Answers to RSPL/1

Section - A

1. Normative economics studies the idealistic situations which deal with things as 'they ought to be'.

2. Average total cost is greater than average variable cost because it is the sum of AFC and AVC.

3. Market period refers to a very short period in which supply curve is perfectly inelastic and production can not be increased at all.

4. (*b*)

5. The three assumptions of the curve that shows production capacity of the economy are:

(*a*) Resources are given and constant.

(*b*) Resources are fully and efficiently utilised.

(*c*) Technology is given and constant.

6. Yes, a rational consumer can increase the quantity demanded of a commodity even when its price remains same.

The factors which cause this situation are:

(*a*) **Rise in price of substitute goods.** It results in increase in quantity demanded of the commodity at the same price as substitute goods can be used in place of each other to satisfy a given want.

(*b*) **Fall in price of complementary goods.** It results in increase in quantity demanded of the commodity at the same price as complementary goods have to be used together to satisfy a given want. (*any other relevant factor*)

OR

(*a*) Though water is essential for survival while diamonds are not, market price of diamond is much higher than that of water because of the difference in their availability.

(*b*) Water is available in plenty, while diamonds are scarce.

(*c*) Scarce goods command higher price than those goods which are available in abundance.

7. Demand curve is downward sloping for luxury goods is incorrect because:

(*a*) There exists direct relationship between price of luxury goods and their demand. Thus, demand curve is upward sloping.

(*b*) This is because luxury goods are the status symbol goods.

(*c*) When price of these goods rise, the prestige value attached with these goods increases due to which their demand rises.

(*d*) Similarly, when price of these goods falls, the prestige value attached with these goods decreases due to which their demand falls.

8.
- Equilibrium price of a commodity is determined by the general interaction of market demand and market supply of the commodity.
- It is the price at which quantity demanded by all the consumers in the market is equal to the quantity supplied by all the firms in the market. Thus, there is neither excess demand nor excess supply.

- Determination of equilibrium price can be explained with the help of the following schedule:

Price of a commodity (₹)	**Market Demand**	**Market Supply**
1	100	60
2	90	70
3	80	80
4	70	90
5	60	100

- In the above schedule, equilibrium price is determined at price of ₹ 3 as at this price Quantity demanded = Quantity supplied, *i.e.*, 80 units.

9.

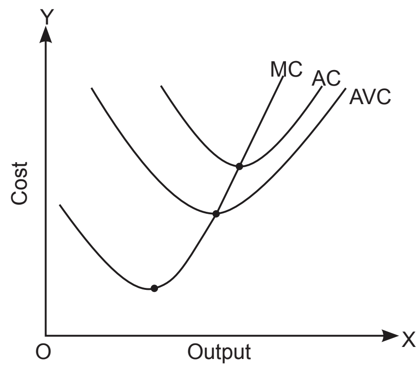
Output (Units)	**MC (₹)**	**TVC (₹)**	**AC (₹)**	**TFC (₹)**	**TC (₹)**
0	—	0	—	200	200
1	500	**500**	**700**	200	700
2	**400**	900	550	200	1,100
3	300	**1,200**	**466.67**	200	1,40,000
4	**400**	1,600	450	200	1,800
5	500	**2,100**	**460**	200	2,300

OR

(*a*) MC, AC and AVC first fall; reach their respective minimum points and then start rising such that MC reaches its minimum first, then AVC and then AC.

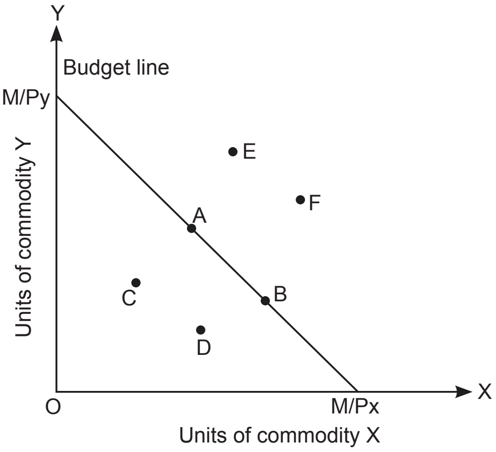
(*b*) When MC is less than AC, AC falls; when MC is equal to AC, AC is minimum and when MC is more than AC, AC rises.

(*c*) When MC is less than AVC, AVC falls; when MC is equal to AVC, AVC is minimum and when MC is more than AVC, AVC rises.



10. (*a*)

Attainable combinations	**Non-attainable combinations**
• Those combinations which the consumer can afford to buy with his entire income or part of his income. • These combinations lie on the budget line or below the budget line.	• Those combinations which the consumer can not afford to buy with his given income. • These combinations lie above the budget line.



In the above diagram, combinations A, B, C and D are attainable combinations while combinations E and F are unattainable combinations.

(*b*) (*i*) $5x + 10y = 150$ where x and y are units of good X and good Y respectively.

(*ii*) $5(0) + 10y = 150$

$10y = 150$

$y = 15$ units

$\therefore$ 15 units of good Y can be bought if the consumer spends his entire income on good Y.

(*iii*) The slope of the budget line remains the same

As before price change it was

$$(-)\frac{P_X}{P_Y} = (-)\frac{5}{10} = (-)0.5$$

While after price change, slope $= (-)\dfrac{10}{20} = (-)0.5$

11. (*a*)

Short-run Production Function	**Long-run Production Function**
• It refers to technological relationship between physical input and physical output in the time period in which some factors are fixed and some are variable.	• It refers to technological relationship between physical input and physical output in the time period in which all the factors are variable.
• It is expressed as $Q = f(L, \overline{K})$ where L is labour which is a variable factor and K is capital which is a fixed factor.	• It is expressed as $Q = f(L, K)$ where L is labour and K is capital and both are variable factors.
• It is applicable in case of law of variable proportions.	• It is applicable in case of returns to scale phenomenon.

(*b*) A rational producer operate in the second stage of production. It is a stage of diminishing returns to a variable factor where every additional unit of variable factor contributes positively to total product, *i.e.*, marginal product is positive and falling. A rational producer finds his equilibrium at this stage of production.

This is because

- A rational producer would not stop in stage I—Stage of increasing returns to a variable factor where every additional unit of variable factor contributes more and more to total product, *i.e.*, MP is positive and rising.
- A rational producer would not enter in stage III—Stage of negative returns where every additional unit of variable factor contributes negatively to total product, *i.e.*, MP is negative.

12. (*a*) False, as monopolist practices price discrimination when price elasticity of demand is different in different market areas. Low price elasticity of demand implies demand is less responsive towards change in price due to which he fixes higher price for his commodity.

(*b*) True, as under perfect competition, firms sell the commodity at the same price, but price of the commodity may change if there is change in market demand or market supply, *i.e.*, from industry point of view.

(c) True, as under monopolistic competition, there are close substitutes available for the product being sold. This makes the demand curve under monopolistic competition more elastic as shown by a flatter curve.

OR

(*a*) Implications of a few big firms under oligopoly:

- Each firm produces a substantial part of total output of the industry.
- There exists severe competition among firms.
- Each firm can influence the price by its own action and can provoke the rival firms to react.

(*b*) Implications of restrictions on the entry of new firms under oligopoly:

- Number of firms is limited in oligopoly.
- Firms may earn super normal profit in the long run.
- Despite super normal profit, new firms cannot enter the industry due to the barriers on their entry. Thus, market supply will not increase. Consequently, price and super normal profit will not fall.

Section - B

13. $K = \frac{1}{1-c} = \frac{1}{1-1} = \infty$ (where c is MPC)

14. Ex-ante investment refers to the planned or desired investment, *i.e.*, the investment which firms are planning to do during a year.

15. (*b*)

16. (*a*)

17. 'Money supply' refers to the stock of money in the country on a particular day.

The components of money supply are:

(*a*) **Currency with public outside the banks**. Currency includes coins and currency notes. These notes are called 'paper money'. Currency is also known as fiat money.

(*b*) **Demand deposits with the banks.** Demand deposit is any deposit on which a cheque can be written. These deposits are known as 'demand deposits' because the amount in such deposits is payable on demand.

Both these are directly usable for carrying out transactions at will.

OR

(*a*) Due to the excess of money supply, purchasing power of people will increase. Higher purchasing power will result in increase in aggregate demand of goods and services in the economy.

(*b*) This would result in rise in general price level. If it continues to persist, there will be a situation of inflation.

(*c*) Inflation would cause rise in the rate of interest which would further result in fall in investment. Fall in investment would hamper the growth of GDP of the country.

18. The impact of reduction in repo rate on different sectors:

(*a*) **On Indian households:** Fall in repo rate will result in reduction in lending rate of interest charged by banks from the public. This would encourage households to borrow more for purchasing houses or consumer durable goods like cars etc.

(*b*) **On investors:** Reduction in rate of interest will reduce the cost of borrowings. This will encourage investors to invest more in productive activities.

(*c*) **On Indian economy:** Increased investment in productive activities will result in increase in production. This will increase GDP and further boost the Indian economy.

19. (*a*) Purchase of machinery from abroad is recorded in current account on debit side in the BoP account. It is recorded in current account because it is a part of visible trade. It is recorded on debit side because it results in outflow of foreign exchange.

(*b*) Borrowings from abroad is recorded in capital account on credit side in the BoP account.

It is recorded in capital account because it results in increase in country's foreign liability.

It is recorded on credit side because it results in inflow of foreign exchange.

20.

Full employment equilibrium	**Underemployment equilibrium**
• It refers to a situation when AD = AS corresponding to full employment level of output.	• It refers to a situation when AD = AS at less than full employment level of output.
• There is no excess capacity in the economy.	• Excess capacity exists in the economy.
• There is full employment of resources in the economy.	• There is unemployment in the economy.
• It was advocated by classical economists.	• It was advocated by J.M. Keynes.

OR

Following fiscal measures can be taken to correct the situation of deficient demand in the economy:

(*a*) **Expenditure policy.**

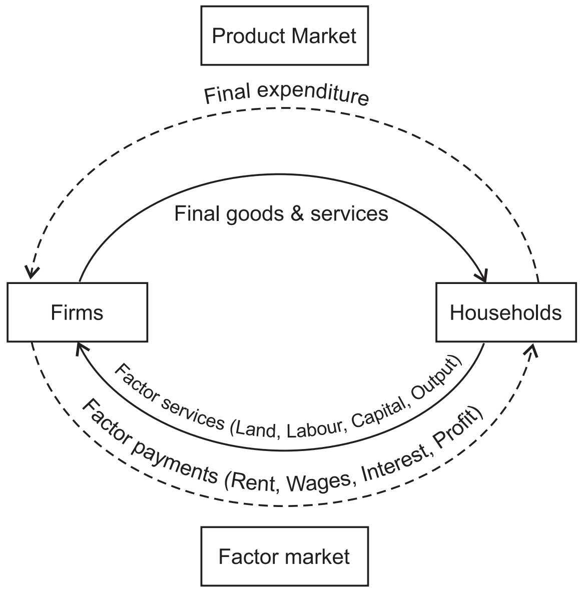
- In a situation of deficient demand, the government should increase its expenditure on public works like construction of roads, dams, bridges, expenditure on education and health, expenditure on the defense of the country and maintenance of law and order etc.

- This will help in increasing the level of economic activities in the economy which will increase employment and income. This will further result in increase in purchasing power of the people. Rise in purchasing power will cause increase in consumption expenditure and hence aggregate demand. Consequently, the situation of deficient demand will get corrected.

(*b*) **Revenue policy.**

- In a situation of deficient demand, the government should reduce the taxes.
- This will help in increasing the disposable income of the people which will further result in increase in consumption expenditure of the people. This will cause increase in aggregate demand. Consequently, the situation of deficient demand will get corrected.

21. Circular flow of income:



In the above diagram, real flows are shown by the plane line and money flows are shown by the dotted line.

- In this economy, firms produce goods and services with the help of the factors of production owned by the households. In return of their factor services, they make factor payments to the household sector. These are factor incomes for the households.
- Households buy those goods and services from the firms and make payments to the firms from their factor incomes (final expenditure).

22. (*a*)

$$Y = \overline{C} + MPC(Y) + I$$

$$1{,}000 = 100 + MPC(1{,}000) + 120$$

$$MPC = \frac{1{,}000 - 100 - 120}{1{,}000} = \frac{780}{1{,}000} = 0.78$$

(*b*)

$$MPS = 1 - MPC$$

$$= 1 - 0.78 = 0.22$$

Note: In question, consider national income as 1,000.

23. For calculating Compensation of Employees, we will have to use the expenditure method for determining the value of NDP_{MP} and then calculate CoE.

$$NDP_{MP} = (i) + (iii) + (v) - (vii) + (ix)$$
$$= 2{,}650 + 1{,}250 + 550 - 50 + (-100)$$
$$= ₹\ 4{,}300 \text{ crores}$$
$$NDP_{FC} = NDP_{MP} - (x)$$
$$= 4{,}300 - 300$$
$$= ₹\ 4{,}000 \text{ crores}$$
$$CoE = NDP_{FC} - (vi) - (viii) - (xi) - (xii)$$
$$= 4{,}000 - 300 - 1{,}450 - 200 - 250$$
$$= ₹\ 1{,}800 \text{ crores}$$

24. Fiscal policy refers to the budgetary policy of the government concerning its expenditure, revenue and debt.

The two objectives of fiscal policy are:

(*a*) **Reallocation of resources.**

- Government aims at reallocation of resources through its fiscal policy in order to maintain the balance between the goals of profit maximisation and social welfare.
- Following measures are used for reallocation of resources:
  (*i*) Taxes or subsidies
  (*ii*) Directly producing goods and services

(*b*) **Redistribution of income and wealth.**

- Through its fiscal policy, the government aims at reducing inequalities in income and wealth. It aims at reducing the gap between the rich and the poor in the society.
- Following measures are used for redistribution of income and wealth:
  (*i*) Progressive taxation
  (*ii*) Expenditure on social security benefits for the poor

OR

(*a*) **False.** They are government's revenue expenditure as these grants neither create assets nor reduce liabilities of the Central government.

(*b*) **False.** Revenue deficit is the difference between revenue expenditure and revenue receipts of the government while recovery of loans which results in reduction of assets is a capital receipt.

(*c*) **True.** As Primary deficit = Fiscal deficit – Interest payments
Alternatively, Fiscal deficit = Primary deficit + Interest payments