#### COMPLEMENTARY COURSE III: BUSINESS ECONOMICS

SEMESTER	COURSE CODE	HOURS PER WEEK	CREDIT	EXAM HRS
ш	3C03 COM	5	4	3

After studying this course, students shall be able to;

CO 1: Understand the concept of economics and its use in business

CO 2: Understand the concept of demand, elasticity and demand forecasting

CO 3: Understand production function and law of production

CO 4: Understand the methods of determining price of a product

CO 5: Explain the methods of computing national income.

CO 6: Conceive the developmental issues of Indian economy and Kerala economy

#### Unit I:

Managerial Economics:- Economics- meaning- definitions -Differences between micro economics and macro economics - Managerial economics— - Definition and characteristics - Nature and Scope - characteristics- distinction between managerial economics and general economics - Relationship of managerial economics with other disciplines - role and responsibility of managerial economist.

#### Unit II:

Demand estimation- demand- Law of demand-demand curve- exceptions of law of demand-elasticity of demand – price – income- advertisement- cross- uses- measurement-Law of diminishing marginal utility. Supply- determinants- Law of supply - Demand forecasting – short term and long term- methods of forecasting- forecasting demand for new product.

#### Unit III:

(20 Hrs)

(18 Hrs)

Production and production function- Cobb Douglas production function- law of production – law of diminishing returns – law of returns to scale - isoquants, isocost, optimum combination of inputs, economies and diseconomies of scale.

(15 Hrs)

#### Unit IV:

Pricing and pricing policies- objectives of pricing - factors affecting pricing policytypes of pricing- cost plus pricing - marginal cost pricing - going rate pricing - BEP pricing - product line pricing - pricing of a new product.

(15 Hrs)

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Unit V: National Income –concept and meaning - Computation of NI- Methods and Difficulties - Economy's income and expenditure – Measurement of GDP –components of GDP – Real versus nominal GDP –GDP deflator – monitory and fiscal policies- pros and cons –Demonetization –meaning – objects and impact. Development issues of Indian economy- Poverty, Inequality, Unemployment and Black money–Features of Kerala economy-Kerala model of development- decentralized planning in Kerala.

(22 Hrs)

#### Reference:

1. R.L. Varshney and K.L. Maheswari, Managerial Economics

- 2. Ahuja. HL; Business Economics, S. Chand & co.
- 3. D.N. Dwivedi, Managerial Economics

4. Dr. S. Sankaran, Managerial Economics

5. DM Mithani: Business Economics

6. Seth M L Text Book of Economic Theory

7. K K Dewett: Economic Theory

8. Dutt & Sundaram: Indian Economy

9. Petersen &. "Lewis: Managerial Economics

- 10. Mote V L peul. S & Gupta G S: Managerial Economics
- 11. H. Craig Petersen & W. Cris lewis: Managerial Economics

## INTRODUCTION TO MANAGERIAL ECONOMICS

## **Economics**

Economics is a social science concerned with production distribution and consumption of goods and services.

## Wealth definition (Adam Smith):

Adam Smith states that economics is the study of wealth i.e, how wealth is produced and distributed.

## Welfare definition (Alfred Marshall):

Marshall states that economics study both wealth and man. He shifted the emphasis from wealth to welfare.

#### Scarcity definition (Robbins):

Robbins state that economics is a science of scarcity.Human wants are unlimited but resources are scarce or limited.

## Growth definition (Samuelson):

This definition states that economics is a study of how people use their limited resources to satisfy their unlimited wants.

Branches or types of economics

# **Economics**

Micro economics

It is the study of individual economic unit

Macro economics

It is the study of entire economy

#### **Managerial Economics**

Managerial economics is the use of economic theories and analytical tools in managerial decision making.

The main difference between managerial economics and business economics is that business economics is economic theory used in business whereas managerial economics is economic theory applied in all organisations whether in business or non business.

## **Characteristics of Managerial or Business Economics**

1.It is micro economic in character

- 2.It is a **normative science.**
- 3.It is pragmatic.
- 4.It prescribe solutions to all business problrms.
- 5.It uses macro-economic theories.

6.It uses theory of firm.

## 7.It is **management oriented**.

8.It is **multi-disciplinary** because It is related wIth various concepts like mathematics and statistics.

## Scope/Importance/Need/Uses of Managerial Economics

1.Managerial economics are used in <u>analysing the demand</u> of products and <u>forecasting the</u> <u>future demands</u>.

2.Managerial economics are required in order to ensure the **<u>optimum utilisation of scarce</u>** <u>resources</u>.

3.It help in the cost and production analysis.

4.Economic tools are used in managerial decision making for the purpose of <u>profit</u> management.

5. It provide tools and techniques for managerial decisions.

6. The price of a product has to be fixed according to the conditions in the market. So <u>the</u> <u>pricing policies</u> is included in the scope of managerial economics

7. Managerial economics helps to estimate the financial requirement i.e, capital budgeting.

8. Managerial economics uses various <u>inventory management</u> techniques to ensure the efficient availability of stock.

## **Objectives of Managerial Economics**

1. Assist in maximising the profit of the firm.

2.Assist in making decisions on risk management, manufacturing, pricing, and investment.

3.Make cost-effective suggestions.

4.To help in demand estimating and forecasting.

5.To help in sales forecasting.

6.To help business in solving business problem.

7.To plan and organise business activities in a strategic manner.

## **Relationship of Managerial Economics with Micro Economics**

Managerial economics make use of mostly micro economics theory and concepts. It makes uses the micro economic concepts like elasticity of demand, marginal analysis, market structures etc. in managerial decision making.

## **Relationship of Managerial Economics with Macro Economics**

Macroeconomics deals with the study of entire economy. It considers all the factors such as government policies, business cycles, national income, etc. which are essential for the managerial decision making.

## **Relationship of Managerial Economics with Statistics**

Statistics supplies many tools to managerial economics. In managerial economics, measures of central tendency like the mean, median, mode, and measures of dispersion, correlation, regression, least square, estimators are widely used.

#### **Relationship Of Managerial Economics with Mathematics**

Mathematics is used in managerial economics for estimating various economic relationships, and it is used in decision-making and forward planning.

## **Relationship Of Managerial Economics with Operations Research**

Operational research is the application of mathematical techniques to solving business problems. Managerial economics uses it to find out the optimum combination of various factors to achieve maximisation of profit, minimisation of cost and time etc.

#### **Relationship of Managerial Economics with Accounting**

Accounting provides information to the management in the form of financial statements such as trading account, profit and loss account, and balance sheet. It helps the management to know the profit and the financial position of the organisation which will help in the decision making and forward planning.

#### **Relationship of Managerial Economics with Management**

Managerial economics helps the management to achieve its objectieves.Managerial economics also helps in discharging various managerial functions such as planning, forecasting, controlling etc.

## **Role/Function/Responsibilities of Managerial Economist**

1.Sales forecasting.

- 2.Understand the objectives of the business.
- 3. Prodution scheduling.
- 4.Keep the management informed about the changing environment
- 5.Suggest ways to expand markets.
- 6.Assist in financing.
- 7.Bring reasonable profit.

# **Demand Analysis**

## Utility

The capacity of a commodity to satisfy a want is known as utility.

## Total Utility

Total utility is the total satisfaction received from consuming a given total quantity of a good or service.

## Marginal Utility

marginal utility is the satisfaction gained from consuming an additional quantity of a goods or services.

## Consumer Equilibrium in Terms Of Utility

The state at which a consumer derives maximum utility from the consumption of one or more goods and services with his/her level of income is called consumer's equilibrium.

## Law of Diminishing Marginal Utility

The law of diminishing marginal utility states that all else equal, as consumption increases, the marginal utility derived from each additional unit declines.

No. of mangoes	Total Utility	Marginal Utility
1 2	5 9	5
3	12	3
4	14	2
5	15	1
6	15	0
7	14	-1

Assumptions of the Law of Diminishing Marginal Utility

1. The units of commodity are identical.

2. Consumers taste and preference are unchanged.

3.No change in the income of the consumer.

4.Price of the goods remain unchanged.

Marginal utility	Total utility
Declines	Increases but at a diminishing rate
Reaches zero	Reaches maximum
Becomes negative	Declines from the maximum

## Relationship Between Marginal Utility and Total Utility

## DEMAND

The quantity which the consumers are willing and able to buy in a given period is known as demand.

## Law of Demand

The law of demand states that when prices go up, demand goes down – and when prices go down, demand goes up. This law state an inverse relationship between price and demand.

# PT D

# P↓D

Assumption of Law of Demand

1. Consumers taste and preference are unchanged.

2.No change in the income of the consumer.

3.Price of the related (substitute and complement) goods remain unchanged.

4. The commodity should not be a prestige commodity.

Law of demand can be explained with the help of *demand schedule and demand curve*.

## **Demand Schedule**

A demand schedule is a table that shows the quantity demanded of a good or service at different price levels.

## Individual demand schedule

Individual demand schedule refers to a tabular statement showing various quantities of a commodity that a consumer is willing to buy at various levels of price, during a given period of time.

#### Market demand schedule

Market demand schedule refers to a tabular statement showing various quantities of a commodity that all the consumers are willing to buy at various levels of price, during a given period of time.

## Demand Curve

Demand curve displays a graphical representation of demand schedule. It shows relationship between price and demand. Demand curve is sloped downward.

## Individual Demand Curve

The graphical representation of individual demand schedule.

## Market Demand Curve

The graphical representation of market demand schedule.

## Reasons for the Downward Slopping of Demand Curve

## 1.Law of diminishing marginal utility

- 2. Change in the no. of consumers
- 3.Multiple use of the commodity.
- 4.Income effect
- 5.Substitution effect

#### 6.Price effect

## **Exceptions to the Law of Demand**

1.Veblen goods: Goods that become valuable with the rise of their price are known as Veblen goods.

2.Inferior goods: Goods whose demand drops when people's incomes rise.

- 3. Necessary Goods
- 4. Income Change among consumers.
- 5. Emaergency situation like war
- 6.Brand loyalty
- 7.Festivals and marriages
- 8.Commodities which are out of fashion.

## Determinants of Demand

1.price of commodity.

- 2.Nature of commodity.
- 3. income of the consumers.
- 4. Taste and preference of the consumers.
- 5.Price of related goods.
- 6.Changes in population.
- 7Availability of credit

#### **Demand Function**

The mathematical relationship between demand and its various factors is called demand function.

The demand function of a commodity can be written as follows: -

D=f(P,Y,T,Ps,U)

Where, D= Demand

P=Price of the commodity

Y=Income of the consumer

T=Taste and preference of the consumer

Ps=Price of substitute and complement

U=Consumer expectation and other factors

F=function of

## Importance of Law of Demand

1.Law of demand help to fix the price of a product.

2.Law of demand help government to fix the tax for goods based on the demand.

3.Law of demand helps farmers to know how his crop will affect his economic condition.

#### Elasticity of Demand

Elasticity of demand is the rate of change in demand in response to the change in price.

## Types of Elasticity

#### 1.Price Elasticity

Price elasticity refers to the degree of responsiveness of change in demand due to change in price.

ED=<sup>Proportionate change in quqntity demanded</sup> Proportionate change in price

**Degrees of Elasticity/Types of price elasticity** 

#### **1.Perfectly elastic demand**

When a small change in price of a product causes a major change in its demand, it is said to be perfectly elastic demand.



Here e (elasticity)  $=\infty$ 

#### **2.Perfectly Inelastic Demand**

When a demand of a product doesn't change with the change in price, it is said to perfectly inelastic.

Here e=0



#### **3.Relatively Elastic Demand**

when the proportionate change produced in demand is greater than the proportionate change in price of a product it is said to be relatively elastic.

Here e = > 1

#### **4.Relatively Inelastic Demand**

when the percentage change produced in demand is less than the percentage change in the price of a product it is said to be relatively inelastic.

Here= < 1

#### 5.Unit Elastic (Unitary Elastic) Demand

When the proportionate change in demand produces the same change in the price of the product, the demand is referred as unitary elastic demand.



#### Measurement of Price Elasticity of Demand

Methods used to measure the price elasticity of demand are: -







#### 1. Proportional or Percentage Method

Where price elasticity is calculated in terms of the rate of the percentage change in the quantity demanded to the percentage change in price.

# $ED = \frac{Proportionate \ change \ in \ quantity \ demanded}{Proportionate \ change \ in \ price}$

#### 2. Expenditure or Outlay Method

This method was developed by professor Alfred Marshall. The price elasticity of demand can, be calculated by comparing the total expenditure on the commodity before and after the change in price and demand.

#### 3.Geometric or Point Method

This method was developed by professor Alfred Marshall. The Geometric method measures the elasticity of demand at different points on the demand curve when there is small change in price and demand. Formula to calculate e: -

 $ED = \frac{Lower \ section \ of \ the \ demand \ curve}{Upper \ section \ of \ the \ demand \ curve}$ 

#### 4.Arc Method

The arc method measures the elasticity of demand at different points on the demand curve when there is large change in price and demand. Formula to calculate e: -

 $ED = \frac{\Delta Q}{\Delta P} * \frac{(P1 + P2)}{(Q1 + Q2)}$ 

#### Uses of Price Elasticity

**1.Determination of price.** 

2.Price determination under discriminating monopoly.

**3.Price determination of joint products** 

4.Wage determination.

5. It helps the government to fix tax for various products.

#### 2.Income Elasticity

Income elasticity refers to the degree of responsiveness of change in demand due to change in income.

Income Elasticity (EY) =  $\frac{Proportionate \ change \ in \ quantity \ demanded}{Proportionate \ change \ in \ income}$ 

#### Types of Income Elasticity

**1.Zero Income Elasticity**: - when a change in income does not lead to change in quantity demanded, there is zero income elasticity.

**2.Negative Income Elasticity**: - When an increase in demand leads to a decrease in quantity demanded, there is negative income elasticity.

**3.Positive Income Elasticity**: - When an increase in income leads to an increase in the quantity demanded, there is positive income elasticity.

## Uses of Income Elasticity

1.Helps in investment decision.

2.Helps in forecasting demand.

3.Helps in categorising goods.

## **3.Cross Elasticity**

Cross elasticity refers to the degree of responsiveness of change in demand due to change in price of another commodity.

ED= <u>Percentage change in quantity demanded of commodity A</u> <u>Percentage change in price of commodity B</u>

## Types Of Cross Elasticity

**1.Positive cross elasticity**: - When increase in the price of good A leads to increase in the demand for good B, there is positive cross elasticity.

**2.Negative cross elasticity**: - When increase in the price of good A leads to a decrease in the demand for good B, there is negative cross elasticity.

**3.Zero cross elasticity**: - When the change in the price of good A does not affect the demand for good B, there zero cross elasticity.

## Uses of Cross Elasticity of Demand

## 1. Determining nature of relationship between any two goods

## 2.Forecasting change of demand

## **3.Pricing policy**

## 4.Determination of boundaries between industries

## 4.Advertising /Promotional Elasticity

Advertising elasticity refers to the degree of responsiveness of change in demand due to advertising/promotional expenses.

 $Advertising \ Elasticity (Ea) = \frac{Proportionate \ change \ in \ sales}{Proportionate \ change \ in \ advertising \ and \ other \ promotional \ expenditure}$ 

## Uses of Advertising Elasticity

1.Helps in preparing advertising budget.

2.Helps in determining optimum level of advertising expenditure.

3.Helps in production planning.

Supply

Supply means the amount of a commodity that a producer is willing to supply at a given period of time.

## Determinants of Supply

1.Price of the commodity.

- 2.Cost of production.
- 3.Price of related goods.
- 4.Technology
- 5.Govt.policy.
- 6.Means of Transportation.
- 7. Environmental/natural factors.

8. Times periods.

## Law of Supply

Law of supply states that price and quantity supplied of a good are directly related to each other. In other words, when the price for a goods rises, then suppliers increase the supply of that good in the market.

## Assumptions of Law of Supply

1. There is no change in the income of the consumers.

- 2. There is no change in the level of technology.
- 3. There is no change in the price of related goods.
- 4. The price of factors of production remains unchanged.
- 5. Production is subject to law of constant returns.
- 6.Supply of factors of production is elastic.

The law of supply can be explained with the help of supply schedule and supply curve.

## Supply Schedule

It is a schedule of different quantities of a good which a producer is willing to supply at different price levels of that good.

Types of Supply Schedule

## 1.Individual Supply Schedule: -

Individual supply schedule refers to a tabular statement showing various quantities of a commodity that an individual producer is willing to sell at various levels of price, during a given period of time.

## 2.Market Supply Schedule: -

Market supply schedule refers to a tabular statement showing various quantities of a commodity that all the producers are willing to sell at various levels of price, during a given period of time.

## Supply Curve

The graphical representation of supply schedule is called supply curve. It shows the relationship between price and quantity supplied. supply curve is normally slopes upward.

## Types of Supply Curve

## **Individual Supply Curve**

The graphical representation of individual supply schedule.

## **Market supply Curve**

The graphical representation of market demand schedule.

# **Demand Estimation and Forecasting**

Demand Estimation	Demand Forecasting	
1.Demad estimation refers to	1.Demand forecasting means	
quantifying links between the	estimating future demand on the basis	
demand for a product and the	of past data	
variables which determine demand.		
2.Demand estimation succeeds	2.Demand forecasting precedes	
demand forecasting.	demand estimation.	
3.It is for short run.	3.It is for long run	

## **Objectives of Demand Forecasting**

Short term objectives

- 1.To ensure best utilisation of machines
- 2.To determine financial requirement.
- 3.To help in the determination of suitable price policies.
- 4. To eliminate the problem of under or over production.

## Long term objectives

- 1.To plan long term production.
- 2.To help the capital budgeting.
- 3.To determine an appropriate dividend policy.

4.To forecast the future problems of material supply and energy crisis.

## Role and Importance of Demand Forecasting

1.Producing the desired output.

- 2.import and export policies.
- 3.Assessing the probable demand.
- 4. Forecasting sales figures.
- 5.Better control.

6.Controlling inventory.

- 7.Assessing manpower requirement.
- 8.Planning import and export policies.

## Steps of Demand Forecasting

## 1.Setting the Objectives: -

An organisation needs to clearly states the purpose of demand forecasting. The purpose may be to understand the market share of the firm or to increase the production.

## 2.Determinig the time period: -

Before taking up forecasting, the company has to decide the period of forecasting — Whether it is a short-term forecast or long-term research.

#### 3.Selecting a method of demand forecasting: -

Appropriate demand forecasting method is selected by the company taking into account all the relevant information, purpose of forecasting and the degree of accuracy required, to save time and cost.

## 4.Collecting data: -

Reliable data are necessary for demand forecasting. Data may be primary or secondary.

#### 5.Estmating the results: -

On the basis of analysis and interpretation of the collected data an estimate for future demand is made according to the method adopted.

## Short Term Demand Forecasting

If the forecasting is done for one year or less than one year, it is known as short term demand forecasting. It provides information for day-to day decisions.

## Long Term Demand Forecasting

If the forecasting is done for a period more than 2 years it is called long term demand forecasting. It is important for taking capital investment decisions, decisions related to diversify, expand, mergers and acquisitions.

## Methods of Demand Forecasting for Established product

## 1.Survey method: -

Under this method surveys are conducted to collect information about the future purchase plans of potential customers. This method is used for short term forecasting. Important survey methods are:

- (a) Consumers interview method: -Under this method consumers are interviewed directly and asked the quantity they would like to buy. If all the consumers are interviewed then it is called <u>complete enumeration method</u>. If only few selected consumers are interviewed then it is called <u>sample survey method</u>.
- (b) Collective opinion method: Under this method the sales man estimates the expected sales in their respective territories on the basis of previous experience. It is also known as sales force method.
- (c) Expert opinion method: under this method demand is estimated on the basis of opinions of experts and distributors other than consumers and sales man. It also known as Delphi method.
- (d) Consumer clinic method: Under this method the consumers are given certain money and are asked to buy the products of the firm at two different prices. Then the demand is estimated on the basis of the behaviour of the consumer in response to the prices.
- (e) End use method: In this method a list of end users of a product is prepared. Then the demand of all end users for the product is added to get the total demand for the product.

#### 2.Statistical method: -

Under this method past data are used as a guide for knowing the level of future demand. It is generally used for long run forecasting. Important statistical methods are: -

- (a) Trend projection method: Trend projection uses the past sales data to project future sales. This method makes use of time series. Then trend in the time series are obtained through least square method, moving average method, semi-average method or free hand method.
- (b) Regression and correlation: -Under this method the relationship between the sales (dependent variable) and other variables (independent variable such as price of related goods, income, advertisements) is ascertained. Such relationship may be used to analyse the future trend.
- (c) Barometric technique: Under this method demand is forecasted just like is weather is forecasted. Certain economic and selected indicators from the time series are used to predict the demand. This is an improvement of trend projection method.
- (*d*) Extrapolation: Under this method the future demand can be assumed by applying binomial expansion method.

## Methods of demand forecasting of new product

## 1.Evolutionary approach: -

This method is based on the assumption that the new product is the improvement of an old product, so the demand is estimated on the basis of the old product.

## 2.Subtitute approach: -

This method is based on the assumption that the new product is a substitute for an existing product, so the demand is analysed as a substitute for some existing product.

## 3.Growth curve approach: -

Under this method the growth rate of demand of a new product is estimated on the basis of the growth rate of demand of an existing product.

## 4.Opinion poll approach: -

Under this method the demand of a new product is estimated on the basis of the information collected from the interviews with the customers.

## 5.Sales experience approach: -

Under this method the new product is offered for sale in the sample market and the total demand is estimated from there.

## 6.Vicarious approach: -

Under this method demand is estimated by surveying consumers reaction through the specialised dealers who are in touch with consumers.

## Criteria of good forecasting method

- 1.Plausibility
- 2.Reliability
- 3.Accuracy
- 4.Ease of use
- 5.Cost effectiveness
- 6.Timeliness
- 7.Flexibility

## **Production and Production Function**

#### Meaning of production

Production is the process of producing goods and services by combining various factors of production. It is the conversion of inputs into outputs.

#### Factors of Production

The resources used or required for producing a given product is called factors of production. Land, Labour, Capital and Organisations are the factors of production.

## **Production Function**

Production function states the maximum quantity of output that can be produced from any combination of inputs.

It can be expressed with the following equation: -

Q=f(L, K, T....n)

Where, Q=output

L=labour

K=capital

T=technology

n=other inputs

## Assumption of Production Function

- 1. The level of technology remains unchanged.
- 2. The firm uses inputs efficiently.
- 3.It relates to a particular unit of time.
- 4. There are two factors of production, (L) Labour and (K) Capital.
- 5. Change in any of the variable factors produce corresponding change in output.
- 6.The outputs are divisible into most viable units.

## Managerial Uses of Production Function

1.Production function helps in determining the combination of various factor which are at least cost.

2.It helps to determine the optimum level of output.

3.It enables to plan the production.

4.It helps in decision making.

## Cobb Douglas Production Function

The Cobb-Douglas production function is one which takes into account two inputs, labour and capital, for the entire output of the manufacturing industry. The formula Is as follows: -

 $Q = K L^a C^{(1-a)}$ 

Where, Q=Output

L=Quantity of labour

C=Quantity of capital

K and a=positive constants

## Importance of Cobb Douglas Production Function

1.It is suitable to all industries.

2.It is more popular in empirical research.

3.It is useful in interpreting the macroeconomic results.

Limitation of Cobb Douglas Production Function

1.It includes only two factors.

2.It is based on the substitutability of factors.

3.It assumes perfect competition in the factor market. This is unrealistic.

Laws of Production

The laws of production show the relationship between additional input and additional output. The laws of production consist of: -

1.Law of Diminishing Returns

2.Laws of Returns to Scale

## A. Law Of Diminishing Returns or Law of Variable Proportion

The law of variable proportion states that, if one factor is used more and more, keeping the other factors constant, the total output will increase at an increasing rate in the beginning and then at a diminishing rate and eventually decreases absolutely.

# This law shows the effect of changes in factor proportions on the quantity of output. That is why the law is called the law of variable proportion.

This law can be explained with the help of following diagram: -



Stage I: -At this stage Total Product (T P), Marginal product (MP) and Average Product (AP) are increasing. Hence this stage is known as stage of increasing returns.

Stage II: - At this stage TP continues to increase at a diminishing rate and both AP and MP diminish. At the end of the second stage, MP becomes zero, TP reaches the maximum, AP shows a steady decline. This stage is known as stage of diminishing return.

Stage III: - In this stage the TP declines. AP Shows a steady decline, MP becomes negative. Hence, the third stage is known as stage of negative return.

\*<u>Note</u>: -

**Total Product or Total Physical Product (TPP):** This is the quantity of output a firm obtains in total from a given quantity of input

**Average Product or Average Physical Product (APP):** This is the total physical product (TPP) divided by the quantity of input.

Marginal product or Marginal Physical Product (MPP): It is the increase in total output that results from a one unit increase in the input, keeping all other inputs constant.

## Assumptions of Law Variable Proportion

1. Only one input factor is variable and other factors are kept constant.

2.All the units of the variable factor are homogenous.

- 3.Factors of production are scarce.
- 4. The law operates in the short run.

## Practical Importance of the Law of Variable Proportion

- 1. Basis of Malthusian theory of population.
- 2.Basis of the marginal productivity theory of distribution.
- 3.Price determination.
- 4.Optimum production.

## **B.** Laws of Returns to Scale

Laws of returns to scale analyse the relationship between input and output, when there is change in all factors. It is along run analysis.

## Assumptions: -

1.All the inputs are variable.

- 2. There are no technological changes.
- 3. The output is measured in quantities.
- 4. There is perfect competition.

## Stages of Returns to Scale

i) Increasing returns to scale

- ii) Constant returns to scale
- iii) Decreasing/Diminishing returns to scale
  - a) Increasing Returns to scale: -

If a proportionate increase in all factors of production results in a more than proportionate increase in output, it is called increasing returns to scale.

b) Constant Returns to Scale: -

If a proportionate increase in all factors of production results in an equal proportionate increase in output, it is called constant returns to scale.

c) Decreasing Returns to Scale: -

If a proportionate increase in all factors of production results in a less than

Proportionate increase in output, it is called decreasing returns to scale.



#### Difference between Law of Variable Proportion and Law of Returns to Scale

Base	Law of Variable Proportion	Law of Returns to scale
1.Time period	Short run	Long run
2.Vriability of factor	One variable factor	All factors are variable
3.Factors of production	Factor proportion is varied	Factor proportion is constant,
		Scale of proportion is altered
4.phases of the laws: -		
1.phase I	Stage of increasing returns	Increasing returns to scale
2.phase II	Stage of diminishing returns	Constant returns to scale
3.phaseIII	Stage of negative returns	Decreasing returns to scale

## Production Function with Two Variable Inputs: -Isoquants

A production function with two variable inputs can by represented by isoquants. Isoquants are the curves which shows all the possible combination of two inputs capable of producing equal or given level of output.

#### Assumption of isoquants: -

1.there are only two inputs.

2. The two inputs can be substituted for each other.

3. Technology remains constant.

4. The shape of isoquants depend upon the extend of substitutability of the two inputs.

#### Isoquant map /equal map/equal product contours

An isoquant map consists of number of isoquants. Each isoquant in the map indicates different level of output.

Properties/Features of isoquants

1. Isoquants is downward sloping to the right.

- 2.A higher isoquant represents larger level of output.
- 3.No isoquant intersect or touch each other.
- 4. Isoquant need not to be parallel to each other
- 5. Isoquant is convex to the origin.
- 6.No isoquant touch either axis.
- 7. Isoquant have negative slope.

# Production Optimisation/Optimum Input Combination (Least Cost Combination/Producers equilibrium)

Optimum input combination or least cost combination is that combination which produces maximum output at minimum cost. This is the producer's equilibrium.

#### Iso-cost Curve

An isocost line indicates the different combination of the two factors which the firm can buy at given prices with a given amount of money. Thus, isocost shows the prices of two factors and the total amount of money that the firm has to spend.

#### Economies of scale

Economies of scale are the cost advantages that enterprises obtain due to the large scale of operation, and are typically measured by the amount of output produced. It can be classified into two: -

a) Internal Economies , b) External economies



#### Internal economies

Internal economies are those economic advantages which arise within the firm when it expands its size or scale of production.

#### TYPES OF INTERNAL ECONOMIES OF SCALE

Purchasing Economies - when large businesses often receive a discount because they are buying in bulk.

Managerial Economies - This is a form of division of labour. Large-scale manufacturers employ specialists to supervise production systems, manage marketing systems and oversee human resources.

Technical Economies - Large-scale businesses can afford to invest in expensive and specialist capital machinery. In the long run, they can produce more at a cheaper cost per unit

Risk Bearing Economies - The ability of large firms to spread risks over a large number of investors.

Financial Economies - Larger firms are usually rated by the financial markets to be more 'credit worthy' and have access to credit facilities, with favourable rates of borrowing. In contrast, smaller firms often face higher rates of interest on overdrafts and loans.

Marketing Economies - A large firm can spread its advertising and marketing budget over a large output and it can purchase its inputs in bulk at negotiated discounted prices if it has sufficient negotiation power in the market.

#### External Economies

When many firms in the industry expands in particular area, each firms get a number of advantages. These are known as External economies. These are also known as pecuniary economies.

## Types of External Economies of Scale

Economies of concentration: -When al large number of firms concentrate in an area then all the firm get some common benefits. These include improved transport system, banking facilities, training facilities etc.

Economies of information: -When the number of firms in an industry increase it becomes possible for them to undertake some activities collectively. A big industry may establish a research centre, Common information centre etc. for all the firms.

Economies of disintegration: -When an industry expands, the firms may mutually agree to divide the production process among themselves. This is called disintegration.

Economies of social development: -The standard of living of the people in the industrially localized area will rise.

## Diseconomies of scale

Diseconomies are the disadvantages which a firm faces when the scale of production is expanded beyond a certain level. These are classified into two: -

- i) Internal Diseconomies
- ii) External diseconomies

#### Internal diseconomies of scale

These are the disadvantages that affect only a particular firm.

## TYPES OF INTERNAL DISECONOMIES

1.Managerial diseconomies: - When a firm expands beyond a limit, managerial problem increases and, managerial efficiency declines.

2.Technical diseconomies: - There exist a chance for breakdown and accidents of existing machinery and equipment may become overstrained due to continuous production on large scale.

3.Financial Diseconomies: - When a firm borrows too much for its expansion the interest burden of the firm will become heavy.

4.Risk and Survival diseconomies: -As the firm expands its capital investment increases, so risk also increases.

## **External Diseconomies**

External diseconomies are the disadvantages that are suffered by all the firms in an industry when the industry expands in a particular area.

## TYPES OF EXTERNAL DISECONOMIES

1.Transportation diseconomies: -Concentration of many firms in an area will increase the pressure on traffic system

2.Commerical Diseconomies: -When the firm expand their sizes, naturally the prices of land, raw material, labour etc. will increase in demand for those factors.

3.Marketing Diseconomies: - When the firm expand their sizes, they are forced to spend huge money on advertisements, sales promotion etc.

4.Social diseconomies: -The concentration of large-scale industries in an area will lead to pollution.

## **Pricing and Pricing Policies**

#### Meaning of price:

Price is the amount paid by the buyer to the seller for a product.

#### Objectives of pricing:

The objectives of pricing may be broadly classified into two-economic objectives and non-economic objectives.

#### A. ECONOMIC OBJECTIVES

1.To maximize profit

2.To maintain the market share

3.To achieve a desired rate of return on investment

4.To meet or prevent competition

5.To stabilize the product prices

6.To mobilize resources for development and expansion

7.To build image and enhance the Goodwill

## **B.NON-ECONOMIC OBJECTIVES**

1.To promote social welfare

2.To contribute for industrial stability and development

3.To contribute for increase of national income

Steps in setting the price

The process of determining the price of a product is called pricing. Pricing decisions or price setting involve a number of steps.

#### **1.Studying target market**

The marketing manager has to study the nature of the target market. Without the knowledge of target market, a marketing manager will not able to determine the price.

#### 2.Selecting the pricing objectives

After studying the target market, the firm should decide what it wants to accomplish with a given product

#### **3.Determining demand**

The firm will have to determine the different quantities of products which would be demanded at different prices.

#### **4.**Estimating costs

The firm wants to set a price that will help recover all costs and yield a fair return on investment.

#### **5.**Analysing price of competitors

The firm needs to know the competitor's price and possible price reactions before deciding its own price

#### 6.Selecting the pricing method

Firm has to select an appropriate pricing method.it is selected after taking in to consideration cost, competitors prices, government legislation etc.

#### 7.Setting the final price

To decide on the final price, consumers psychology, firms pricing policies, impact on other parties etc must be considered.

#### Pricing policies

Pricing policy is the policy adopted to determine the price of a product.

#### Factors influencing pricing decisions or pricing policies

Pricing is probably the most difficult decision faced by the management. While fixing the price number of factors need to be considered. The following are the factors which influence the product price:

#### **Internal factors:**

**1.Costs**: the price must cover the cost of production.

**2.Company objectives:** maximization of sales, targeted rate of return, increase of market share etc are the important objectives.

**3.Organisational factors:** it refers to the internal arrangement or mechanism for decision making and its implementation.

**4.Marketing mix:** pricing policies have to be coordinated with policies related to other elements of marketing mix.

5.Product life cycle: the price of the product is different in each stage of life cycle.

**6.Product differentiation:** the price of the product also depends upon the characteristics of the product.

#### **External factors:**

**1.Demand:** the nature and condition of demand should be considered when fixing the price.

**2. Competition:** a firm must be vigilant about the prices charged by competitors for the similar products

**3. Channel members distribution channels:** longer the distribution channel higher would be the price and vice versa.

**4. General economic conditions:** price is affected by the general economic conditions such as inflation, deflation, trade cycle etc.

**5.** Government policy: while fixing the price, a firm has to take into consideration the taxation and trade policies of government.

**6.** Consumer's reactions: if a firm fixes the price of its product unreasonably high the consumers may boycott the product.

## Types of pricing (Methods of pricing)

An organization uses a number of method and strategies to determine the prices of its products and services. The important pricings method and strategies are:

## **1.Cost plus pricing**

Under this method the price is computed by adding a certain percentage of profit to the cost of the product per unit. This method is also known as margin pricing or full cost pricing of markup pricing.

## Advantage of cost-plus pricing:

- 1. It is the safest method.
- 2. It help to set the price easily.
- 3. Both single product and a multi-product firm can apply this method for pricing.
- 4. It ensures stability in pricing.

## **Disadvantage of cost-plus pricing:**

- 1. This method ignores the effect of demand.
- 2. It does not consider forces of market and competition.

## 2. Marginal cost pricing

Under the marginal cost pricing, the price is determined on the basis of marginal or variable cost. This method is also called variable cost pricing.

## Advantage of marginal cost pricing:

- 1. This Method is very useful in a competitive Market
- 2. This method is suitable to pricing over the life cycle of the product.
- 3. It is the most suitable method of short run pricing.

## **Disadvantage of marginal cost pricing:**

1.It requires a better understanding of marginal costing technique.

2. This method is not suitable for long run.

## 3. Break even pricing

Under this Method the firm determines the price at which it will break even. It is the point at which the total sales are equal to total cost.

## Advantages of break-even pricing:

- 1. It helps in understanding the relationship between revenue and costs of a firm.
- 3. It helps in profit planning.

## **Disadvantages of break-even pricing:**

- 1. This method is risky
- 2. This method for a long period of Time.
- 3. This method does not considered demand for the product.

## 4. Going rate pricing

It is the method off dodging prices according to what competitors are charging. This method is also called acceptance pricing or market equated pricing or parity pricing

## Advantage of going rate pricing:

1.It helps in avoiding cut-throat competition among the firm.

- 2. It is suitable to avoid price war in oligopoly
- 3. This can be used to for pricing new products.

## Disadvantage of going rate pricing:

1. This method is not suitable for long run pricing.

2. Cost of the product and other marketing factors are not considered at all under this policy.

## Pricing Strategy

A pricing strategy is a special kind of plan formulated in order to meet the challenge of external factors particularly from the policies of competitors.

## Difference between pricing policy and pricing strategy

- 1) Pricing strategy is applied to achieve a selected objective, while pricing policy is a guide to management.
- 2) Pricing policy is for the longer period while pricing strategy is a temporary period.

## Product Line

Product line refers to a group of products which have similar physical features and perform similar function.

## Product Line Pricing

Product line pricing means determining prices of all the products of a product line and their mutual relationship.

## Specific problems in product line pricing

The problems in product line pricing can be classified into two:

- A) Pricing of products with different size
- B) Pricing of products with different quality

## 1.Pricing of products with different size

This problem can be eliminated with two alternatives. They are: -

- A) Uniform price for all the products: -Under this policy uniform price is fixed for all the products irrespective of the different sizes. This is mainly used for shoe manufacturers
- **B) Different Prices for different product:** Under this policy different prices are fixed for the product of different sizes. This method used when production cost differs with the size of the product.

## 2.Pricing of product with different quality

For determining the price of the product which differ in quality, prices will be based on producer's object. These objects may be: -

- A. **To enhance the goodwill of the firm:** If the object of the producer is to enhance the goodwill of the producer, then firm will produce two or more products of different size. A higher price is fixed for quality products and lower price for other.
- B. **To face competition:** When affirm aims at facing the competition, it will produce comparatively lower quality product and fixes comparatively low price.

## Methods of Product line Pricing

1) Full cost pricing: -

Here each product covers its share of common overhead expenses, besides incremental cost

2) Incremental cost pricing: -

Here the profit margin is added to the marginal cost.

3) Pricing based on elasticity of demand: -

Under this method a low price is fixed for a more elastic market and a high price is fixed for less elastic market

4) Conversion cost Pricing: -

Under this method a uniform margin is added to the conversion cost of each product in the group. Conversion cost means cost incurred for converting raw material into a finished product.

#### 5) Life cycle pricing: -

Under this method different price is charged in each stage of a product life cycle.

Introduction stage: - High price Growth stage: -Normal price Maturity Stage: - low price Decline stage: - very low price

## Pricing of New Product (Factors affecting)

The introduction of new price in a market poses high challenges for a firm because there is no past information regarding the trends and demand. The factors affecting the pricing of new products are as follows: -

- **1.) Potential Demand: -** The estimate of demand should be made on the basis of product acceptability, market research etc.
- **2.) Pricing Objectives:** Price of the new product also depends upon the pricing objectives.
- **3.) Degree if competition**: -If a new product is introduced in a competitive market, it is desirable to fix low price and vice versa.
- **4.) Strategies of competition:** -The company while fixing the price of a new product it has to consider the strategies of their rival companies.
- 5.) Rate of market growth: If the market growth is low, it is better to charge a low price.
- **6.) Rate of erosion of distinctiveness:** If a product loses its distinctiveness at a faster rate, a high price may be charged
- **7.)** Cost structure: -If cost of production is lower than a low price is charged and vice versa.

## Methods or strategies of pricing new products

**1) Skimming price policy: -** Price skimming is a product pricing strategy by which a firm charges the highest initial price that customers will pay and then lowers it over time.

## The main reason to adopt this method: -

- A) To cover the heavy expenditure incurred on research, advertisement etc.
- B) Elasticity of demand is unknown
- C) To attract customers of high-income group.
- 2) Penetration price policy: This is the practice of charging a low price right from the beginning to stimulate the growth of the market and to capture a large share of market.

#### The main reason to adopt this method: -

- A) To discourage new competitors
- B) When the cost of production is low.
- C) When most of consumers are low-income group.

## National income

## Meaning And Definition of National Income

National Income is the aggregate of final goods and services produced in a country during one year.

## Concepts of National Income

## 1.Gross Domestic Product (GDP): -

This is the money value of all final goods and services produced by normal residents in an accounting year in the domestic territory of a country.

## 2.Net Domestic Product (NDP): -

It is the money value of all goods and services produced in an accounting year within the domestic territory of a country after providing for depreciation.

NDP=GDP-depreciation.

## 3.Gross National Product (GNP): -

It refers to the total market value of all final goods and services produced in a year.

GNP= GDP + Net income from abroad

## 4.Net National Product (NNP): -

It is the net production of goods and services in a country during an year.

NNP≈GNP-depreciation

## **5.National Income at Factor Cost**

National income at factor cost means the sum of all incomes earned by suppliers of resources for their contribution of land, labour, capital and entrepreneurship during the years net production.

National income at factor cost = NNP (or national income at market price) – (indirect taxes + subsidies)

**6.Net Domestic Product at Factor Cost:** NDP at factor cost is defined as that national production which is made by the domestic factors of a country during one year.

NDP at factor cost =NNP at factor cost – Net income from abroad

**7.Personal Income:** Personal income is the income actually received by all individuals or households in a country during the year from all sources.

Personal income = National Income -Social Security Contributions – Corporate income taxes – Undistributed corporate profits +Transfer Payments

**8 Disposable Income:** Therefore, the income left after the payment of direct taxes is called disposable personal income. This is the income available to spend and save.

Disposable Income = Personal Income - Personal Taxes

Or

Consumption +Savings

## 9. Discretionary Income:

Discretionary income is the amount of an individual income that is left for spending, investing, or saving after paying taxes and paying for personal necessities, such as food, shelter, and clothing.

## **10. Real Income**

Real income is the income which is expressed in terms of base years price (constant price)

## 11. Per Capita Income

The per capita income indicates the changes in economic progress in terms of goods and services available per head of population.

Per Capita Income =  $\frac{Natinal income}{Size of population}$ 

## Computation Of National Income

There are three phases of flow of national income, namely, production, income and expenditure. Thus, there are three methods of measurement of national income. They are, output or product method, income method, and expenditure method.

## 1. Product or Inventory Method

Under this method national income is computed by adding the net value of all commodities and services produced during a given period. Thus, national income is equal to the total of final products.

- (a) Classify the economy into different sectors such as primary sector, secondary sector, tertiary sector.
- (b) Take the physical units of output of each sector and multiply the outputs with their respective market prices and obtain the values.
- (c) Add up the total values thus obtained.
- (d) Subtract the indirect taxes from the total obtained above and then subsidies are added. This gives the N1 under value added method or product method.

## 2. Income Method

Under this method the national income of a country is obtained by adding the incomes accrue to factors of production within the national territory. In short, the national income represents the total of rent, wages, interest and profit.

Income method involves the following steps:

- (a) Divide the economy on the bases of income such as wage/salary earners, rent earners, profit earners, and so on.
- (b) Calculate the income of each of these groups.

- (c) Add the income of all these earners and include income from abroad and undistributed profits.
- (d) From the total income as per step (c), income earned by foreigners and transfer payments must be subtracted. The resultant income is the N1.

## 3. Expenditure Method

Under this method the personal consumption expenditure, government purchase of goods and services, gross private domestic investment and net foreign investment are added together to get the national income of a country. This method id is also known as consumption – saving method. Expenditure method involves the following steps:

- (a) Classify the economy into primary, secondary, tertiary sectors.
- (b) Divide the expenditure of an economy into two consumption expenditure and investment expenditure.
- (c) Add these expenditures and obtain the total. This gives the national income under expenditure method.

## **Transfer Payments**

Payment without expecting anything in returns is called transfer payment. Examples include gifts received by employees, tax payment to government, donation, charity, scholarships, pocket money, lotteries, prices etc.

## 1. Non- monetised Transactions: -

There are certain transactions which cannot be measured in terms of money. These are excluded from the national income figure.

## 2. Illiteracy:

Due to illiteracy, most of the producers of less developed countries have no idea about the quality and value of their output. This makes it difficult to calculate National Income.

## 3. Problem of Double Counting:

When we estimate national income many goods and services are counted more than once.

#### 4. Unorganised Sector:

The unorganised sector of any economy, including petty traders, unskilled labours, domestic servants etc. Contributes substantially to the national income. But most of them go unrecognised.

#### 5. Problem of Expertise:

Lack of professionals such as statisticians, researchers, programmers and analyst is a major problem.

## 6. Changes in Price Level:

The national Income rises falls with rise and fall in price level, irrespective of the physical quantity of production.

## 7. Public Services:

It is difficult to measure the income earned by public utility services like dams, power objects, roads, railways etc.

#### 8. Multiple Sources of Earnings:

People are engaged in a number of jobs.

9. Income From Illegal Activities:

Income obtained from illegal activities such as black marketing not included in the national income.

**10. Problems of False Information:** 

People do not disclose their income. They do so to evade tax.

## **11. Problem of Depreciation Account:**

The calculation of the depreciation on capital consumption is another difficulty.

## Methods of Measuring GDP

GDP measures two things at once, that is, the total income of everyone in the economy and the total expenditure of economy's output of goods and services. There are three methods for measuring GDP: -

- 1) Production method
- 2) Income distribution method
- 3) Final expenditure method

## **1.Production Method**

When the GDP is measured in the income creation stage, the method of measurement is known as value added method or production method.

Under this approach,

GDP  $_{mp} = \text{GVA}_{mp}$  of each sector

 $NNP_{fc} = GDP_{mp} + NFIA - CFC - Net IT$ 

## 2.Income Distribution Method

When the GDP is measured in the income distribution stage, the method of measurement is known as income distribution method.

Under this approach,

 $GDP_{mp} = NDP_{fc} + CFC + Net IT$ 

NNP  $_{fc} = NDP _{fc} + NFIA$ 

GVA m p= Gross Value Added at market priceGDP m p= Gross Domestic Product at market priceNNP fc= Net National Product at factor cost (national income)NFIA= Net Factor Income from AbroadCFC= Consumption of Fixed Capital (Depreciation)Net IT= Net Indirect TaxNDP FC= Net Domestic Price at factor cost

## **3.Final Expenditure Method**

When the GDP is measured in the spending or expenditure stage, the method of measurement is known as final expenditure method.

Under this method,

GDP  $_{m p}$  = Private Final Consumption Expenditure (PFCE) + Govt Final Consumption Expenditure

(GFCE) + Gross Domestic Capital Formation (GDCF) + Net Exports(X-M)

 $NNP_{fc} = GDP_{mp} + NFIA - CFC - Net IT$ 

## Components of GDP

GDP is divided into four components: - Consumption (C), Investment (I), Govt Purchases (G), Net Exports (X-M)

GDP = C + I + G + (X - M)

**1.Consumption:** -Consumption refers to the spending on all commodities and services that households and individual buy.

2.Investment: -Investment refers to the acquisition of new physical capital.

**3.Govt Purchases:** -Government purchases include spending on goods and services by local, state and central governments.

4.Net Export: - Net export means X - M. X refers to export and M refers to Imports.

## Real GDP and Nominal GDP

When GDP is measured in current prices, it is called nominal GDP. It is also known as GDP at current prices.

When Nominal GDP is adjusted for price changes, in relation to some chosen year's price called base year price, it is called real GDP. It is also known as GDP at constant prices.

#### **GDP** Deflator

The GDP measures the changes in prices for all of the goods and services produced in an <u>economy</u> not in the quantities produced.

GDP Deflator =  $\frac{Nominal GDP}{Real GDP} \times 100$ 

#### Monetary Policy

Monetary policy refers to the tools used by the Govt. through central bank to control the supply of money.

## Cheap and Dear Money policy: -

When credit is made available to trade and industry at low rates of interest, we call it cheap money policy.

When credit is available at high rates of interest, we call it dear money policy.

## Monetary Policy in India

The monetary policy of India is being formulated by RBI. The objectives of the monetary policy of RBI are: -

- 1) To promote savings and tap potential savings.
- 2) To mobilise savings for capital formation and for growth.
- 3) To promote investment by creating an investment climate.
- 4) To control inflationary trend.

## Instruments or Tools of Monetary Policy

The tools of monetary policy are also known as weapons of credit control. They can be classified into two: - quantitative techniques and qualitative techniques

#### **Quantitative techniques**

Quantitative techniques are used for controlling and regulating the demand and supply of money.

## 1) Bank Rate Policy: -

A bank rate is essentially the rate at which the RBI lends money to commercial banks without any security or collateral.

In times of inflation the central bank will increase the bank rate, thus, money supply is reduced. In case of deflation the bank rate is reduced.

## 2) Open Market Operation: -

Open market operation refers to the purchase and sale of securities by the central bank in the open market.

In order to reduce the supply of money Government will sell their securities. And to increase the money supply they will purchase securities.

## 3) Change in Cash Reserve Ratio (CRR): -

Cash Reserve Ratio (CRR) is the portion of deposits with the commercial banks that it has to deposit to the central bank.

In time of Inflation the central bank will increase the reserve ratio to reduce the supply of money. In case of deflation, it is vice versa.

## 4) Change in Statutory Liquidity Ratio (SLR): -

The Statutory Liquidity Ratio (SLR) is the percent of total deposits that the <u>commercial</u> <u>banks</u> have to keep with themselves in form of cash reserves or gold.

In times of Inflation the central bank will increase the SLR to reduce the supply of money. In case of deflation, it is vice versa.

## **Qualitative/Selective Technique**

Selective credit control measures are meant to regulate the flow of credit for specific purpose.

## 1) Rationing of credit: -

Credit rationing refers to controlling and regulating the purpose of which bank credit can be used. It is normally used by a central bank when there is a shortage of fund.

## 2) Changing Margin Requirements: -

The difference between the value of the security and the amount lent against this security is known as margin. The central bank may change the margin requirement to control and release funds.

## 3) Regulation of Consumer Credit: -

This technique is meant to regulate credit for the purchase of consumer goods.

## 4) Moral Suasion: -

Moral suasion refers to persuading commercial banks to take measures from time to time as per the directions of the central bank.

## 5) Direct Action: -

This method is adopted when some commercial banks do not cooperate with the central bank in controlling credit.

## Pros/Arguments for Monetary Policy

1.Neutralkity of money.

2. Stability of exchange rates.

3. Maintaining price stability.

4. Achieving economic growth.

5.Generatimng employment.

Cons/Arguments against Monetary Policy

- 1.Underdevoloped money market.
- 2. Non monetised sector.
- 3.Deficit financing.
- 4.Lack of banking facility.
- 5.Investment in unproductive channel.

## Fiscal policy

Fiscal policy means the use of taxation and public expenditure by the govt for stabilisation or growth.

## Instruments of Fiscal Policy

1) Budget: -

Budget exercise control over the size and relationship of the Govt. receipts and expenditure.

## 2) Taxation: -

Taxes are the main sources of public revenue. During depression the govt. will reduce tax.

## 3) Public Expenditure: -

Public expenditure refers to the expenses which govt. incurs for maintaining itself as well as the economy as a whole.

## 4) Public debt: -

When the govt find its difficult to match its public revenue with public expenditure, it relies on public debt.

## 5) Deficit financing: -

When the Govt. expenditure exceeds the govt. Revenue, it resorts to deficit financing. It involves either withdrawing or borrowing cash from central bank.

Monetary Policy during Inflation and Deflation

Instruments	Inflation	Deflation	
1.Bank Rate	Increases	Decreases	
2.Open Market	Sell securities	Purchase securities	
3.Cash Reserve Ratio	Increases	Decreases	
4.Statutory Liquidity Ratio	Increases	Decreases	
Fiscal Policy during Inflation and Deflation			

## Fiscal Policy during Inflation and Deflation

Instruments	Inflation	Deflation
Public Expenditure	Control/Decrease	Increase
Taxes	Increase	Decrease
Deficit financing	Not suitable	Adopt
Public Debt	Increase public borrowing	Maintain borrowing and increase social welfare expenditure
Budget	Surplus budget	Deficit Budget

Advantages of Fiscal Policy

1.It mobilises resources for economic growth.

2.It can promote economic growth.

3.It can increase employment opportunity.

4.It ensures equitable distribution of income and wealth.

**Disadvantages of Fiscal Policy** 

1. Take long time to bring desired result.

2.Complicated tax laws make implementation difficult.

3.Administrative problems.

4.Limitaations in underdeveloped countries.

## Demonetisation

Demonetisation is the process of removing currencies from general usage or circulation.

## **Objectives / reasons of Demonetisation**

- 1) To unearth and curb black money
- 2) To detect fake currency
- 3) To promote a cashless economy
- 4) To curb inflation
- 5) To increase the tax collection
- 6) To curb antisocial and terror funding

## Impact of Demonetisation on the Indian Economy

## Negative impacts

- 1) Liquidity Crisis: -Demonetisation give rise to liquidity problem. People found it difficult to get sufficient amount of cash to fulfil their basic needs.
- 2) Small businesses worst hit: Cash payments to workers and employee is still a practice in small scale businesses. So as India faced cash crunch, small business units were not able to pay its workers.
- 3) **BPL families most affected by demonetisation:** -As small businesses shut down / limited their activities, many BPL (Below Poverty Line) Indians lost their jobs temporarily and got into trouble.
- 4) **GDP came down:** -GDP of India has slowed down after implementation of demonetisation move as small industries were finding it difficult to carry out business. Due to decrease in consumption, demand for products in domestic market sharply fell down.
- 5) **Black money:** The main reason for demonetisation was to curb the black money. But the black money was majorly kept in the form of land, gold and building.
- 6) **Hospitality and Tourism: -** Due to demonetisation the tourism industry has come to a halt as majority of spending is in form of cash.
- 7) **Agriculture:** In agricultural sector majority of transaction were carried out in the form of cash, hence demonetisation surely affected this sector.

## Positive Impact

Promoting digital transactions: - Promotion of digital transactions is one of the major achievements of the demonetisation implementation

Hawala transaction were reduced

Counterfeit /Fake currency were tracked

Terror financing were reduced

The black money circulating through real estate were halted

## Development Issues Indian Economy

## Basic Characteristics of Indian Economy

- 1. Low per capita Income
- 2. Rapid growth of population.
- 3. Higher income inequality
- 4. Technological backwardness
- 5. Under-utilisation of natural resources
- 6. Inadequate infrastructure
- 7. Slow industrial Development
- 8. Under developed money market

## Major development Issues of Indian Economy

- 1. Low per capita Income and low level of economic growth
- 2. High proportion of the people below the poverty line
- 3. Low level of productivity and efficiency.
- 4. Problem of Unemployment
- 5. Population pressure
- 6. Lack of heavy industry
- 7. Low agricultural productivity
- 8. Unequal distribution of income and wealth

## Poverty

Poverty may be defined as the social phenomenon in which a section of the society is unable to fulfil even the basic necessities of life.

## Poverty line

The estimated minimum level of income needed to secure the necessities of life.

Absolute and Relative poverty

Absolute poverty – is a condition where household income is below a necessary level to maintain basic living standards (food, shelter, housing).

**Relative poverty** – A condition where household income is a certain percentage below median income

## Causes of Poverty in India

## Economics causes

- 1) Unequal distribution of income and wealth
- 2) Unemployment and under employment
- 3) Low per capita income
- 4) High rate of population growth
- 5) inflation
- 6) Primitive method of agriculture

## Socio and cultural causes

- 1) Liberal spending on social ceremony
- 2) Joint family system
- 3) Poor social overheads

## **Political Causes**

- 1) Governments negative attitude
- 2) Wide spread corruption

## Administrative Causes

- 1) Inefficient administrative machinery
- 2) Improper implementation of govt. programmes

## Poverty Alleviation measures of Indian Government

- 1) Land reforms
- 2) Expansion of credit facilities in rural areas
- 3) Establishment of Small Farmers Development Agency (SFDA)
- 4) Implementation of Training of Rural Youth for Self-Employment Scheme (TRYSEM)
- 5) Implementation of National Food for Work Programme (NFFWP)

## Inequality in Income Distribution in India

A very small percentage of population will be very rich while masses are suffering from extreme poverty in India. This means that there is inequality in income distribution in India.

## Causes of inequalities in income distribution in India

- 1) Difference in occupation.
- 2) Private ownership of property.
- 3) Policy of the govt. in favour of big industrialists.
- 4) Chronic unemployment
- 5) High tax evasion
- 6) Difference in levels of education
- 7) Corruption

## Unemployment

Unemployment refers to a situation when people are willing and able to work are not gainfully employed in productive activity

## **Causes of Unemployment in India**

- 1) High population pressure
- 2) Slow growth rate of economy.
- 3) Inappropriate technology.
- 4) Inappropriate education.
- 5) Rural urban migration.
- 6) Decline in traditional industrial activities.
- 7) Defective employment planning and manpower planning

## Remedial Measures Undertaken by the Govt. to Reduce Unemployment

- 1) Food for work (FFW) programme to make payment of wages in food grain
- 2) Rural works programme to provide employment opportunity.

- 3) Promotion of MSME sector for employment generation.
- 4) Crash programme for Rural Development to provide large scale employment to rural people
- 5) Implementation of Training of Rural Youth for Self-Employment Scheme (TRYSEM) for training rural youth

## Underemployment

The condition in which people in a labour force are employed at less than full-time or regular jobs or at jobs inadequate with respect to their training or economic needs.

## Full Employment

Full employment is a situation where all available resources in the economy are employed to produce goods and services.

## Jobless Growth

Jobless growth is a situation in which GDP has been increasing without accompanying any increase in job opportunities.

## Black money

Black money means money, resources or assets generated from illegal ways. It is an unaccounted money on which no tax is paid.

## Cause of Generating Black Money

- 1) Higher rate of taxes
- 2) Ineffective enforcement of tax laws
- 3) Donation to political parties
- 4) Deterioration of the quality and morality of the general masses.
- 5) Hawala transaction
- 6) Corruption

## Impact of black money

- 1) Loss of revenue to the Govt
- 2) Widening the gap between the rich and the poor
- 3) Lavish consumption spending
- 4) Misallocation of resources
- 5) Deteriorate the general moral standards of the society
- 6) Boost inflation

## Measures taken by the Government to Eliminate Black Money

- 1) Raid
- 2) Demonetization
- 3) Preventing the inflow of the smuggled gold
- 4) Policy against the black money stored in the Swiss bank
- 5) Efforts to convert cash economy into cashless economy

## Decentralised Planning

Decentralised planning means to transferring administrative power from the state govt. to local Govt and ensuring the participation of people in development. local Govt and ensuring the participation of people in development.