likely to go up. On the other hand, if the prices of coffee decreases, the consumption of tea is likely to go down. The demand for a good usually moves in the direction of the price of its substitutes.

8. **SHIFTS IN THE DEMAND CURVE**:
   The demand curve had following assumptions:
   - no change in consumer's income
   - no change in price of other goods
   - no change in preference of the consumer

   WHAT WILL HAPPEN IF ANY OF THESE THINGS CHANGES
   THERE WILL BE SHIFT IN DEMAND CURVE: The demand for the good at each price changes
   For normal goods, the demand curve shifts rightward and for inferior goods, the demand curve shifts leftward.
   If there is an increase in the price of a substitute good, the demand curve shifts rightward. On the other hand, if there is an increase in the price of a complimentary good, the demand curve shifts leftward.
   The demand curve can also shift due to a change in the tastes and preferences of the consumer. If the consumer's preference changes in favour of a good, the demand curve for such a good, shifts rightward.
   The demand curve for ice-creams, for example, is likely to shift rightward in the summer because of preference for ice-creams goes up in summer.
   Revelation of the fact that cold-drinks might be injurious to health can adversely affect preferences for cold drinks. This is likely to result in a leftward shift in the demand curve for cold drinks.

9. **MOVEMENTS ALONG THE DEMAND CURVE**: At higher prices, the demand is less, and at lower prices, the demand is more. Thus, any change in the price leads to movements along the demand curve.

10. **ELASTICITY OF DEMAND:** The demand for a good move in the opposite direction of its price. But the impact of the price change is always not the same.
Sometimes, even for a small change in price leads to change in demand considerably.
There are some goods for which the demand is not affected much even when the price changes.

    Price elasticity of demand for a good is defined as the percentage change in demand for the good divided by the percentage change in the price.
    Demand for essential goods is often found to be same even when price increases.

    Demand for luxury goods is seen to be elastic (means changes in demand levels) when there is changes in market price.
    For some commodities there is change in quantity demanded is equals to change in price. This is called unitary elastic at that price.
    The demand for a good is likely to be elastic if close substitutes are easily available. Ex. Mobile phone, computers

CHAPTER III
PRODUCTION AND COSTS / BEHAVIOUR OF THE CONSUMERS

1. **PRODUCTION** is carried out by producers or firms. A firm acquires different inputs like labour, machines, land, raw materials etc. It uses these inputs to produce output. This output is consumed by consumers. Firm has to pay for the inputs, this is called the cost of production. Once output has been produced, the firm sell it in the market and earns revenue. The difference between the revenue and cost is called the firm's profit. Firms will try to earn maximum profit.

2. Production function: the production function of a firm is a relationship between inputs used and output produced by the firm. For various quantities of inputs used, it gives the maximum quantity of output that can be produced. It is for a given technology. If the technology improves, the maximum levels of output obtainable for different input combinations increase. We have then new production function.

3. **ISOQUANT**: consider a production function with two inputs labour and capital. An isoquant is the set of all possible combinations of the two inputs that yield the same maximum possible level of output. Each isoquant represents a particular level of output and is labelled with that amount of output.

4. **SHORT RUN AND THE LONG RUN**:
In the short run, at least one of the factor-labour or capital cannot be varied (changed) and therefore remains fixed. In order to vary the output level, the firm can very only the other factor. The factor that remains fixed is called the fixed factor whereas the other factor which the firm can vary is called the variable factor.

    In the long run, all factors of production can be varied. A firm in order to produce different levels of output in the long run may vary both the inputs simultaneously. So, in the long run, there is no fixed factor.

5. **TOTAL PRODUCT**: Suppose we vary a single input and keep all other inputs constant. Then for different levels of that input, we get different levels of output. This relationship between the variable input and output, keeping all other inputs constant, is often referred to as Total Product of the variable inputs.

6. **AVERAGE PRODUCT**: Average product is defined as the output per unit of variable input.

7. **MARGINAL PRODUCT**: Marginal product of an input is defined as the change in output per unit of change in the input when all other inputs are held constant.

PERFECT COMPETITION: A perfectly competitive market has the following features:
- The market consists of a large number of buyers and sellers
- Each firm produces and sells a homogeneous product. The product of one firm cannot be differentiated from the product of any other firm.
- Entry into the market as well as exit from the market are free for firms
- Information is perfect and everyone has the access to the same information.

NON-COMPETITIVE MARKETS

1. Perfect competition is a market structure where both consumers and firms are price takers. Perfect competition market structure has following conditions:
- there exist a very large number of firms and consumers of the commodity, such that output sold by each firm is negligibly small compared to the total output of all the firms combined, and similarly, the amount purchased by each consumer is extremely small in comparison to the quantity purchased by all consumers together
- firms are free to start producing the commodity or to stop production; entry and exit free
- The output produced by each firm in the industry is indistinguishable from the others and the output of any other industry cannot substitute this output
- Consumers and firms have perfect knowledge of the output, inputs and their prices.

If one of these conditions are not satisfied, the market will not remain perfect.
In case entry and exit is not happening then market may not have many firms. In the extreme case a market may have only one firm. Such a market where there is one firm and many buyers is called a monopoly.

A market that has a small number of large firms is called an oligopoly

2. In a market structure in which there is a single seller is called monopoly. A monopoly market structure there is a single producer of a particular commodity. No other commodity works as a substitute for this commodity.