CBSE Class–12 Economics

Micro Economics

Chapter 1 – Introduction

Revision Notes

Economy: - An economy is a system of organizations and institutions that either facilitate or play a role in the production and distribution of goods and services in a society. Economies determine how resources are distributed among members of a society; they determine the value of goods or services; and they even determine what sorts of things can be traded or bartered for those services and goods.

Three Types of economy:

1. **Market/capitalist economy: -** In this type of Economy the factors of production are owned and operated by individuals or group of individuals. Main objective of production is self-interest or profit maximization. Central problems are solved by price mechanism or market forces of demand & supply.

2. **Planned/centrally planned/ socialistic economy:** - Factors of production are owned and operated by Govt. Main objective of production is social welfare. Central problems are solved by central planning authority.

3. **Mixed Economy: -** The Economy in which factors of production are owned and operated by both Govt. and private sector. Main objective is profit maximization (private sector) and social welfare (Government sector). Central problems are solved by central planning authority(in public sector) and price mechanism (in private sector)

Economics: - Economics is a branch of social science focused on the production, distribution and consumption of goods and services. The origin of economics can be traced to Adam Smith's book, 'An inquiry into the Nature and Causes of Wealth of Nature' published in the year 1776. Economics was used to mean home management with limited funds available in the most economical manner possible.

The word 'economics' comes from two Greek words, 'eco' meaning home and 'nomos' meaning accounts. The subject has developed from being about how to keep the family accounts into the wide-ranging subject of today.

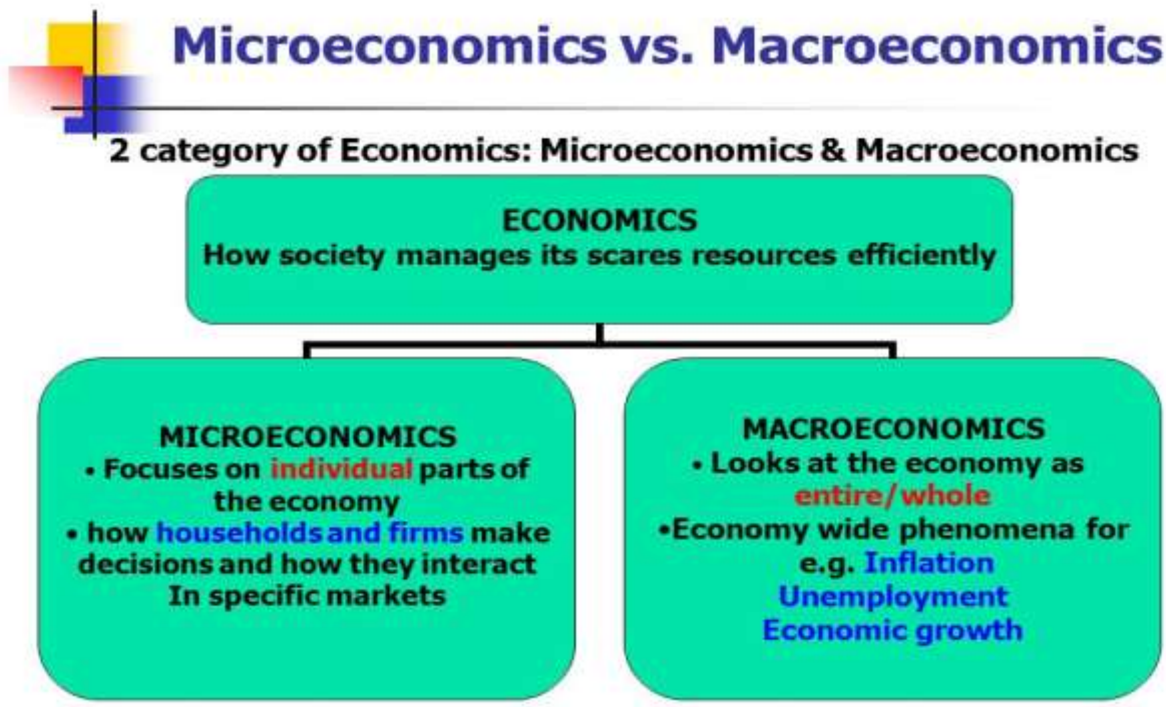
Economics is actually:-

- economics is about the study of **scarcity** and **choice**
- economics finds ways of reconciling **unlimited want**s with **limited resources**
- economics explains the problems of living in communities in terms of the underlying **resource costs** and **consumer benefits**
- economics is about the **co-ordination of activities** which result from specialisation

Definition of Economics: - Robbins emphasises that economics is a study of human behaviour, where there is a relationship between ends and scarce means and that the scarce means have alternative uses.

Samuelson's definition of economics is most comprehensive, relevant and accepted. The definition includes both the aspects of economics, i.e., distribution of limited resources and problem of economic development.

Microeconomics and Macroeconomics:-



	Points of Difference	Microeconomics	Macroeconomics
1.	Origin	The word micro has been derived from a Greek word 'Mikros' which means small. It is also called Price theory.	The word macro has been derived from a Greek word 'Makros' which means large. It is also called Theory of Income and Employment
2.	Study matters	It studies about individual economic relations or issues like households, firms, consumers, etc.	It studies about an economy as a whole.
3.	Objective	its main objective is to analyse the principles, problems and policies for the achievement of the goal of optimum allocation of resources.	it investigates principles, problems and policies related to achievement of full employment and expansion with productive Capacity.
4..	Deals with	It deals with how consumers or producers make their decisions depending on their given budget and other variables.	It deals with how different economic sectors such as households, industries, government and foreign sector make their decisions.
5.	Method	It uses the method of partial equilibrium, i.e. equilibrium in one market	It uses the method of general equilibrium, i.e. equilibrium in all markets of an economy.

6.	Variables	The major microeconomic variables are price, individual consumer's demand, wages, rent, profit, revenues, etc.	The major macroeconomic variables are aggregate price, aggregate demand, aggregate supply, inflation, unemployment, etc.
7.	Theories	Various theories studied are: 1) Theory of Consumer's Behaviour and Demand 2).Theory of Producer's Behaviour and Supply 3).Theory of Price Determination under Different Market Conditions 4) Theory of factor pricing / distribution 5) Theory of economic welfare	Various theories studied are: 1) Theory of National Income 2) Theory of Money 3) Theory of General Price Level & Inflation 4) Theory of Employment 5) Theory of International Trade 6) Macro theory of distribution 7) Theory of economic growth
8	Main Problem	Its main problems are price determination and allocation of resources	Its main problem is determination of level of income and employment in the economy
9	Popularise by	Alfred Marshal	J.M. Keynes

Both micro and macroeconomics are complementary and should be utilised for proper understanding of an economy.

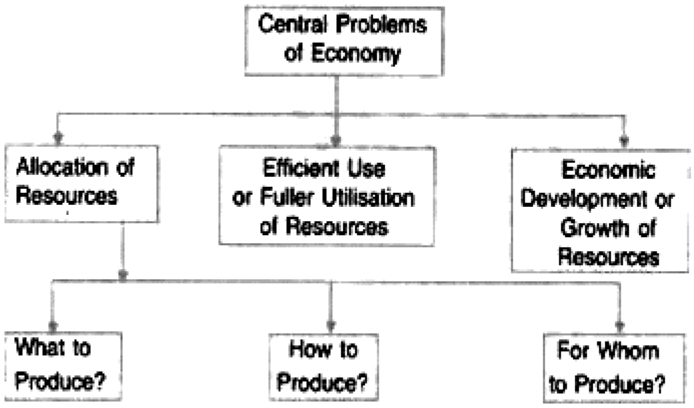
Difference between Planned Economy and Market Economy is as follows:-

SNo	Planned Economy	Market Economy
1	All the materials means of production are owned by government.	All the materials means of production are owned by private individuals.
2	Main objectives of production is social welfare	Main objectives of production are maximization of profit.
3	Ownership of property is under government control.	There is no limit to private ownership of property.
4	All the economic problems are solved as per direction of the planning commission.	All the economic problems are solved through price mechanism i.e., demand and supply.

Difference between Positive Economics and Normative Economy is as follows:-

SNo	Positive Economics	Normative Economics
1	It deals with what is what was.	It deals with what ought to be.
2	It is based on cause and effect of facts.	It is based on ethics.
3	It can be verified with actual data	It cannot be verified with actual data.
4	In this value of judgments are not given.	In this value of judgments are given.

Central Problems of an Economy:-



- Basic economic problem is the problem of choice which is created by the scarcity of resources. It is also called problem of economising the resources, i.e., the problem of fuller and efficient utilisation of the limited resources to satisfy maximum number of wants.
- Main causes of central problems are unlimited human wants, limited economic resources and alternative uses of resources.
- Resources of factors of production can be natural like (land, air), human (i.e., labour), capital (like machines, building) and entrepreneurial (i.e., a person who bears risk).
- Central problems facing every economy are like allocation of resources:-

(i) What to produce and how much to produce?

(ii) How to produce?

(iii) For whom to produce?

- **What to produce: -** An economy have unlimited wants and limited means having alternative use. Economy can’t produce all type of goods like consumer goods, producer goods etc. So, Economy has to make a choice what type of goods and services are to be produced and in what quantities.

- **How to produce: -** It is the problem of choice of technique of production. There are two techniques of production.

- (a) **Labour Intensive Technique**: - It is the technique of production when labour is used more than capital.

- (b) **Capital Intensive Technique**: - In this technique capital is used more than Labour.

- **For whom to produce: -** It is the problem related to distribution of produced goods among the different group of the society.

It has two aspects:-

1. Personal distribution
2. Functional distribution

Personal distribution: - When the National Income is distributed according to the ownership of the factors of production.

Functional distribution: - When the national Income/Production is distributed among different factors of production like Land, Labour, capital and Entrepreneurship for providing their service in term of rent, wages, interest and profit respectively.

- **Problem related to the efficient use and fuller utilization of resources:-**

Efficiency of production means the maximum possible amounts of goods and services are being produced with available resources. The resources are already scare in relation to the need for them and therefore an economy has to ensure that its resources do not remain underutilized their under employment is nothing but wastage of resources.

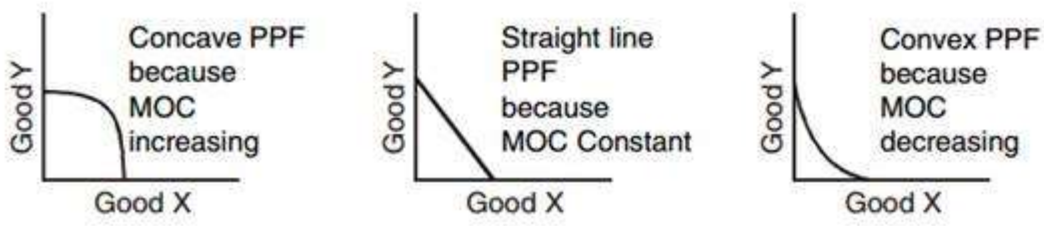
- **Problem related to Growth of Resources**:-

It is related to increase in the production capacity of the economy so that the quantity of production will rise.

Production possibility frontier or production possibility curve

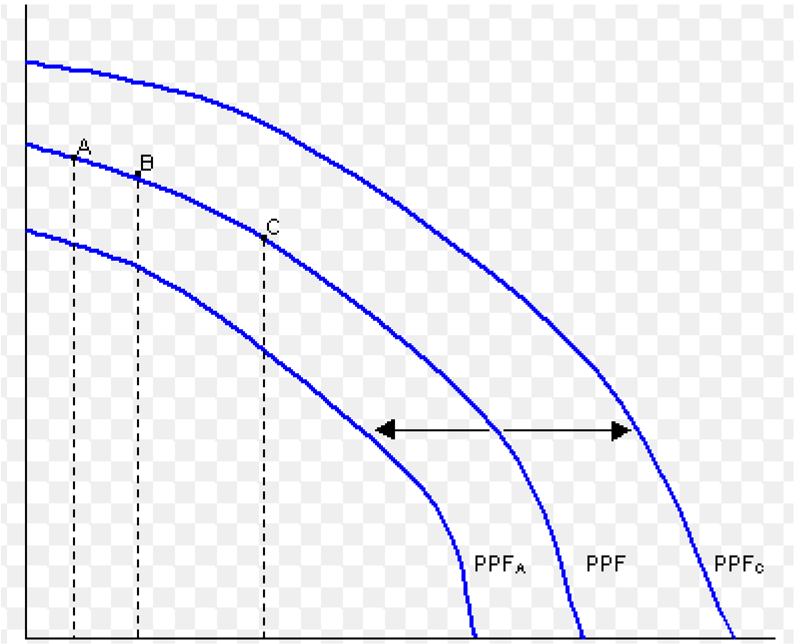
This shows all possible combinations of two set of goods that an economy can produce with available resources and given technology, assuming that all resources are fully and efficiently utilized.

Production Possibility Frontier or Curve Features (a) Slopes downward from left to right because if production of one commodity is to be increased then production of other commodity has to be sacrificed as there is scarcity of resources.(b) Concave to the origin because of increasing marginal opportunity cost or (MRT)



The Production possibility curve will shift under following two conditions:

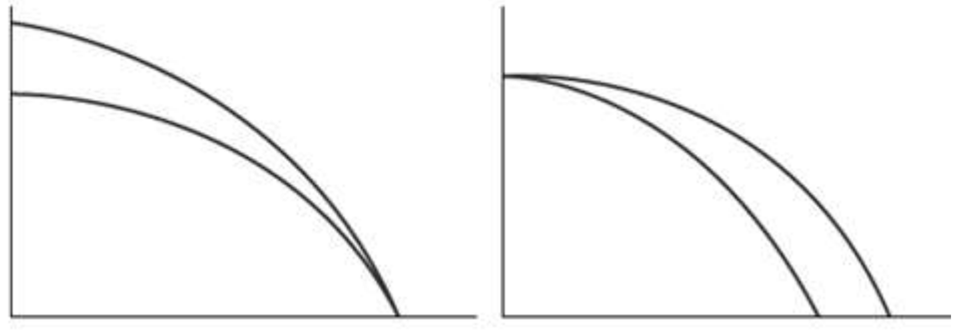
(a) Change in resources, (b) Change in technology of production for both the goods.



Rightward shift of PPF shows increase in resources or improvement in technology. Ex- Labour becoming more skilled, improvement in technology, increase in productivity of land.

Leftward shift of PPF shows the decrease in resources or degradation of technology in the economy.

The Production possibility curve will rotate outward under following two condition: (a) Improvement in technology in favour of one commodity (b) Growth of resources for the production of one commodity



Marginal Rate of Transformation (MRT) – It is the amount of one commodity that is to be sacrificed to increase the production of other commodity by one unit. It can also called Marginal Opportunity Cost. It is defined as the additional cost in terms of number of units of a good sacrificed to produce an additional unit of the other good.

MARGINAL RATE OF TRANSFORMATION: MRT is the ratio of units of one good sacrificed to produce one more unit of other good.

$$\text{MRT}=\frac{\text{Unit of good Y sacrificed}}{\text{Unit of good X produced}}=\frac{\Delta y}{\Delta x}$$

(Marginal= at the border or adjacent/next to/adjoining)(Transformation= a change in form, shape appearance or size)

Production Possibility Curve and Opportunity Cost:-

1. It is a useful device to graphically explain the central problems of an economy. It indicates the various combinations of goods and services which can be produced by full and efficient utilisation of all resources of an economy.
2. It is downward sloping concave to the origin curve.
3. Slope of PPC is called MRT or Marginal Opportunity Cost. Slope of PPC is increasing showing that if a country wants to produce more of good X it has to give up increasing number of units of good Y it is called law of increasing marginal opportunity cost.
4. Any point inside the curve shows inefficient utilisation of resources and any point outside the curve is unattainable because of scarcity of resources.

5. Opportunity cost is the cost of alternative opportunity gives up.

6. Production possibility curve is called opportunity cost curve at every point measures opportunity cost of good X in terms of good Y given up.

Production Possibility Curve and Central Problems:-

The production possibility curve solves five problems – what and how much to produce, how to produce, and full utilisation of resources, economic efficiency and economic growth. All points on the curve solves problems of what and how much to produce, how to produce, full employment of resources and economic efficiency. Production possibility curve is unable to solve the economic problem 'for whom to produce'.

Ways to solve fundamental problems in captalistic and planned economies:-

In a market oriented or capitalist economy, the fundamental problems are solved by the market mechanism. Price is influenced by the market forces of demand and supply. These forces help us to decide what, how and for whom to produce.

In a planned economy, all the economic decisions regarding what, how and for whom to produce are solved by the state through planning. Economic planning replaces the price mechanism. The market is regulated by the state. The prices of the various products are fixed by the state which are called administrated prices.