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INDIAN ECONOMY

QUICK AND COMPREHENSIVE REVISION SERIES

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1 Basic Microeconomics

INTRODUCTION

Microeconomics is the branch of economics that studies the behaviour of individual agents, such as households, firms, and individuals, and how they make decisions to allocate limited resources. It focuses on **supply and demand**, **price mechanisms**, and the **allocation of resources** within specific markets. Microeconomics examines how these decisions impact the utilisation and distribution of resources, aiming to achieve optimal efficiency and equity in the market.

Scarcity of Resources, Problem of Choice, Theory of Unlimited Wants, and Opportunity Cost

- **Scarcity of Resources**
  - Resources such as **land**, **labour**, and **capital** are limited in supply and cannot fulfil all human needs and desires. This **scarcity** is fundamental to economics, as it requires that choices be made to prioritise how resources are allocated.
- **Problem of Choice**
  - Given the scarcity of resources, individuals and societies must make choices about how to allocate resources most effectively. This leads to questions about *what* to produce, *how* to produce, and *for whom* to produce.
  - **Example:** A factory must choose between producing cars or bicycles based on demand and potential revenue.
- **Theory of Unlimited Wants**
  - Human desires and needs are **boundless**; as one want is satisfied, new wants arise. This ongoing cycle intensifies the pressure on limited resources, forcing individuals and societies to prioritise certain needs over others.
  - **Example:** A person may wish for both a vacation and a new car, but with limited funds, they must decide which to pursue.
- **Opportunity Cost**
  - **Opportunity cost** refers to the value of the next best alternative that is forgone when a choice is made. It represents the benefits lost by choosing one option over another.
  - **Example:** If the factory chooses to produce cars instead of bicycles, the opportunity cost is the revenue it could have earned from selling bicycles.

If a commodity is provided free to the public by the Government, then the opportunity cost is transferred from the consumers of the product to the tax-paying public. **[UPSC 2018]**

ORGANIZATION OF ECONOMIC ACTIVITIES

To address **scarcity** and meet societal needs, economic activities are organised in various ways, often combining elements of the following systems:

- **Market Economy**
  - In a **market economy**, prices and production are determined by **supply and demand** forces. The private sector primarily drives economic activities, with minimal government intervention.
  - **Example:** In a market-driven economy, the price of bread depends on consumer demand and producer supply.
- **Command Economy**
  - In a **command economy**, the government directs most economic decisions, including what goods to produce, how to produce them, and who will receive them. This system aims to reduce inequalities but may lack efficiency.
  - **Example:** The government may choose to allocate resources to produce essential goods like food and healthcare over luxury items.
- **Mixed Economy**
  - Most modern economies are **mixed**, blending features of market and command economies. Both the private sector and government influence economic decision-making to balance efficiency with social welfare goals.

THEORY OF CONSUMER BEHAVIOR

The **Theory of Consumer Behavior** explores how consumers maximise **utility** within budget constraints. It examines choices based on preferences, available resources, and market conditions.

Utility

- **Utility** represents the satisfaction derived from consuming goods or services.
- **Total Utility (TU):** The overall satisfaction from all units consumed.
- **Marginal Utility (MU):** The additional satisfaction from consuming one more unit.

Law of Diminishing Marginal Utility

- As more units of a good are consumed, the **Marginal Utility** of each additional unit decreases.
- **Example:** The first slice of pizza provides high satisfaction, but subsequent slices offer less additional satisfaction.

Utility Analysis

- **Cardinal Utility Analysis**
  - Assumes that utility can be assigned a measurable value.
  - **Utility Maximisation:** Consumers allocate income to maximise total utility, choosing goods where the **Marginal Utility per Rupee (MU/P)** is equal across goods.
- **Ordinal Utility Analysis**
  - Assumes consumers rank preferences without exact values, leading to **Indifference Curve Analysis**.

Indifference Curve and Map

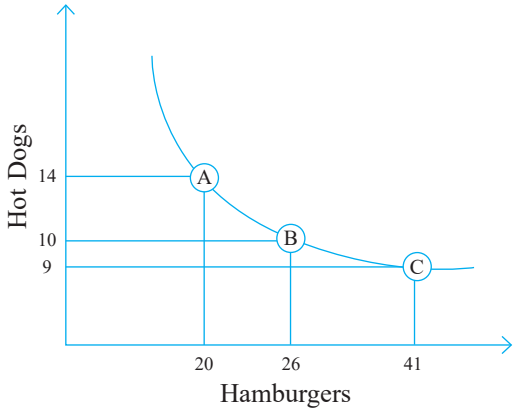

Fig.: Indifference Curve

Indifference Curves represent combinations of two goods yielding equal satisfaction.

Indifference Map shows a set of indifference curves, each representing different utility levels. Higher curves indicate greater utility.

Look at this indifference curve. You may be indifferent to buying a combination of 14 hot dogs and 20 hamburgers, a combination of 10 hot dogs and 26 hamburgers, or a combination of nine hot dogs and 41 hamburgers if you like both hot dogs and hamburgers. Each of these three combinations provides the same utility.

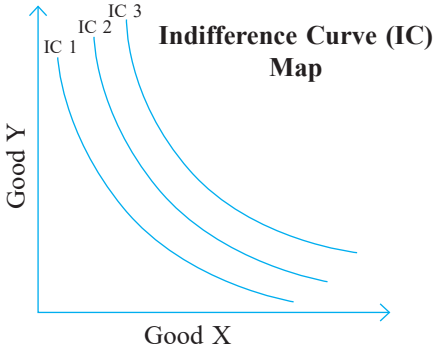

Fig.: Indifference curve map

Higher Indifference Curves: An indifference curve to the right of another indicates more goods available to the consumer, which means more utility. This is based on the assumption of monotonic preferences.

Budget Set and Budget Line

- **Budget Set:** All possible combinations of goods a consumer can buy given income and prices.
- **Budget Line:** The line representing combinations of two goods that can be purchased with a fixed income.
- Here p1 and p2 represent the price of 1 unit of Mangoes and bananas each.

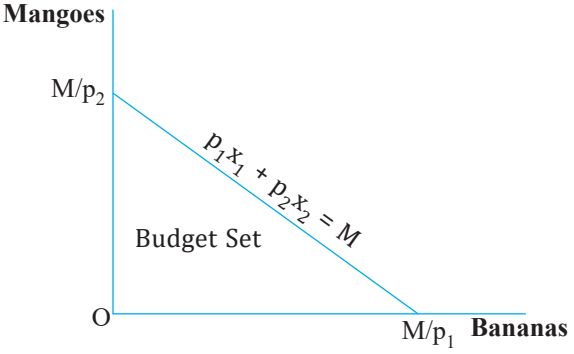

Fig.: Budget Set: Quantity of bananas is measured along the horizontal axis and quantity of mangoes is measured along the vertical axis. Any point in the diagram represents a bundle of the two goods. The budget set consists of all points on or below the straight line having the equation $p_1x_1 + p_2x_2 = M$.

Marginal Rate of Substitution (MRS)

- The **MRS** represents the rate at which a consumer is willing to trade one good for another while maintaining the same utility level.
- **Example:** Bananas and apples-If a consumer is willing to give up 6 bananas for 3 apples, then the MRS is –6/3 = –2.

Optimal Choice of Consumer

- The optimal point of consumption is where the **Budget Line** is tangent to the highest **Indifference Curve**.
- This is because a consumer would want to maximise his utility and remain in Budget also. Thus the point where the budget line touches indifference curve is optimum Choice of consumer.

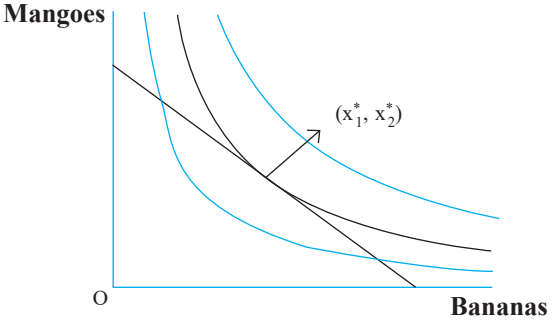

Fig.: Consumer's Optimum: The point (x_1^*, x_2^*), at which the budget line is tangent to an indifference curve represents the consumers optimum choice

LAW OF DEMAND

The Law of Demand states that, all things being equal, as the price of a good or service increases, consumer demand for that good or service will decrease, and vice versa.

Example: If the price of smartphones decreases, consumers are likely to purchase more smartphones. Conversely, if the price increases, the demand for smartphones typically drops. This inverse relationship between price and quantity demanded is a fundamental principle of consumer behaviour in economics. However, this law applies only to ***normal goods***.

Demand Curve

- For any change in price, there is an inverse change in quantity demanded
- Normally, the demand slopes downwards from left to right. But there are some unusual demand curves which do not obey the law/usual demand curve. For them, a fall in price brings about a contraction of demand and a rise in price results in an extension of demand. Therefore, the demand curve slopes upwards from left to right.
- **Speculative Effect** reverses the demand curve due to expectation of certain future events. If the price of the commodity is increasing then the consumers will buy more of it because of the expectation that it will increase still further. For example: stock markets.

Demand Curve from Indifference Curves and Budget Constraints

- The **Demand Curve** can be derived by observing changes in optimal consumption as prices vary, based on **Indifference Curves** and **Budget Constraints**.

TYPES OF GOODS [UPSC 2021]

Inferior goods

It is an economic term that describes a good whose demand drops when people's incomes rise. These goods fall out of favour as incomes and the economy improve as consumers begin buying more costly substitutes instead.

Example: cheap cereals and food grains like rice (inferior goods) will be replaced by better quality food items like eggs, milk when income rises.

Giffen goods

A Giffen good is a low income, non-luxury product that defies standard economic and consumer demand theory. Demand for Giffen goods rises when the price rises and falls when the price falls. This results in an upward-sloping demand curve, contrary to the fundamental laws of demand which create a downward sloping demand curve.

The generally accepted explanation is that Giffen goods are a type of inferior good without a substitute. For example, when the price of rice increases, people cannot shift out of rice but rather eat only rice instead of other vegetables.

- Examples of Giffen goods can include bread, rice, and wheat. These goods are commonly essentials with few near-dimensional substitutes at the same price levels

Substitute Goods

They are pairs of competing goods which, in the opinion of buyers, can replace each other. For example, if tea is costly, buyers may drink coffee.

Complementary goods

They are pairs of goods that are interdependent or compatible. **For example:** Bread and jam, Tea and sugar etc.

Veblen Effect: Conspicuous Consumption of Luxury Goods. It means spending money on luxury goods and services to display financial power. Demand for Veblen goods increases with a rise in their price. For example - A Rolex watch or Rolls Royce car is desirable because of their high price and associated status symbol.

SHIFTS IN DEMAND CURVE

Factors like income changes, prices of related goods, and preferences shift the **Demand Curve**. Increase shifts the curve rightward, and decrease shifts it leftward.

Market Demand

The total demand for a good from all consumers in the market, calculated by summing individual demand curves horizontally.

Elasticity of Demand

Elasticity of demand is a measure of the responsiveness of the quantity demanded of a good or service to a change in its price. It helps us understand how sensitive consumers are to price changes.

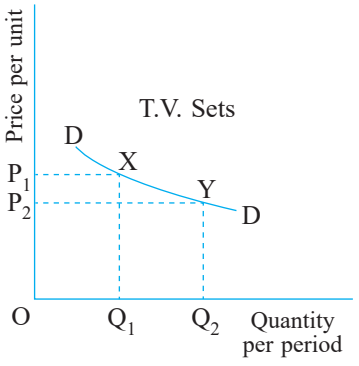

Fig.: (*a*) Elastic Demand

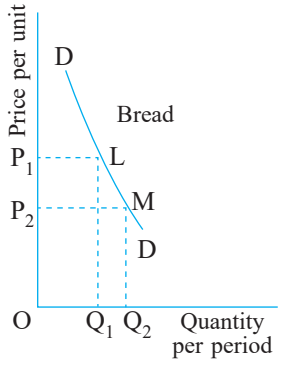

Fig.: (*b*) Inelastic Demand

Types of Elasticity of Demand

- **Perfectly Elastic Demand:** Infinite change in quantity demanded for a very small change in price.
- **Perfectly Inelastic Demand:** No change in quantity demanded regardless of price changes.
- **Relatively Elastic Demand:** Large change in quantity demanded for a small change in price.
- **Unitary Elastic Demand:** Proportional change in quantity demanded equals the change in price.

- **Relatively Inelastic Demand:** Small change in quantity demanded for a large change in price.

LAW OF SUPPLY

The Law of Supply states that, other things being equal as the price of a good or service increases, the quantity supplied of that good or service also increases, and vice versa.

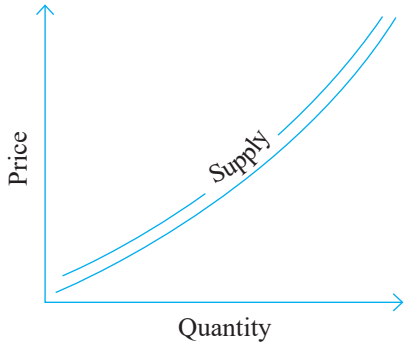

Fig.: Law of Supply

Example: If the market price of coffee beans rises, farmers are incentivized to grow more coffee beans,increasing the supply. Conversely, if prices fall, farmers may reduce their coffee production due to lower profitability. This principle illustrates the direct relationship between price and supply in economics.

Elasticity of Supply

Elasticity of supply is a measure of the responsiveness of the quantity supplied of a good or service to a change in its price. It helps us understand how producers will adjust their output levels in response to price fluctuations.

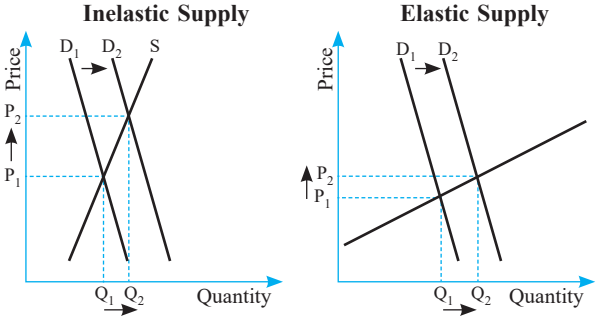

Fig.: Elasticity of supply

- **Relatively Elastic Supply:** More than proportional change in quantity supplied due to price change.
- **Unitary Elastic Supply:** Proportional change in quantity supplied equals the change in price.
- **Relatively Inelastic Supply:** Less than proportional change in quantity supplied due to price change.

Income and Cross Elasticity

- **Income Elasticity:** Measures how quantity demanded or supplied responds to changes in income.
- **Cross Elasticity:** Examines how the quantity demanded or supplied of one good responds to changes in the price of another good.

PRODUCTION, COSTS, AND INCREMENTAL CAPITAL OUTPUT RATIO (ICOR)

- **Production Function**
  - **Definition:** Represents the relationship between input factors (labour and capital) and the maximum output produced.
  - **Formula:** Q = f(L, K) where Q is the output, L is labour, and K is capital.
  - Timeframes influence input flexibility, impacting costs and output.
- **Short Run and Long Run Production Periods**
  - **Short Run:** At least one input (usually capital) remains fixed, while labour can adjust to influence output.
  - **Long Run:** All inputs, including capital, are variable, allowing firms to scale production up or down more freely.
- **Total, Average, and Marginal Product**
  - **Total Product (TP):** Total output produced with a given set of inputs.
  - **Average Product (AP):** Output per unit of input, such as labour.
  - **Marginal Product (MP):** Additional output from one more unit of input.
- **Law of Diminishing Marginal Product and Law of Variable Proportions**
  - **Law of Diminishing Marginal Product:** Adding more of a variable input to fixed inputs eventually decreases marginal product.
  - **Law of Variable Proportions:** In the short run, varying a single input results in three stages: increasing, diminishing, and negative returns.
- **Returns to Scale**
  - **Definition:** Long-run relationship between proportional input increase and output change.
  - **Types:**
    - **Increasing Returns to Scale (IRS):** Output rises more than inputs.
    - **Constant Returns to Scale (CRS):** Output rises proportionately to inputs.
    - **Decreasing Returns to Scale (DRS):** Output rises less than inputs.

COSTS IN PRODUCTION

Short Run and Long Run Costs

- **Short Run Costs:** Comprise both variable and fixed costs, with limited flexibility due to fixed capital.
- **Long Run Costs:** All costs are variable, allowing for economies of scale, which reduce per-unit costs as production grows.

Incremental Capital Output Ratio (ICOR)

- **Definition:** ICOR measures the additional capital required to produce an additional unit of output, reflecting capital efficiency.
- **ICOR=ΔK/ΔY**, ΔK is the increase in capital, and ΔY is the increase in output.
- **Significance:** A lower ICOR indicates higher efficiency, meaning less capital is needed for growth. It's a critical factor for economic planning:
  - **India:** Higher ICOR of India leads to higher capital requirement for growth.
  - **China:** Lower ICOR from efficient capital allocation and high infrastructure investments.
  - **USA:** Maintains a moderate ICOR, balancing advanced technology with high capital investments.

Importance of Marginal Product and ICOR Across Economic Sectors

- **Agriculture:** ICOR helps in determining optimal capital investment in technology to boost productivity.
- **Manufacturing:** High marginal product and low ICOR allow firms to scale effectively, particularly in capital-intensive sectors.
- **Service Sector:** Efficiency gains from technology investment improve productivity, affecting ICOR positively.

THEORY OF FIRM

The **theory of the firm** describes how businesses decide on production levels and pricing to maximise profits. Firms are assumed to operate with the goal of profit maximisation, producing up to the point where **marginal cost (MC)** equals **marginal revenue (MR)**. This theory also considers factors like **cost structures**, **production functions**, and **revenue analysis**. It explains how individual firm supply curves are derived and how firms react to changes in market prices.

Perfect Competition

A **perfectly competitive market** is characterised by:

- **Many Buyers and Sellers:** No single participant can influence the market price.
- **Homogeneous Products:** Goods are identical across sellers, so consumers are indifferent between firms.
- **Free Entry and Exit:** Firms can enter or leave the market freely, maintaining long-term equilibrium.
- **Perfect Information:** All participants are fully informed about prices and product quality.

Firms in this setting are "price takers," meaning they must accept the prevailing market price.

Other Types of Competition

Other market structures contrast with perfect competition:

- **Monopoly**: A single seller with no close substitutes controls the market, influencing price and quantity.
- **Oligopoly**: A few large firms dominate, leading to interdependent pricing and potential collusion.
- **Monopolistic Competition:** Many firms sell differentiated products, allowing them to set prices to some extent.

Each structure influences pricing, output, and market efficiency differently.

MARKET SUPPLY AND SUPPLY CURVE

The **market supply curve** represents the total quantity of a good that all firms are willing to supply at various prices. It is derived by summing individual firm supply curves. Typically, the supply curve slopes upward, indicating that higher prices encourage firms to supply more, often due to increasing marginal costs.

Market Equilibrium

Market equilibrium occurs when the quantity demanded equals the quantity supplied, resulting in a stable price where the intentions of buyers and sellers align. At this price, there is no incentive for change unless an external factor shifts either demand or supply.

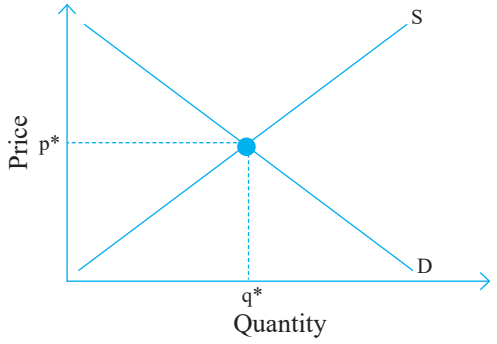

Fig.: Equilibrium Price

Excess Demand and Excess Supply

- **Excess Demand:** When demand exceeds supply at a given price, leading to upward pressure on prices.
- **Excess Supply:** When supply exceeds demand, resulting in downward pressure on prices until equilibrium is restored.

These imbalances drive price adjustments toward equilibrium.

Equilibrium with a Fixed Number of Firms

In markets with a **fixed number of firms**, equilibrium occurs where the market demand intersects the combined supply of these firms. Price adjustments occur due to shifts in demand or supply but do not affect the number of firms in the market.

Equilibrium: Free Entry and Exit

In markets allowing **free entry and exit**, firms can join or leave based on profitability. High profits attract new firms, increasing supply and lowering prices until only normal profits remain. If firms incur losses, some exit, reducing supply and pushing prices up to equilibrium.

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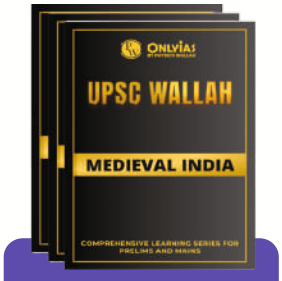
OUR CONTENT



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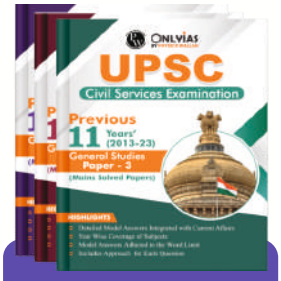

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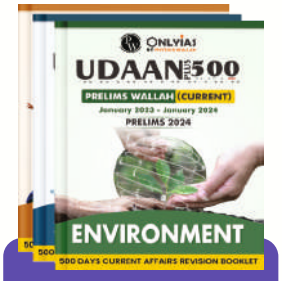

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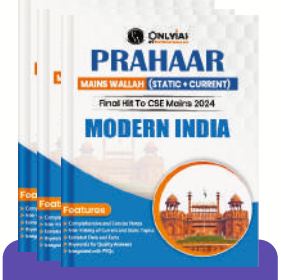

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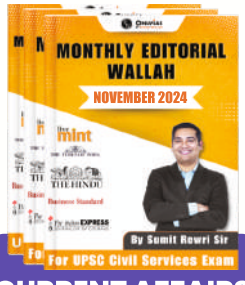

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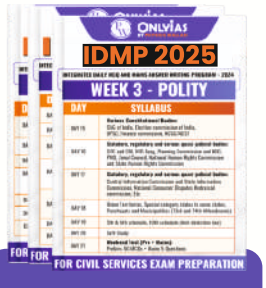

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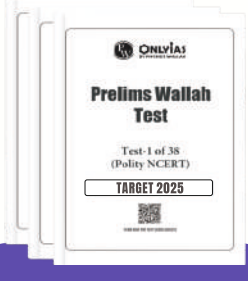
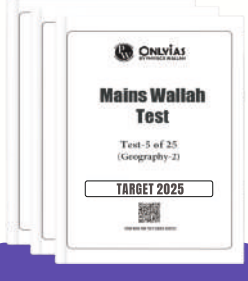


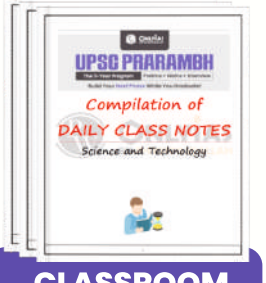
TEST SERIES

35+ Tests for Prelims



TEST SERIES

25+ Tests for Mains



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