

College Saral Adhyayan Mala

APPLIED ECONOMICS

B.Com. Second Year : Elective Subject

-
- According to New Syllabus and Examination Pattern for Annual System
 - Long, Short, Very Short and Objective Types Questions
-



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SYLLABUS : APPLIED ECONOMICS

B.Com. II Year : Elective – Marks 100 (30 + 70)

UNIT I • Historical Background of Applied Economics, Concept of Applied Economics, Scope, Nature and Importance, Its Limitations, Difference between Micro and Macro Economics, National Income – Concept, Gross National Product, Net National Product and Gross Domestic Product, Net Domestic Product, Methods of Measurement of National Income and problem related to that.

UNIT II • Income and consumption relationship – Principles of Determination of Income classical and Keynes's Theory, Solution of short term and long term consumption function, consumption function in Indian economy.

UNIT III • Value of Money, Concept and determinants of value of money, Quantity theory of money, Theory of Fisher and Cambridge, Theory of demand and supply of money Theory of money, Theory of liquidity of money, Keynes's money income theory.

UNIT IV • Concept of economic development and economic growth, economic development, Determining factors, economic and non-economic factors affect economic growth classical and modern theories of economic development, stages of economic development of Keynes and Rostow, strategy of balanced and imbalanced development.

UNIT V • Changes in the value of money – Money Inflation, Money deflation, inflation and narrative inflation demand driven inflation, cost growth inflation, stagflation effect of money Inflation and Money deflation in the Indian economy.

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APPLIED ECONOMICS – B.Com. II Year : Elective

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- Nature, Scope Importance of Economics
- Difference between Micro and Macro Economics
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- Net, Gross National Income and Gross Domestic Product
- Measurement of National Income

1

ECONOMICS : BACKGROUND AND CONCEPT

■ Long Question-Answer

Q.1 Discuss the historical background of economics and mention its various definitions.

Or

Discuss the following-

- (a) Background of economics in the reference of Kautilya.
- (b) Science of Wealth.
- (c) Science of material welfare
- (d) Science of Scarce means

HISTORICAL BACKGROUND OF ECONOMICS

In modern time Mr. Adam Smith is known as father of economics, How ever the thoughts and theories propounded by Indian ancient scholars regarding economic activities are important in this connection. In this reference name of 'Kautilya' known as 'Chanakya' the Chief adviser of Samrat Chandra Gupta Maurya is important. Kautilya was a famous thinker, he propounded many important theory regarding political science as well as economics. He propounded some important guidelines regarding public finance connecting to revenue of the state. He wrote that a ruler or state should impose tax on public considering the taxable capacity. The state should follow the rule of justice as well sufficient revenue to administrate and public welfare after Chanakya many Indian thinkers expressed their view in this regard in the light of their political concepts.

□ DEFINITIONS OF ECONOMICS

Economics has been defined differently by different economists. At one time there seemed to be almost as many definitions of the subject as there were economists. Few writers on economics were satisfied with the definitions of their predecessors. They all found it necessary to frame their

own definitions. But the situation at present is not so confusing. A consensus on the definition is emerging amongst the economists. In order to be able to understand the various definitions given by different economists it is necessary to know the subject matter of economics, i.e. human economic activities.

□ CLASSIFICATION OF DEFINITIONS OF ECONOMICS

Keeping in mind the subject matter of economics, it is necessary to learn some of the definitions of the subject put forward by various economists. For the sake of simplicity and logical exposition, the various definitions of economics developed during the course of history can be classified in the following categories.

These definitions are classified into following four categories :

- I. 'Wealth' definitions.
 - II. 'Material welfare' definitions.
 - III. 'Scarcity of means' definitions.
 - IV. 'Development and growth oriented' definitions.
- These definitions are discussed below :

I. WEALTH DEFINITIONS

Classical economists have defined Economics as the science of wealth. **Adam Smith**, for example, considered his work to be "An enquiry into the nature and cause of the wealth of nations". **Adam Smith** defined it as treating of the nature and cause of wealth of nations, where by it proposes to enrich both the people and the sovereign. Similarly according to **F.A. Walker** in America, "Economics is that body of knowledge which relates to wealth". **J.S. Mill** looked on Economics as 'the practical science of the production and distribution of wealth'. Thus it is clear that the classical economists laid stress on wealth in defining economics.

Criticism :

Adam Smith's definition of economics as a science of wealth made it a dismal science. People started thinking that economics is merely a science of bread and butter, and a 'gospel of mammon'. Thus with Smith's definition of economics, writers like Carlyle and Ruskin held that the subject makes a man selfish.

II. WELFARE DEFINITIONS

Dr. Marshall gave economics a respectable place among social sciences. Marshall laid emphasis on man and his welfare. Wealth was regarded as the source of human welfare. Dr. Marshall has defined economics in the following words :

"Economics is a study of mankind in the ordinary business of life : it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites

of well being. Thus, it is on the one side, a study of wealth, and on the other, and more important side, a part of the study of man."

According to **Prof. A.C. Pigou**, "Economic welfare is the subject matter of economic science, economic welfare being that part of social welfare that can be brought directly or indirectly into relation with the measuring rod of money."

Thus in brief, according to Prof. Marshall, Cannan and Pigou, economics is the study of material welfare of mankind.

□ CRITICISM OF MATERIAL WELFARE DEFINITION

Material welfare definition has been sharply criticised by Robbins. Points of criticism of material welfare Robbins has criticised the distinction between material and non-material things as drawn by Marshall and other 'material welfare' economists. Marshall also restricted the scope of economics to the production and consumption of material goods only. According to Robbins it is not proper to relate economics to welfare. Human welfare is a subjective concept which varies from person to person and place to place.

Conclusion : Even though Marshall's definition is an improvement over the wealth definitions of economics, on logical grounds it is not free from criticism.

III. SCARCITY DEFINITION

It was Prof. Robbins who explained the weaknesses in Marshall's definition of economics. In defining economics he has completely ignored the emphasis on 'wealth' or material welfare. He has defined economics in terms of unlimited nature of human wants and limited resources with alternative uses. His definition is given below :

□ CRITICISM :

Robbins definition focuses too much stress on the phenomenon of scarcity. However, at present the focus has shifted to the question, as to how to overcome this problem of scarcity. Therefore the focus is shifting to economics of development and growth. Modern economics is growth oriented rather than scarcity oriented.

Indian economist Dr. Mehta defined economics as a science of Wantless theory.

IV. GROWTH DEFINITIONS

The economists are not content with analysing the problems arising out of scarcity. Economics is increasingly being look up on to suggest how the means can be further increased to assure maximum satisfaction of wants for a good living. It is in this light that **Prof. Samuelson** has propounded what has come to be known as the growth oriented definition of Economics.

"Economics is the study of how man and society choose, without the use of money, to employ scarce productive resources which could have alternative uses, to produce various commodities over time and distribute them for consumption now and in the future among various people and groups of society."

Q. WHICH DEFINITION IS BETTER?

A question which now arises in the mind of a student of economics is that which of the definitions is the best. It is a very tough job to give a conclusion which is universally acceptable. However, a detailed analysis of the various definitions can lead us to derive our own opinion on this issue.

The definition of economics given by Adam Smith suffered from many defects as it stressed much on wealth.

After Smith, Marshall made a bold attempt to give a better definition of the subject. He laid emphasis on man and gave only secondary place to wealth.

Robbins gave a more scientific and analytical definition. His definition is recognised as universally applicable because it has made economics a science which studies human behaviour as a relationship between ends and scarce means which have alternative uses. However, Marshall's definition is better than all because he presented economics as a tool for human welfare. /

Q.2. Examine critically the definitions of Economics given by Marshall's and Robbins and compare them.

Definitions given by **Dr. Marshall** and **Prof. Robbins** are most important among the various definitions of economics. Dr. Marshall and his followers stated that economics is the subject of material welfare while according to Prof. Robbins it is science of scarce means. Analysis of both thoughts is as under-

MARSHALL'S DEFINITION

Dr. Marshall gave a Material Welfare based definition of economics in the 19th century. Dr. Marshall gave more emphasis to human welfare than to wealth. He said that wealth is a means to satisfy human wants and not just an end in itself. Marshall emphasised that **wealth is for man and not man for wealth.**

According to him, "Economics is a study of mankind in the ordinary business of life. It examines that part of individual and social action which is most closely connected with the attainment and with the use of material requisites of well being."

CHARACTERISTICS OF MARSHALL'S DEFINITION

The definition given by Marshall has the following main features. The salient features of the 'material welfare definition' of economics are discussed below :

- (1) Marshall shifted the emphasis from wealth to human beings and human welfare. It is concerned with man's ordinary business of life. It is related to his wealth getting and wealth using activities.
- (2) Marshall laid greater emphasis on economics being a social science.
- (3) It is related to only those economic activities that promote material welfare. Non-economic activities are excluded from the study of economics.
- (4) Economics is a social science. It is a study of men as they live and move and think in the ordinary business of life.

CRITICISM OF MARSHALL'S DEFINITION

Marshall's definition was quite popular until it was attacked by **Prof. Robbins** in his book 'An Essay on the Nature and Significance of Economic Science'. The main criticisms are :

1. **Study of all types of Human economic activity-** Marshall's definition restricted economics to the study of man in the ordinary business of life.
2. **Restricts the scope of Economics-** Marshall's definition has limited the scope of Economics to the study of material goods only which promote material welfare.
3. **A narrow view of economic activities-** The definition thinks of economic activities as concerning material goods, and increasing the welfare of man. This is an extremely narrow view.
4. **Economics as pure science-** The definition based on material welfare tends to show that economics is a social science. In Robbins' view this idea is wrong. Economics is not a social science.
5. **The definition is not analytical-** This definition is only classificatory in nature. It does not tell us the central problem of economics.
6. **Impractical-** The classification of human activities into economic appears to be illusory and impracticable.
7. **Welfare is relative term-** Welfare is a matter of individual's own consideration and it cannot be the subject-matter of scientific enquiry. There are many things and activities which do not promote human welfare.

ROBBIN'S DEFINITION

Prof. Robbins criticised Marshall for his normative view of economics. He gave his own definition which he called an analytical definition. According to him, "Economics is the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses."

□ **MAIN FEATURES OF ROBBINS' DEFINITION**

The definition of Robbins brings home the following conditions. Important elements of this definition are given below :

- (1) Human wants are unlimited.
- (2) Means to satisfy the human wants are scarce. It should be remembered here that the term 'scarce' has been used in a relative and not in an absolute sense.
- (3) Scarce resources have alternative uses. Therefore, we are always faced with the problem of choice as to the use of the resources.
- (4) There is a hierarchy of wants. In other words according to Robbins wants differ in intensity and urgency. We try to first of all satisfy our more urgent wants. As a result of this difference in intensity of wants we are able to decide as to which wants are to be satisfied first.
- (5) We are faced with the choice of using the limited means to satisfy this want or that. Much of man's economic activity is moving around the problem of scarcity or choice.

□ **CRITICISM OF ROBBINS' DEFINITION**

The definition given by Robbins is logical and scientific. But it has been criticised by some economists on different grounds.

1. **Scarcity is not the only cause of economic problems.** According to prof. Robbins, scarcity of resources is the basic cause of economic problems. However, economic problems arise not only under conditions of scarcity but also under conditions of abundance.
2. **Economics is not only positive science.** Robbins has made economics a positive science, but many economists regard it not only as a positive science but also as a normative science.
3. **Impractical definition.** But all practical men of affairs are interested in a science only if it can help to solve humanity's problems.
4. **Self contradictory.** The scarce means are to be adjusted to the multiple ends in such a manner as to secure the maximum utility or material welfare. The concept of material welfare enters his definition through the back door.
5. **Concealed concept of welfare.** According to Robbins, economics is concerned with the choice between ends and allocation of resources. It is understood that there is something to guide the solution of this problem. It is nothing else than maximisation of satisfaction.
6. **Narrow scope.** The 'Scarcity' definition as too narrow and restricted in scope for a social study like Economics.

7. **Artificial separation of Economist's personality.** Robbins wants the analyst to refrain from commenting on ends and means. In the practical life, the economist is supposed to give his verdict on economic matters.

8. **Macro analysis ignored.** Robbins' conception of economics is essentially a micro analysis which is concerned with individual behaviour. But economics is not concerned with individual ends alone. Our economic problems are related to social rather than individual behaviour.

Though economics is defined by many Economists, but these two definitions seems more suitable. The economists are of the view that it does not matter which definition we take when we are studying economics. From the real science point of view, Prof. Marshall's definition seems better. His definition is simple and proper as Marshall has considered economics as a science of welfare.

SHORT ANSWER TYPE QUESTIONS

Q.3. 'Economics is the Science of Wealth', explain the statement and critically examine the definitions relating to wealth.

SCIENCE OF WEALTH

Adam Smith, who is generally regarded as the Father of Economics, defined economics as a science of wealth in the first systematic treatment of economics in the form of a book which was rightly entitled "An Enquiry into the Nature and Causes of the Wealth of Nations."

□ **WEALTH DEFINITIONS**

Wealth has always assumed a significant role to control and regulate economic activity. But with the development of trade, industry and commerce, the role of wealth has become more dominant. Adam Smith, J.B. Say, F.A. Walker and other contemporary economists had defined economics as that part of knowledge which relates to wealth.

Adam Smith defined economics as "a science which studies the nature and causes of the wealth of nations."

J.B. Say wrote that "Political economy makes known the nature of wealth."

J.S. Mill defined Political Economy as the "science which traces the laws of such of the phenomena of society as arise from the combined operations of mankind for the production of wealth."

Thus, all the classical economists worked upon economics as a science of wealth. To them only thing important was wealth. The term 'wealth' was interpreted in a very narrow sense to mean riches or abundance of money, and the economist as such was expected to suggest ways and means of increasing the wealth of society.

□ CHARACTERISTICS OF WEALTH DEFINITIONS

The main points of the wealth based definitions are as under-

1. Economics is the study of wealth only. It deals with consumption, production, exchange and distribution.
2. Only such material commodities constitute wealth as are scarce and useful. Non-material goods like services and free goods like air and water are not wealth.
3. Economics studies the causes of wealth changes which means economic development. To increase wealth, production of material goods will have to be stepped up.

□ CRITICISM OF THE WEALTH DEFINITION

Adam Smith's definition was severely criticised by social reformers and writers like Carlyle, Ruskin and Maurice. Ruskin called Economics a Bastard Science. In Carlyle's view, economics was a dismal science because it encouraged money-making.

Q.4. Make difference between definitions of Marshall and Robbins.

COMPARISON BETWEEN MARSHALL AND ROBBINS DEFINITIONS

The main differences between the definitions given by Robbins and Marshall are as under :

1. **Distinction between economic and non-economic activities-** According to Marshall Economics studies only economic activities. As against this, Robbins' believes all those economic activities to be the subject matter of economics wherever the problem of valuation or scarcity arises.
2. **Social and human science-** According to Marshall and his followers economics is a social science. It studies normal social human beings. In Robbins' view economics is a human science concerned with the economic activities of all men, whether ordinary or extra-ordinary, since everyone faces the economic problem.
3. **Normative and positive science-** Marshall's definition clearly made economics a normative science. He talked of human welfare and was committed to the problem-solving nature of economics. Robbins

wanted economics to be a positive science. He wanted an economist to be neutral towards ends.

4. **Classificatory and analytical definitions-** Marshall's definition is classificatory in nature because it put economics as a subject as it is separated from other social sciences. He delimited the subject matter of economics to material activities leading to material welfare. While Robbins gave an analytical definition which was centred on the basic economic problem of scarcity.

5. **Practical and theoretical view-** Marshall's definition is nearer reality and more useful for economic policies. Robbins' definition is of an abstract nature and, therefore, removed away from reality.

6. **Difference regarding man and his welfare-** In Marshall's definition emphasis is on man in sharp contrast to the emphasis on the economic problem in Robbins' definition. Marshall's definition has a human element while Robbins' definition being scientific lacks the human touch.

7. **Applicability to different economies-** Marshall's definition is relevant only for a monetary capitalist economy where individual choice is free and market-oriented. Robbins' definition is relevant for all economies whether primitive or advanced.

Thus these definitions are completely different from one another.

VERY SHORT ANSWER TYPE QUESTIONS

Q.5. What do you mean by Economics ?

MEANING OF ECONOMICS

Economics is a social science which studies human behaviour which aims at allocating scarce resources to satisfy the unlimited wants in such a way that consumers can maximise their satisfaction, producers can maximise their profit and society can maximise social welfare.

Economics is defined as a study that discusses how society tries to solve human problems of unlimited wants and scarce resources.

Economics is related to economic activities. The ways adopted to organise economic activities from social angle are called economic systems or economy.

Q.6. 'Economics is the science of wantlessness' comment the definition given by prof. J.K. Mehta.

Renowned economist of Allahabad University prof. J.K. Mehta defined the economics in a different way in the light of Indian philosophy. According to him 'Economics is a science which studies human behaviour to restrict unlimited wants due to scare sources. He propounded want lessness theory.

Q.7. Classify the definitions of economics.
Definitions of economics given by different economist may be classified in the following sections -

1. Science of wealth - Adam-smith, waker, JB say Mill etc.
2. Science of physical welfare - Marshall, Pigue canon etc.
3. Science of scarcity of means - Robbins, Lerner, Friedman.
4. Science of want lessness - Dr. J.K. Mehta.
5. Science of Growth - Samuelson, Robinson.

INTRODUCTION AND DEFINITIONS OF ECONOMICS : OTQ

□ Choose Correct Option -

1. Oldest economist of India was -
(a) Manu (b) Kotliya
(c) Aryabhata (d) Bhavbhuti
2. According to Adamsmith economics is science of -
(a) Wealth (b) Welfare
(c) Data (d) All of above
3. Welfare definitions is given by -
(a) Marshal (b) Smith
(c) Recordo (d) Robbins
4. The economist give priority human welfare rather than wealth -
(a) Samuleson (b) Marshal
(c) J.K. Mehta (d) Robbins
5. Main Problems is choice definition is given by-
(a) Marshal (b) Robbins
(c) Robinson (d) Mehta
6. Science of wantlessness definition is given by-
(a) Robbins (b) Mehta
(c) Pegue (d) Samuelson
7. Name of Adamsmith's book was -
(a) Science of wealth (b) world's Economy
(c) Wealth of Nations (d) Modern Economics

Ans. (1) b (2) a (3) a (4) b (5) b (6) a (7) c.

Economics is Science and Art both

2

SCOPE AND NATURE OF ECONOMICS

■ Long Question-Answer

Q.8. Discuss the nature of economics. Is economics a Science or an art or both.

NATURE OF ECONOMICS

OR

IS ECONOMICS A SCIENCE OR AN ART ?

Nature of economics is differ from natural sciences. Economics is a social science, so it is a science and an art both. Nature of economics can be explained as below -

1. ECONOMICS AS A SCIENCE

Science is a systematised body of knowledge depending on experiments and observations or we can also say, it is a body of generalisation, principles, theories or laws which traces out, finds out, or establishes a casual, relationship between cause and effect. Economics is, in this sense, is certainly a science, because it is an orderly study of consumption, production, exchange, distribution and public revenue. A definite result is expected to follow from a particular cause in economics like all other sciences.

Economics is a social science. Does economics deserve the name or title 'science' ? Physics, Chemistry, Botany, etc., are easily recognised as science. Science is derived from the Latin word 'Scientia' which merely means know ledge. But the modern meaning of science has a restricted connotation Characteristics of a science are :

- (1) Selection and classification of relevant material,
 - (2) The using of these as a basis for generalisation.
- In this sense, economics is a science. The fundamental facts of economics are observations from everyday life.

In its scientific aspect economics is strictly a positive science. It answers the question "what is reality like" ? As a positive science it considers things as they are. But normative issues in public policy such as

"what ought to be" or "what ought to be done?" also require economic analysis.

Economics is a positive science which shows relationship between economic causes and outcomes and all the economic laws are based on these relationships. Along with it economics is also a negative science, as besides telling the status quo it also suggests ways and means to improve the circumstances.

Social and human science—According to Marshall and his followers economics is a social science. It studies normal social human beings. In Robbin's view economics is a human science concerned with the economic activities of all men, whether ordinary or extra-ordinary, since everyone faces the economic problem.

Normative and positive science—Marshall's definition clearly made economics a normative science. He talked of human welfare and was committed to the problem-solving nature of economics. Robbins' wanted economics to be a positive science. He wanted an economist to be neutral towards ends.

Economics then is a science, but a social rather than a physical science. It aims at offering explanations of 'What is' and opens up the possibility of forecasting and even controlling what the economic future will be. It is also a perspective discipline aimed at illuminating other possible states of the world.

Economics is one of the social sciences. As is the case with other social sciences, economics too is concerned with understanding how society works. Economists study the behaviour of people in society. They analyze how people are motivated by the production, distribution and consumption of material, wealth and services.

II. ECONOMICS AS AN ART

Art is the practical application of scientific principles or it is a way of doing any work in an efficient way. Hence, economics is also an art as in economics we not only study about what is the economic condition and what should it be but also about the resources for achieving ideal economic condition.

Dr. Marshall tells that Economics is a social science. It is not a pure science. It is also an art. It is one among the social sciences.

1. A Study of Manking—Economics studies only the economic activities of man. Man performs many types of activities, but economics is the study of economic activities which are concerned with the material welfare of man.

2. Ordinary business of life—Every man works mostly to earn wealth and spends his earning to get the maximum enjoyment out of it. In other words it includes the income earning and income spending activities of the human beings. So it studies only the material activities of an ordinary man.

3. Material activities of well being—There may be others, viz., political, social and religious activities of human beings. But these activities are not amenable to quantitative measurements through the measuring rod of money. Therefore, Marshall restricted the scope of economics to the study of only those economic activities which can have a money measure.

Conclusion : Thus, Prof. Marshall is of the opinion that, "Economics is not only a science but also an art, because with the study of economic activities of human beings, it also keeps human welfare in mind."

Marshall's definition based on material welfare tends to show that economics is a social science. In Robbins' view this idea is wrong. Economics is not a social science simply because it studies human beings. It may at best be called a human science. It is a pure science because it has universally applicable laws.

SHORT ANSWER TYPE QUESTIONS

Q.9. Discuss the subject matter of Economics and its divisions.

SUBJECT MATTER OF ECONOMICS

Thought it may be difficult to agree upon a satisfactory, concise definition of Economics, its subject matter is generally beyond dispute.

All the economists agree that needs of human beings are unlimited, and to satisfy these needs economic effort is essential. These economic efforts lead to economic activities. As a result of these activities, a human being is able to procure the desired commodity and consume them to achieve satisfaction.

DIVISION OF ECONOMICS

On the basis of various human economic activities, Economics has been broadly divided into the following five main divisions :

1. **Consumption** – Wants Utility, Law of utilities, demand etc.
2. **Production** – Factors of Production, division of Labour, efficiency of Labour, theories of population, production scale and laws.

3. Exchange – Market, price determination etc.
4. Distribution Rent, wages, interest, profit.
5. Public Finance – Revenue and expenditure of Government, public dept, Budget etc.

A man has a limited amount of money or material wealth or income and time; but his wants are unlimited and of varying importance. So he must spend his money and time in the way that he maximises satisfaction. This constitutes the subject matter of Economics.

The subject matter of Economics, according to the traditional approach, is consumption (i.e., the satisfaction of human wants), production (i.e., producing things with the help of factors of production), exchange (i.e., then processes by which goods are transported, stored, valued, sold and paid for in the market) and finally distribution (i.e., division of what has been produced among the members of the group).

The subject matter, as given in the above para, is now regarded as constituting only one branch of Economics namely, Price Theory, also called Micro-economics. Modern approach to the subject matter of economics considers the social national income as well as individual income.

This is one way of dealing with the subject matter of economics. Another is to look at the focal point of economics which is income. The economist looks at his subject matter from many advantageous points. He studies many complex economic institutions. In spite of all these, his central interest is always social income, that is, the output of useful goods and services. It is so because it is with social income that man satisfies his wants.

So, the subject matter of Economics is man and his behaviour or action in relation to social rather than individual life. The personal peculiarities of temper and character do not form its subject matter. The steadiest motive to ordinary business work is the desire for pay. It (pay) is money or the material reward for work. It is the centre around which economic science clusters. This is so, not because money or material wealth is regarded as the main aim of human effort. It is not also the main subject matter of the study of economics. It is so because it is the one convenient means of measuring human motive on a large scale.

Q.10. "Economics is a positive science as well as normative science" Comment.

POSITIVE AND NORMATIVE ECONOMICS

In positive economic analysis, we study how the different mechanisms function and in normative economics, we try to understand whether these mechanisms are desirable or not. Hence, the concept of positive economics is concerned with 'what is' and a normative science with 'what ought to be'.

No.	Positive Economics	Normative Economics
1.	It deals with issues related to past, present and future.	It deals with opinions of economists related to economic issues.
2.	It is based upon facts and can be verified with actual data.	It gives value judgements and cannot be verified with actual data.
3.	It does not involve value judgements Ex.: There is problem of unemployment due to population explosion in India.	It involves value judgements. Ex.: Indian Government should take steps to increase employment opportunities.

Economics is a positive science- Marshallian definition is criticised for its normative character. In Robbins' view economics is entirely neutral between ends, as every positive science is. The study of ends is outside its scope. An economist does not study the nature of norms.

VERY SHORT ANSWER TYPE QUESTIONS

Q.11. Discuss the scope of Economics.

Scope mean the range of study or action. So under the scope of economics, we need to consider the range of the study of economics. The range of economics include -

- (1) The subject matter of economics, human economic activities i.e. consumption, production, exchange distribution public financial.
- (2) Economics as a social science Art Economics as a positive or a normative science. It is also an art.

Q.12. Discuss the views of different economist regarding subject matter of economics.

We saw that the traditional central nucleus of economics was rational human behaviour in a group. Modern economists examine this nucleus in the context of scarcity. We also noted that economics as a separate discipline is only a little over two centuries old. Since economists use the scientific procedure to generalise economic facts, economics is a science. It is both a positive science concerned with what it is and a normative science dealing with what ought to be.

Economists do not completely agree on the scope of economics. The some, economics is merely about 'means', while society or the head of the state is to specify the 'ends'. But others feel that economist is not simply a technician or agent of a policy maker but worldly philosopher, a thinker who helps to give direction to society.

Economist is merely concerned with the process of using scarce means to achieve chosen ends but it is not the function of economics as a science to promote one of these ends above the others.

SCOPE AND NATURE OF ECONOMICS : OTQ

Choose Correct Option -

1. Subject matter division of economics are-
 (a) 2 (b) 3
 (c) 4 (d) 5
 2. Economics is-
 (a) Science (b) Art
 (c) Both (d) None of above
 3. According to Marshall economics is-
 (a) Positive Science (b) Normative Science
 (c) Art (d) Natural Science
 4. According to Robbins economics is-
 (a) Positive Science (b) Social Science
 (c) Normative Science (d) Physical Science
- Ans.** (1) d (2) c (3) b (4) a.

A human being has to face economic problems in every field of his activity. The study of economics gives him the right direction.

3

SIGNIFICANCE OF ECONOMICS

■ Long Question-Answer

Q.13. Discuss the practical significance of Economic study.

Or

What are the practical advantages of Economic study in life ?

SIGNIFICANCE OF ECONOMIC STUDY

There are two objects of the study of a subject. Firstly, to gain knowledge, and secondly to gain advantage in practical life. Keeping this in view, Marshall has remarked that "The first object of the study of economics is to gain knowledge, and the second object is demonstration of a path in practical life." Prof. Pigou has characterised economics as a subject giving knowledge and fruitful results.

PRACTICAL ADVANTAGES

Practical advantages are significant by the study of economics to all sections of society as the present age is an age of economics.

The following are the practical advantages of economic study :

(1) To consumers or house holders- Consumers or house holders get much help from the study of economics. It is necessary to gain knowledge about economic laws in order to obtain maximum utility from limited income. House holders learn from economic study to make budgets and spend accordingly. They consume essential articles and avoid use of those harmful.

(2) To Industrialists and businessmen- There is a chain of information in the field of industry and trade, data of which are collected and compiled and policies are decided. The main object of a businessman is to maximise profits. Economic study is essential to gain this object.

(3) To Social Reformers- In the present day economy, major economic problems are found in the society. Besides theft, murder, loot, dacoity, there are several problems due to which there is struggle in the society. Social reformers can suggest solutions after studying them in detail by economic study.

(4) To Politicians- There is close relation between politics and economics. In majority of cases, political problems involve economic problems. Therefore, politicians should gain knowledge about economic problems so that they can solve them easily.

(5) To Students- For students, economic study is necessary as a profession. A student should possess higher knowledge of economics to become a banker, accountant or manager of a firm. We see economists work in various fields like statistics, business administration, banking, Government concerns, industrial sectors, marketing etc. Thus, doors are open for students to take up a profession. That is why, economics has become a popular subject in schools, colleges and universities.

(6) To a Finance Minister- A Finance Minister having knowledge of economics can easily prepare the budget. By imposition of various taxes, he makes several sources praiseworthy and forecasts expenditure. A separate branch of economics is revenue in which income and expenditure is studied which gives direction to the Finance Minister to prepare a budget.

(7) To Workers- The labour class can make its position sound from economics study. Many a time, workers have no knowledge of collective bargaining due to which they are cheated by their employers. They are ignorant about Government laws passed in their favour. They can be acquainted with welfare plans only when they have studied economics.

(8) To Producers and Manufacturers- A producer wants to produce maximum articles at a minimum cost. Laws of production, division of labour and economics of large scale production can help the producer in this direction. With their help, he can get maximum production at a minimum cost. Besides it, knowledge of competition in the market, selling cost and policies of price determination is essential for a producer/manufacturer.

(a) To Farmers- Farmers get several advantages from economic study. Farmers can determine the price of agricultural products according to the forces of demand and supply and in this way they can sell their products at reasonable price. Farmers get knowledge about the laws of production. In order to control the law of diminishing returns, they make use of good seeds, implements and fertilizers as also rotation of crops. Farmers also get knowledge about the problems of small scale and cottage industries.

(10) To Administrators- The study of economics is not less significant to administrators. The responsibility of implementation of plans and policies lies on the shoulders of administrators. With the help of economic study, they can obtain a detailed knowledge of economic policies.

Thus, the study of economics is significant more or less to every section of society. This is the reason why this subject is gaining popularity day by day.

SHORT ANSWER TYPE QUESTIONS

Q.14. Discuss theoretical advantages of Economic study.

THEORETICAL ADVANTAGES

The theoretical advantages of the study of economics are as follows :

(1) Increase in Knowledge- the study of economics helps in increasing knowledge of a human being. Views are broadened and they become good citizens. The study of economics enables us to know about economic laws and problems.

(2) Mental Development- With an increase in knowledge, there is mental development as well. Two methods are used in the study of economics one is the deductive and the other is the inductive method. The deductive method increases our power of logic. Whereas the inductive method increases survey and analysing power.

(3) Genuine economic laws- The main objects of genuine economic laws are -

(a) Economic laws help to contribute significant role in giving description of the causes and effects of different events.

(b) Economic laws help in giving forecasts in results consequent on changes in economic elements.

(c) A solid structure can be built up with the help of economic laws.

Q.15. Explain importance of study of Economics for Consumer.

CONSUMERS OR HOUSE HOLDERS

The following are the particular advantages of economic study -

(1) Consumers or house holders get much help from the study of economics. It is necessary to gain knowledge about economic laws in order to obtain maximum utility from limited income.

(2) House holders learn from economic study to make budgets and spend accordingly. They consume essential articles and avoid use of those harmful.

- (3) Economics helps individual consumers and producers to take decisions in their respective areas.
- (4) Economics studies individual so it gives a comprehensive picture of the whole economy.

Q.16. Give the significance of Economics study to the Industrialists and businessmen.

IMPORTANCE FOR INDUSTRIALISTS AND BUSINESSMEN

There is a chain of information in the field of industry and trade, data of which are collected and compiled and policies are decided. The main object of a businessman is to maximise profits. Economic study is essential to gain this object.

- 1. **Analysis of financing problems** - Economics provides solutions to various financial problems of businessmen and industries.
- 2. **Helpful in analysis of business cycles** - It helps to know the impact of business cycles on the whole economy.
- 3. **Helpful in growth of business** - economics helps in formulating principles and theories of business and industries operations providing a basis for study.
- 4. **Importance of allocation of resources** - It helps to value and allocate the production resources.
- 5. **Helpful in price determination theory** - Micro economics helps to determine price of factors and products too.

VERY SHORT ANSWER TYPE QUESTIONS

Q.17. For which sections study of economics is useful.

Practical advantages are significant by the study of economics to all sections of society as the present age is an age of economics.

The following are the practical advantages of economic study :

- (1) To consumers or house holders
- (2) To Industrialists and businessmen
- (3) To Social Reformers
- (4) To Politicians
- (5) To Students
- (6) To a Finance Minister
- (7) To Workers
- (8) To Producers and Manufacturers
- (10) To Administrators

Q.18. Discuss the need of Economics study for social workers.

SOCIAL REFORMERS

In the present day economy, major economic problems are found in the society. Besides theft, murder, loot, dacoity, there are several problems due to which there is struggle in the society. Social reformers can suggest solutions after studying them in detail by economic study.

Q.19. Why is essential the knowledge of economics for finance minister.

Public finance is a part of economics, it helps to finance minister as under -

- 1. **Helpful in understanding functioning of an economy**- Every economy faces lots of economic problems like - poverty, full employment etc. Economics analyse these problems and suggested solutions for the name.
- 2. **Helpful in economic planning**- Economics provides all the required information which is necessary to prepare plans.
- 3. **Helpful in measuring growth**- The Government can measure the growth of an economy with the help of macro economic study.

IMPORTANCE OF ECONOMICS : OTQ

Choose Correct Option -

- 1. **Utility study of economics may be dividend in the following heads-**
 - (a) Theoretical advantages
 - (b) Practical advantages
 - (c) Both above (a) and (b)
 - (d) Many advantages
- 2. **Improvement of knowledge is economics study-**
 - (a) Theoretical advantages
 - (b) Practical advantages
 - (c) Educational advantage
 - (d) Mental advantages
- 3. **Utility of study of economics for -**
 - (a) Consumer
 - (b) Producer
 - (c) Finance minister
 - (d) All of above

Ans. (1) c (2) a (3) c.

Micro and Macro economics are closely related with each other, yet there is fundamental difference between them.

4

DIFFERENCE BETWEEN MICRO AND MACRO ECONOMICS

■ Long Answer Type Question

Q.20. Distinguish between Micro and Macro Economics. They are two complementary to each other rather than being the alternate methods of study. Discuss.

Or

There is really no opposition between Micro and Macro Economics. Both are absolutely vital and you are really half educated if you understand the one while being ignorant of the other." (Samualson). Discuss.

Or

(a) Explain the interdependence of Micro Economics and Macro Economics.

(b) Distinguish between Micro and Macro Economics.

Micro Economics and Macro Economics are the important methods of the study of economic analysis. Micro Economics studies an individual whereas Macro economics studies the aggregate. Before we distinguish between the two methods, it is essential to know the meaning of each method.

□ Meaning of Micro Economics

Micro Economics is a branch of economic analysis which is concerned with the trend of an individual unit. An individual unit may be an individual person or a particular firm. How an individual person can get maximum satisfaction, how a firm can maximise its profits, how the value of a thing is determined, are studied under Micro Economics.

□ Meaning of Macro Economics

Macro Economics is concerned with big totals and the study of aggregates. It studies total income, total savings, total consumption, general price level and total employment. It gives a general trend of the whole economy.

[22]

Difference between Micro and Macro Economics / 23

Thus, in brief, **Macro Economics is the branch of economic analysis which covers the study of an overall economic structure, like big totals and averages, their trends and mutual relations.** The main instrument of Macro Economics is the analysis of national income.

DISTINCTION BETWEEN MICRO-ECONOMICS AND MACRO ECONOMICS
The micro economics differs from macro economics in the following respects—

S. No.	Basis of difference	Micro-Economics	Macro-Economics
1.	Meaning	It is that branch of economic science which studies individual economic variables like individual demand, supply, price, etc.	It is that branch of economic science which studies aggregate economic variables like aggregate demand, aggregate supply, general price level etc.
2.	Scope	It has a narrow scope— an individual market etc.	It has a wide scope— national and international markets etc.
3.	Evolution	It is evolved earlier than macro economics.	It is evolved after the publication of Keynes' book "General Theory of Employment, Interest and Money."
4.	Subject matter	Individual demand, individual supply, individual income, individual consumption, individual investment etc. are studied in micro economics.	Aggregate demand, aggregate supply, national income, economic growth, monetary policy, general price level, public revenue, public expenditure etc. are studied in macro economics.
5.	Purpose of study	It aims at analysing the behaviour of an individual economic unit.	It aims at analysing the behaviour of aggregates.
6.	Theories	Theory of demand, theory of production theory of price determination etc. form part of micro economics.	Theory of national income, theory of employment, theory of money, theory of general price level, etc. form part of macro-economics.
7.	Importance	It is important in analysing individual problems and individual policy formation.	It is important in analysing the national and international problems and policy formation.
8.	Nature	It is simple.	It is complicated.
9.	Relation	It relates to price analysis.	It relates to income analysis.

MUTUAL INTER-DEPENDENCE

Although the scope of each method is separate, yet there is close relation between the two methods. Both these methods are subsidiary and supplementary to each other. Both of them remove shortcomings of each method. There is no contradiction with each other. The help of the study of Micro Economic analysis is taken to solve the problems of Macro Economics and that of Macro Economic analysis for the solution of Micro Economic Problems.

Thus it should not be understood by the difference, that there is any fundamental difference. The difference, in fact, is that of division or classification. There is no clear demarcation between the two methods of economic analysis.

The inter-dependence of the two methods of economic analysis can be made clear from the following -

- (1) The central point of the study of Micro economic analysis is an individual unit or a part of a group, whereas Macro economics studies groups of units or aggregates.
- (2) Macro economics gives a picture of the whole economy whereas Micro economics specifies structural process.
- (3) Conclusion derived from both the methods may differ to a large extent from each other.
- (4) Micro economics is suitable for the plans of individuals, families and firms and Macro economics is suitable for national income.
- (5) Macro economics conforms from the total of individual of different character.

The objects, methods and processes of both are similar. The aim of both the methods is to contribute towards economic development of an individual and the group of individuals. Sometimes the line of demarcation between these methods is not clear.

So, Macro and Micro economics are closely related with each other, yet there is fundamental difference between them. Conclusions of one method must be utilised in the other method very carefully. What applies to a particular person or unit does not necessarily apply to a group. For example, a particular individual may be rich by getting paper money, but it is not necessary, a nation may be progressive by printing notes. Besides, frequent changes take place in the case of individuals in matters of economics and money. Therefore, proper care should be taken, particular trends should not be treated general trends and general trends as particular ones. Thus, we take it for granted that macro and micro economics are inter-dependent and supplementary to each other.

Q.21. Explain the concept, characteristics and scope of Micro Economics.

Or

Define Micro Economics. Discuss its features, and scope of its study.

CONCEPT OF MICRO ECONOMICS

The word 'Micro' is derived from Greek word 'MIKROS' which means brief or small. The idea of Micro Economics was given by Adam Smith, but Marshall gave it an important place. Micro Economics studies a single or individual unit not a group. Economics behaviour of an individual person or thing is studied in Micro Economics. Various authors have defined Micro Economics as under -

According to **Prof. Boulding**, "Micro Economics studies individual firms, individual families, individual prices, individual wages, individual incomes, individual firms and individual things".

In the words of **Prof. Chamberlain**, "Micro Economics is wholly dependent on the individual description. It is also concerned with inter-relationship of individual things."

According to **Prof. Mehta**, "Micro economics is the study of price determination of things and services."

In simple words, **Micro economics can be defined, as an economic analysis which studies individual persons, units, firms and services.** How to determine the price of a thing or service or any factor of production is the problem of micro economics.

CHARACTERISTICS OF MICRO ECONOMICS

The characteristics of micro economics are as under-

1. Study of individual Units- Micro economics studies individual units, e.g., study of one consumer, study of one firm, study of prices of one article. Micro economics studies the individuals units other than all the units combined together.

2. Study of small variables- Micro Economics gives emphasis of the study of small variables. These variables have such a little influence that they do not affect the whole economy. For example, the consumption by a single consumer or output of a single firm cannot have any influence on the whole economy.

3. Determination of individual price- Micro Economics is called price theory. It determines the individual price of different products by analysing the demand and supply i.e. Behaviour of buyers and behaviour of sellers.

4. Quick Decisions- When individuals are studied, decisions are quickly made. Micro economics studies small flexible individual units. Thus problems are solved soon.

5. Central Concept is market- The central concept in micro economics is the market and much of the analysis is related to the type of market in which the firm operates, in particular, with the degree of competition. The analysis of individual behaviour concentrates on Consumer Demand Theory.

6. Equilibrium- Traditional micro economics concentrated on Partial Equilibrium analysis. Modern micro economics places a much greater emphasis on General Equilibrium, analysis. In both the cases the emphasis is on equilibrium analysis. Therefore, micro economics is also called equilibrium theory, whereas macroeconomics is known as disequilibrium theory. The normative sub-branch of micro economics is known as Welfare Economics.

7. Microscopic Study- Micro economics refers to the microscopic study of economy; we do not study the national economy in its totality. Since micro economics splits up the entire economy into smaller part for the purpose of intensive study.

SCOPE OF MICRO ECONOMICS

Scope and subject matter of micro economics may be discussed under the following heads-

1. Pricing Theory- Micro Economic theory is known as the price theory. In micro economic analysis, concerned with individual choices among various courses of action, special emphasis is placed on the role of Prices in business and personal decisions. Economists try to analyse how the prices of particular goods and services are determined and how the prices influence decisions. This preoccupation with prices is the reason why micro economics is also called the price theory. Price theory is defined as that part of economics which is concerned with analysing the ways in which prices are determined in a market economy.

2. Factor Pricing- Micro economics studies the distribution among the factors of production e.g. land, labour, capital, organiser and entrepreneur. There for it includes-

- (a) Theory of rent,
- (b) Theory of wages,
- (c) Theory of interest and
- (d) Theory of profits.

3. Theory of welfare economics- An efficient method of production is one where it is not possible to produce more of at least one product without simultaneously producing less of any other product, given the method of production. Efficient distribution is that in which a redistribution of output among the members of the society cannot make at least one person better off without simultaneously making another worse off.

Q.22. Discuss the concept by Macro Economics ? Discuss the nature and subject matter of Macro Economics.

MEANING OF MACRO ECONOMICS

Macro Economics is concerned with big totals and the study of aggregates. It studies total income, total savings, total consumption, general price level and total employment. It gives a general trend of the whole economy.

According to Prof. Boulding, "Macro economics does not study individual units, but aggregate of these units, it is concerned not with individuals income but national income, not with individual prices but general price level, not with individual production but with national production."

Thus, in brief, **Macro Economics is the branch of economic analysis which covers the study of an overall economic structure, like big totals and averages, their trends and mutual relations.** The main instrument of Macro Economics is the analysis of national income.

□ NATURE OR CHARACTERISTICS OF MACRO ECONOMICS

The above analysis reveals the following characteristics of macro economics-

1. Study of Aggregate Economy - Macro economics studies the aggregate economy and not individual units. In macro economics, we do not study the individual or group of individuals but the economy as a whole such as general price level or problem of unemployment etc.

2. Scope- Macro economics deals with economic affairs 'in the large'. It, therefore, concerns with the overall dimensions of economic life. It looks at the total size and not at a particular part of the economy. In macro economics is studied, total national income, total savings, total production, total consumption, total employment.

3. Technique- Macro economics, uses the technique of quasi-general equilibrium or partial equilibrium analysis to study determination of aggregate price and output levels and fluctuations in these aggregate magnitudes.

4. Extensive view point - Macro economics, with the help of the study of various problems, gives an aggregate solution. macro economic analysis is not based on assumptions. It assume under employment equilibrium.

5. Subject matter- Income determination is studied under macro analysis. Therefore, in micro, we study consumption, production, sources of production while total consumption, total investment are dealt in macro economic analysis.

6. Interdependence- Micro and macro theories are not totally separate and independent but inter-connected and inter dependent. The subject matter of study on various aspects is dependent on each other to a large extent, e.g., production, employment and savings.

7. Priority to group interest- Macro economics gives priority to group interest instead of individual interest.

SCOPE OR SUBJECT MATTER OF MACRO ECONOMICS

Scope of macro economics has been explained as under :

1. Theory of National Income- Macro economics studies the concept of national income, its different elements, methods of its measurement and social accounting.

2. Level of output and Employment- We analyse the factors that determine the level of national output and employment. National output is a function of employment of resources. In the short run output varies with employment of labour. Output and employment rise or fall together. At times unemployment of labour mounts up. At times the economy reaches near full employment level. Keynes analysed the factors that determine the level of output and employment in the economy in the short run.

3. Theories of Distribution- There are macro economic theories of distribution. These theories try to explain how the national output is distributed among the factors of production.

4. Economic Development- UDCs are blessed with mass poverty and low per capita income curve for economic development. Economic development is a long run process. In it, we analyse the problems and theories of development.

5. Theory of International Trade- It also studies principles determining trade among different countries. Tariffs' protection and free trade policies fall under foreign trade.

6. Theory of Money- Changes in demand and supply of money effect level of employment. Therefore, under macro economics functions of money and theories relating to money are studied.

7. Theory of Business Fluctuations- It also deals with the fluctuations in the level of employment, total expenditure, general price level.

8. Theory of General Price Level- A continuous rise in the general price level is called inflation. Deflation is the opposite of inflation. The general price level falls continuously. Macro economics provides explanation for the occurrence of inflation and deflation.

SHORT ANSWER TYPE QUESTIONS

Q.23. Distinguish between Micro Economics and Macro Economics.

Micro Economics and Macro Economics are the important methods of the study of economic analysis. Micro Economics studies an individual whereas Macro economics studies the aggregate. Before we distinguish between the two methods, it is essential to know the meaning of each method.

□ DISTINCTION BETWEEN MICRO-ECONOMICS AND MACRO ECONOMICS

The micro economics differs from macro economics in the following respects-

S. No.	Basis of difference	Micro-Economics	Macro-Economics
1.	Meaning	It is that branch of economic science which studies individual economic variables like individual demand, supply, price, etc.	It is that branch of economic science which studies aggregate economic variables like aggregate demand, aggregate supply, general price level etc.
2.	Scope	It has a narrow scope- an individual market etc.	It has a wide scope- national and international markets etc.
3.	Evolution	It is evolved earlier than macro economics.	It is evolved after the publication of Keynes' book "General Theory of Employment, Interest and Money."
4.	Subject matter	Individual demand, individual supply, individual income, individual consumption, individual investment etc. are studied in micro economics.	Aggregate demand, aggregate supply, national income, economic growth, monetary policy, general price level, public revenue, public expenditure etc. are studied in macro economics.

5. Purpose of study	It aims at analysing the behaviour of an individual economic unit.	It aims at analysing the behaviour of aggregates.
6. Theories	Theory of demand, theory of production theory of price determination etc. form part of micro economics.	Theory of national income, theory of employment, theory of money, theory of general price level, etc. form part of macro-economics.
7. Importance	It is important in analysing individual problems and individual policy formation.	It is important in analysing the national and international problems and policy formation.
8. Nature	It is simple.	It is complicated.
9. Relation	It relates to price analysis.	It relates to income analysis.

Q.24. Explain the Inter-dependence of Micro and Macro Economics.

Micro and macro-economics are interdependent and both contribute to each other. Though they deal with different subjects, yet there is a good deal of interdependence between them. The two approaches are, therefore, not in any way mutually exclusive and as such must be properly integrated to secure fruitful results. Professor Samuelson has aptly remarked that 'there is really no opposition between micro and macro-economics. Both are absolutely vital. You are less than half educated if you understand the one, while being ignorant of the other.'

MUTUAL INTER-DEPENDENCE

Although the scope of each method is separate, yet there is close relation between the two methods. Both these methods are subsidiary and supplementary to each other. Both of them remove shortcomings of each method. There is no contradiction with each other. The help of the study of Micro Economic analysis is taken to solve the problems of Macro Economics and that of Macro Economic analysis for the solution of Micro Economic Problems.

The inter-dependence of the two methods of economic analysis can be made clear from the following -

- (1) The central point of the study of Micro economic analysis is an individual unit or a part of a group, whereas Macro economics studies groups of units or aggregates.
- (2) Macro economics gives a picture of the whole economy whereas Micro economics specifies structural process.
- (3) Conclusion derived from both the methods may differ to a large extent from each other.

- (4) Micro economics is suitable for the plans of individuals, families and firms and Macro economics is suitable for national income.
- (5) Macro economics conforms from the total of individual of different character.

Q.25. Explain the dependence of Macro Economics on Micro Economics.

Micro economics contributes towards macro economics in a number of ways as :

1. Study of Economic Fluctuations—Business cycles which are universal in every sector, is influenced by both individual and aggregate factors. Unless and until we review both micro and aggregate variables, we can not provide an appropriate solution to business cycle. Therefore to study trade cycle micro and macro economics contributes significantly.

2. Basis of Economic Laws—Micro economics acts as a basis of macro economics because macro is the aggregate of individual units. The success and accuracy of aggregates depends on the individual accuracy. Similarly, macro theories are used by micro economists.

3. Role in International Trade—In international trade both the approaches are used. Economists have developed their theories on the basis of micro economic theory presuming full employment of resources and mobility of factors of production. However, modern economists looked on the economy as a whole as recognised as a role of aggregates, so general equilibrium is nothing but an extension of equilibrium of micro economics.

4. Balance of Payments and Interdependence—Balance of payments problem is also a burning problem for the economy. An individual sector may have favourable balance of payments whereas the other sectors, unfavourable balance of payments. On the other hand, the overall position of an economy is to be assessed from aggregate position of all sectors.

5. Theory of Tariffs—Many economists have propounded that modern macro approach of imposing tariffs with the intension of correcting balance of payments position is virtually based on the theory of monopoly. So micro economics has influenced the modern macro economic theory.

VERY SHORT ANSWER TYPE QUESTIONS

Q.26. What do you mean by Micro Economics ?

Micro economics is a method of study of economic activity of an individual unit. In simple words, **Micro economics can be defined, as**

an economic analysis which studies individual persons, units, firms and services. An individual unit may be a person, family or firm. How an individual gets maximum satisfaction, how a firm earns maximum profits, how is the price of a commodity determined are all studied by micro economics.

Q.27. What do you understand by Macro Economics ?

MACRO ECONOMICS

Macro means aggregate study of the whole group. Therefore, aggregate economy is studied in Macro Economics. In Macro economics are studied, total income, total savings, total consumption, general price level, total employment. As such, a general view is revealed from the aggregate economy.

Thus macro economics is the branch of economic analysis which covers the whole economy and is concerned with big totals, aggregates and averages, their behaviour and mutual relations.

Q.28. Which are principles or theories included in micro economics.

THEORIES OF MICRO ECONOMICS

The contents of micro economics can be broadly divided into 3 groups, namely.

1. **Product pricing-** Micro Economics is referred to as Price Theory. Its included (a) Theory of Consumer Demand, and (b) Theory of Production and Costs.
2. **Factor Pricing-** Its included (a) theory of Rent, (b) Theory of Wages, (c) Theory of Interest and (d) Theory of profit.
3. **Theory of Welfare Economics-** Micro economics insists on welfare of society therefore it is also called welfare economics.

Q.29. Show the characteristics of Macro Economics.

NATURE OR CHARACTERISTICS OF MACRO ECONOMICS

Following characteristics of macro economics-

1. **Study of Aggregate Economy -** Macro economics studies the aggregate economy and not individual units.
2. **Subject matter of study -** In macro economics is studied total national income, total savings, total production, total consumption, total employment.

3. **Extensive view point -** Macro economics, with the help of the study of various problems, gives an aggregate solution.

4. **Interdependence -** The subject matter of study on various aspects is dependent on each other to a large extent, e.g., production, employment and savings.

Q.30. Discuss the scope of Macro Economics.

SCOPE OF MACRO ECONOMICS

The scope of macro economics consists of the following-

- (1) **Theory of income, output and employment-** with its constituents of -
 - (a) Theory of consumption function and
 - (b) Theory of investment function
 - (c) Theory of business cycles.
- (2) **Theory of Prices with its constituents of -**
 - (a) Theory of inflation, (b) Theory of deflation and (c) Theory of deflation.
- (3) **Theory of Economic Growth** dealing with long run growth of income, output and employment as applied to developed and underdeveloped countries.
- (4) **Macro theory of distribution** dealing with the relative shares of wages, and profits in the total national income.
- (5) **Theory of international trade and foreign exchange.**
- (6) **Theory of Public Finance-** Public Revenue, Public-Expenditure, Public Debts, Taxation, Fiscal Policy etc.
- (7) **Theory of Money and Banking-** Monetary Policy, Credit system, Banking system, Central Banking, International Finance etc.

Q.31. Micro Economics is depends on unreal assumptions. Explain.

Principles and theories propounded under Micro Economics are based on some assumptions. Like other things should be equal is essential for many laws and theory under consumption and price determination principles. Law of diminishing utility, law of equi-marginal utility, law of Demand, price determination theory, marginal productivity theory of distribution are based on some assumptions and these assumption are unreal, in other words not founded in practical field.

CONCEPT OF MICRO AND MACRO ECONOMIC : OTQ

Choose Correct Option -

1. **Micro Economics studies of -**
 - (a) Families
 - (b) Individual Units
 - (c) All firms
 - (d) Whole society
2. **Micro Economics studies-**
 - (a) Small industries
 - (b) Retail Business
 - (c) Individual Consumer
 - (d) All of above
3. **Micro and Macro economics are-**
 - (a) Competitive
 - (b) complementary
 - (c) Separate
 - (d) Alternative
4. **The following Economist is developer of micro economic theory-**
 - (a) Adam smith
 - (b) Prof. Marshall
 - (c) Prof. Kynes
 - (d) Wallras
5. **"Price theory is main instrument of ... economics" the statement of -**
 - (a) Macro Economics
 - (b) Aggregate economics
 - (c) Micro economics
 - (d) Applied Economics
6. **Second name of Micro economics-**
 - (a) Employment theory
 - (b) Income theory
 - (c) Price theory
 - (d) All of above
7. **Which one of the following is related to micro economics-**
 - (a) Theory of general prices
 - (b) Theory of employment
 - (c) Theory of Economic
 - (d) Optimum allocations of resources
8. **The following is characteristics of Micro economics-**
 - (a) Study of individual units
 - (b) Stable economics
 - (c) Based of assumptions
 - (d) All of above
9. **Micro economics is base on the assumption-**
 - (a) Total employment
 - (b) Perfect competition
 - (c) Stable economy
 - (d) All of above

10. **In Macro Economics studied-**
 - (a) Individual
 - (b) Unit
 - (c) Group
 - (d) All of above
 11. **The following is not studied in Macro economics-**
 - (a) Employment theory
 - (b) Inflation
 - (c) Price determination
 - (d) General price level
 12. **General price level is studied in-**
 - (a) Micro economics
 - (b) Macro economics
 - (c) Above both
 - (d) None of above
 13. **Main contribution in Macro Economics-**
 - (a) J.M. Keynes
 - (b) K.E. Bolding
 - (c) Kwine
 - (d) Marshall
 14. **Micro and Macro Economics are -**
 - (a) Opponent each other
 - (b) Complimentry of each other
 - (c) Independent
 - (d) Equal
 15. **Macro economics word firstly introduce by-**
 - (a) Keyns
 - (b) Ragner Frish
 - (c) Malthus
 - (d) Karl Marx
- Ans. (1) b (2) c (3) b (4) a (5) c (6) c (7) d (8) a (9) d (10) c (11) c (12) b (13) c (14) b (15) b.
-

GDP is scale to measure growth of the economy.

5

NATIONAL INCOME : CONCEPT GROSS, NET AND DOMESTIC PRODUCT

■ Long Answer Type Question

Q.32. What is National Income ? In this connection, discuss the views of Marshall, Pigou and Fisher.

Or

- (a) Explain the meaning of National Income.
- (b) Critically examine the definitions given by Marshall.

MEANING OF NATIONAL INCOME

The importance of the concept of national income in economics in the field of distribution is very great. It is essential to know about the concept of national income for the study of any problem of distribution. A comparison of the progress of different countries, national income is the basis of economic development. A simple meaning of national income is total income earned by the whole nation. But, in economics, there is a special view of national income. It is as under -

"National income is the total monetary value of a country's total production and services in a particular year." In other words, national income is the total of production of all the factors in a particular year in a country".

There are different opinions of economists about the definition of national wealth. Definition of Marshall, Pigou and Fisher are important.

I. MARSHALL'S DEFINITION

According to Marshall, "National income is the sum total of the net production of material and non-material goods and services in a country obtained by labour and capital with the help of natural resources."

□ FEATURES

The following points emerge from Marshall's definition -

- (1) National income depends upon the production of goods and services in a country.

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National Income : Concept Gross, Net and Domestic product / 37

- (2) Total of net production of goods and services of a country in a particular year is national income.
- (3) Both material and non-material goods shall be included in calculation of national income.
- (4) National income is generally calculated on a yearly basis.
- (5) In order to find out the net national income, wear and tear and depreciation must be excluded from gross production.
- (6) Services of the members of families and friends rendered gratuitously are not included in national income.

□ CRITICISM OF MARSHALL'S DEFINITION

- (1) **Difficulty in calculation**- Calculation of goods produced and services rendered in a country is a difficult task. The quantity and quality of goods produced in a country is too large to calculate.
- (2) **No exchange** - There are a large number of goods and services which are not exchanged. Several commodities are consumed by producers and are not sold in the market. These commodities are not taken into account in calculation of national income.
- (3) **Possibility of Double calculation**- Double calculation is possible in the case of several goods and services. For example production of groundnut as well as its oil will be included in national income.
- (4) **Impractical** - The concept of Marshall is impractical. In spite of these criticisms, Marshall's definition of national income has a broad view.

II. PIGOU'S DEFINITION

Pigou's definition is somewhat different from Marshall's definition. Pigou has connected national income with money.

□ FEATURES

According to Pigou, " National income is that part of real income (including foreign income) of a community which can be measured in terms of money."

The following points emerge from Pigou's definition :-

- (1) Only those goods and services are included in national wealth which can be measured by money.
- (2) Income earned in foreign countries is also included in national income.
- (3) The goods and services which cannot be measured in terms of money are not included in national income, for example, services rendered by a housewife.

□ **CRITICISM OF PIGOU'S DEFINITION**

(1) **Narrow viewpoint** - According to critics, Pigou has limited the scope of national income. That is, Pigou has included only those goods and services in national income which can be expressed in terms of money.

(2) **Inexplicit and Uncertain**- Pigou's definition is not clear. It is uncertain too. For example, a person pays ₹ 100 per month to his maid servant. Her services will be included in national income because it is in terms of money. But, if he marries the maid servant, the services will not be included in national income because she will not be paid for her services.

III. FISHER'S DEFINITION

Prof. Fisher's definition is based on consumption rather than production. Thus Fisher's definition is quite different from that of Marshall and Pigou. In the words of Fisher, "National dividend or income includes the services obtained by ultimate consumers whether, by material or human environment. Thus a piano or an over-coat which has been made for my use this year, is not a part of national income but simply an increase in capital. The services made available to me by these articles this year are not national income, but increase in capital."

□ **FEATURES**

The analysis of Fisher's definition is as under -

(1) National income of a country is determined not by its production but by consumption.

(2) If an article is consumed for a long period, the value consumed in a particular year will be included in national income.

□ **CRITICISM OF FISHER'S DEFINITION**

(1) **Impractical**- On the surface, Fisher's definition seems to be more scientific in comparison to Marshall's and Pigou's definition, since it takes into account the value of consumption in a particular year. But, it has no value from practical point of view.

(2) **Difficulty in estimate of life time** - The basis of consumption for national income is wrong because production of several countries is more while consumption is less. This does not mean national income of a country is low.

□ **WHICH DEFINITION IS THE BEST**

It is difficult to say which of the three definitions given above by Marshall, Pigou and Fisher is the best, because all the three definitions are important from their point of view.

(i) Theoretically, Marshall's definition is important. It helps to give us a comparative view of economic development of different countries.

(ii) Pigou's definition represents a true form of national dividend. It is practical.

(iii) Fisher's definition is useful to know economic welfare of the masses and compare their standard of living.

Thus, all the three definitions throw light on national income from different angles.

Q.33. Discuss the various concept of National Income and describe its components.

Or

Explain fully the following concept of National Income-

- (i) **Gross National Product or (GNP)**
- (ii) **Net National Product or (NNP)**
- (iii) **National Income (NI)**
- (iv) **Personal Income (PI)**
- (v) **Disposable Income (DPI)**

National income is the sum total of goods and services produced in a particular year. Economists have given the following five concepts about national income -

- (i) **Gross National Product (GNP)**
- (ii) **Net National Product (NNP)**
- (iii) **National Income (NI)**
- (iv) **Personal Income (PI)**
- (v) **Disposable Income (DPI)**

□ **I. GROSS NATIONAL PRODUCT (GNP)**

Total gross product of goods and services in a year x Market Value = GNP i.e. Gross National Product.

The concept of GNP can be made clear as under -

(1) **To measure the value of goods and services in terms of money and make its total** - Total of all the goods and services of a country in a year are added in terms of money. The total amount is calculated by multiplying the total commodities with their market value. This amount is called Gross national income.

Why are goods and services expressed in terms of money? The answer is that a large number of commodities of different varieties are

produced. They are of different sizes and weight. For example, cloth in terms of metres, coal in metric tons, petrol in litres. If these products are not expressed in terms of money, it will not be possible to assess national income. It will not be indicated whether there is any increase or decrease in them. If we desire to compare national income of two years, production of both the years in terms of money will be necessary. For example in the year 2017, production of cereals was 26 crore tons, cloth 1,000 crore metres, sugar 50 lac tons. It will not indicate national income. If we convert this production into money, say goods and services produced in the year 2017 were of the order of 150 lac crores of rupees it will give us a clear idea of national income.

(2) **Inclusion of closing stock of goods and services** - Only closing stock of goods and services produced in a year are included in gross national income. For example, the value of biscuits will include the value of the powder the biscuit is made from and not the value of wheat from which powder is made. This is necessary to avoid duplicate calculation.

(3) **No deduction of Depreciation** - Depreciation is not deducted while calculating gross national income. Therefore, total value of all the goods and services produced is called gross national income.

□ II. NET NATIONAL PRODUCT (NNP)

The amount of gross national product arrived at after deducting depreciation of machinery is called Net National Product or NNP. There is wear and tear of capital goods or machinery in the production of goods. Thus value of capital goods diminishes. Therefore, depreciation of machinery is deducted from gross national income. The balance is the net national income.

GNP - Depreciation = NNP

It makes it clear that concept on NNP is superior to GNP, because depreciation of capital goods is provided for.

□ III. NATIONAL INCOME (NI)

This is also called national income on cost factor. National income is the income of each factor of production. In simple words, the income of various factors of production land, labour, capital, organisation and enterprise earned by way of rent, wages, interest and profit is called national income.

In order to find out net national income, indirect taxes are deducted therefrom -

$$\text{NNP} - \text{Indirect Taxes} = \text{NI i.e. National Income}$$

The concept of national income is important from the point of view of cost of factor of production. It gives us information about the share of factors of production of national income.

□ IV. PERSONAL INCOME (PI)

Income of factors of production in a year is not obtained by them in total. Certain deductions are made therefrom, e.g., income-tax, professional tax and Provident Fund. Besides it, several persons get income even without giving any contribution in production. e.g., unemployment insurance, old age pension etc. Thus, the total income in fact obtained by all the persons in a particular year in the country is called personal income.

$$\text{PI} = \text{National Income} - \text{Deductions} + \text{Grants}$$

□ V. DISPOSABLE INCOME OR (DPI)

A large number of persons and families in a country obtain personal income. The whole personal income is not spent on consumption. Disposable income is that part of personal income remained after deduction of taxes imposed by the government.

$$\text{DPI} = \text{PI} - \text{Personal Taxes}$$

The whole personal income is not consumed or disposed of. A part of it is saved for a rainy day.

SHORT ANSWER TYPE QUESTIONS

Q.34. Explain the concepts of National Income.

CONCEPTS OF NATIONAL INCOME

A simple meaning of national income is total income earned by the whole nation. But, in economics, there is a special view of national income. It is as under -

"National income is the total monetary value of a country's total production and services in a particular year." In other words, national income is the total of production of all the factors in a particular year in a country."

So, this is the basic social accounting measure of the total output or aggregate supply of goods and services. Gross National Product is defined as the total market value of all final goods and services produced in a year. It is a measure of the current output of economic activity in the country.

In the production of gross national product of a year, we consume or use up some capital, i.e., equipment, machinery etc. The capital goods, like machinery, wear out or depreciate in value as a result of its consumption or use in the production process. This consumption of fixed

capital or fall in value of capital due to wear and tear is called depreciation. When charges for depreciation are deducted from the gross national product, we get net national product. It means the market value of all final goods and services after providing for depreciation. Therefore, it is called national income at market prices.

Q.35. Discuss the importance of computation of National Income of a country.

IMPORTANCE OF NATIONAL INCOME

Computation of national income of a country's economy is important, whether it be developed, under-developed or undeveloped. National income is a mirror in which the picture of a country's economy is reflected. Its importance can be made clear as under -

(1) Assistance in formation of Govts. Economic Policies. Statistics of national income help the government in formation of economic policies. The government frames various plans in respect of credit, money, investment and employment on the basis of data of national income.

(2) Importance for Economic planning. Statistics of national income are very important in a planned economy as priority is given to various sectors in respect of factors of production. Data of national income help in this direction.

(3) Study of Hindrances Present in Economic Progress. Data of a country's national income help us to know the hindrances appearing in economic development. Therefore the government can face the hindrances by planned development.

(4) Knowledge of contribution of various sectors. The analysis of national income enables us to know the contribution of agriculture, industry, trade and commerce in national economy.

(5) Standard of living. National and per capita income of a country throws light on the standard of living of the people of a country. For example, due to low per capita income of India, the standard of living is lowest in the world.

(6) Taxable Capacity. A study of statistical data of national income enables us to know the taxable capacity of the people. On this basis, the government adopts the tax system.

(7) Index of Economic Welfare. National income affects economic welfare of a country to a large extent. Therefore, the degree of economic welfare depends upon the quantity of its income. The larger the

quantity of national income, the greater will be economic welfare. Thus, national income is an indicator of a nation's economic welfare.

In this way, the study of national income is important for the government, businessmen, industrialists, economists and consumers.

Q.36. Discuss briefly concept of Gross National Product (GNP) and Net National Product (NNP).

GROSS NATIONAL INCOME AND NET NATIONAL INCOME

The Gross National Product (G.N.P.) is the money value of the total national production for any given period. In estimating the G.N.P. care has to be taken to include the money-value of only the final goods and services produced in the economy to avoid double counting. In computing the G.N.P., we do not deduct the total depreciation of the fixed assets from the gross income. The G.N.P. is a better index than any other concept of the actual conditions of production and employment in a country during a specified period. To get an accurate idea of the achievements of an economy, we have to find out its net national product or income. And that can be found out by deducting the total depreciation from the gross national product of the country. The net national product (N.N.P.) is, on the contrary, a better concept than G.N.P., because it makes proper allowance for the depreciation suffered by machinery, equipment, buildings etc. during the year. This concept is also highly useful as it gives an idea of the net increase in the total production of the country. It also proves helpful in the analysis of the long-run problem of maintaining and increasing the supply of physical capital of the country. The N.N.P. is, therefore, a highly useful concept for the study of Growth Economics.

VERY SHORT ANSWER TYPE QUESTIONS

Q.37. What do you mean by National Income?

In other words, the total amount of income accruing to a country from economic activities in a year's time, is known as national income. It includes payments made to all resources in the form of wages, interest, rent and profits. It is thus, the process of counting the value of flow between sectors and then summing up them to find the total value of economic activities in an economy.

Q.38. What is meant by Consumer goods?

Consumption Goods or Consumer Goods : Consumption goods are those goods which are directly used for the satisfaction of human wants. For example : bread and butter.

Q.39. What is meant by intermediate goods ?

Intermediate Goods : Those goods which are within the boundary line, not ready for use and in which is value addition is still to be done are called as Intermediate goods. These goods are used as raw material by the producers or purchased for further sale. For example wood purchased by a carpenter to make chairs.

Q.40. What do you mean by final goods ?

Final Goods : Those goods which have crossed the boundary line, are ready for use "and in which value addition is done are called as final goods. Hence, these goods are ready for use by their final users. For example : Car used by the households, machine used by the producers.

Q.41. What do you mean by Capital goods ?

Capital Goods : Capital goods are those goods which are used for further production of goods and are used as fixed assets by the producers for production. For example : Tractors used by the farmers.

Q.42. What are the components of GDP ?

G.D.P (Gross Domestic Product) of country consist of a total of all types of agricultural, industrial and commercial goods and services produced in the country, disregarding its export and import. The GDP is measured at, current market price symbolically,

G.D.P is measured at current market price symbolically GDP (Gross Domestic Product) $(C + I + G) + (x - m)$

Q.43. What do you mean by Gross Domestic Products (G.D.P.) ?

G.D.P refers to aggregate value of output of final goods and services produced within the territories or political boundaries of a country. It is the total output of domestic economy excluding the foreign or external sector. For example, G.D.P of India consists of a total of all types of agricultural, industrial and commercial goods and services produced in the country (disregarding its exports and imports) The G.D.P is measured at current market price symbolically $G.D.P = (C + I + G) + (x - m)$.

NATIONAL INCOME : ESTIMATES AND ANALYSIS : OTQ

Choose Correct Option -

1. Traditional definition of National Income is given by-

- (a) Prof. Marshall
(b) Prof. Bolding
(c) Prof. J.S. Mill
(d) Kyens

2. Definition of national Income on the basis of consumption given by-

- (a) Marshall
(b) Pigou
(c) Fisher
(d) V.K.R.V. Rao

3. Marshall defined national Income on the basis of-

- (a) Consumption basis
(b) Income basis
(c) Production basis
(d) Expenditure basis

4. National Income means -

- (a) Annual income of the Government of a country
(b) Total income earned in a country
(c) Sum of Net income earned by Citizens
(d) Sum of income of Central and State Government

5. The following is method for computation of national income-

- (a) Production method
(b) Income method
(c) Expenditure method
(d) All of above

6. Monetary value of goods and services produced in a country with in year is called-

- (a) Gross Domestic Product
(b) Net Domestic Product
(c) National Income
(d) Personal Income

7. Components of National Income-

- (a) Total National product
(b) Net National product
(c) Gross National product
(d) All of above

8. Meaning of G.N.P. is-

- (a) Gross National production
(b) Gross Net production
(c) Gross Nationalised profit
(d) General National production

9. Modern definition of National income is given by-

- (a) Prof. Pigou
(b) Prof. Cannon
(c) Prof. Simon Kuznets
(d) Fisher

10. Production stable and population increased in such case per capita income shall be-

- (a) Stable
(b) Increase
(c) Decrease
(d) None of above

11. Which of the following equations applies under income method -

- (a) Market price of services and goods
(b) Market price of goods

- (c) Revenue + Wages + Interest + Profit
- (d) Consumption + Surplus

12. Which statement is true -

- (a) $NNP = GNP - \text{Depreciation}$
- (b) $NNP = GNP - \text{Depreciation}$
- (c) $GNP = NNP - \text{Depreciation}$
- (d) $GNP = NNP$

13. After deducting depreciation against total National Income we find -

- (a) Total National Production
- (b) Net National Production
- (c) Final National Production
- (d) None of these

14. Which equation is right-

- (a) National Income = GNP
- (b) National Production = $GNP - \text{Depreciation} - \text{Indirect Tax}$
- (c) National Income = $\text{Depreciation} \times \text{Taxes}$
- (d) All of above

15. National Income is-

- (a) Income of the government
- (b) Profits of public enterprises
- (c) Budget of government
- (d) Total factor of Incomes

Ans.: (1) a (2) c (3) c (4) c (5) d (6) a (7) d (8) a (9) c (10) c (11) c (12) a (13) b (14) a (15) d.

□

*National income is a measuring rod of a nation's economy.
There are various methods to measure national Income.*

6

METHODS OF MEASUREMENT OF NATIONAL INCOME

■ Long Question-Answer

Q.44. Describe the various methods of measurement of National Income.

Or

Discuss the problems that arise in determination of National income?

Or

Write short Notes on :

- (i) Commodity Service Method or Census of Production Method
- (ii) Income Received Method or Census of Income Method
- (iii) Consumption Savings Method
- (iv) Social Accounting Method

COMPUTATION OF NATIONAL INCOME

National Income is a measuring rod of a nation's economy. The total number of ultimate goods and services produced in a country, their monetary value is called national income. In other words, total income received from different factors of production is called national income. National income has been defined by some on the basis of production, while some have defined it on the basis of consumption.

The following are the main methods of measuring national income-

1. Commodity Service Method or Census of Production Method

Under this method, production is taken as the base for computation of national income. National income is the gross of total goods and services produced measured in terms of money in a year in a country. The following points should be taken into consideration while computing national income-

- (i) The total value of the total goods and services produced in a particular year is the gross production.

- (ii) Depreciation value should be deducted from gross production.
- (iii) A commodity should be taken only once and duplicate valuation should be avoided.
- (iv) Ultimate production should be included in national income, e.g., value of cloth should be taken instead of raw cotton or cotton.
- (v) Foreign exchange transactions must also be taken into account while computing national income.

Example : Ultimate price of a bread is 50 Paise. It includes wheat powder worth 40 Paise. For production of wheat seed cost 15 Paise and urea 5 Paise. Ultimate article bread now costs $50 P - (15 + 5) = 30$ paise. National production value will be 30 paise.

This is the most simple and convenient method of computation of national income. We come to know the actual quantity of different goods and services produced. But, the main defect of this method is the possibility of duplicate valuation.

2. Census of Income Method

This method of computation of national income is based on the income received by the people. Income of all the persons actually received is made gross. In other words total income received by different factors of production in the form of rent, labour, interest and salary is called national income.

The following should be borne in mind while computing national income—

- (i) Gross total of rent, salary, wages, interest and profit should be made.
- (ii) The commodities and services which have not been paid in terms of money, should be included.
- (iii) Payments which do not help production should not be included, e.g., pension and charities.
- (iv) Amount received on sale of assets will not be treated as income.

This method of computation of national income helps us to know how much share a factor of production has received. There is less possibility of duplicate computation. But, it is difficult to compute correct income of agriculturists and backward classes.

3. Consumption Savings Method

Under this method, total consumption and total savings of the masses in a year is calculated. Gross total of savings and gross total of the consumption together is the national income of a country.

This method of computation is based upon the assumption that the people spend a part of income on expenditure and save a part for future emergency. Therefore, the gross total of expenditure and savings together of the masses will be equal to national income. The gross total will be national income.

Since this method is based on total expenditure, this is also called Census of Expenditure Method.

4. Census of Occupational Method

Under this method, national income is computed on the basis of occupation of the masses. A list is made of persons having different occupations like agriculturists, labourers, businessmen, employees and professionals. Income of all classes of workers is taken together and the gross total of all the classes of persons is made total. This is gross national income.

This method is suitable in finding out the incomes of persons of different occupations separately, but it is not practical. This method can be adopted in a small country and in educated masses.

5. Social Accounting Method

The total population of a country is divided into various income groups. Each income group is computed separately and by means of average income of all the groups is calculated. The total of all the groups of income is the national income.

This method enables us to know distribution of wealth in the country, but it is difficult to adopt it.

□ Conclusion. - Which method is superior?

As seen above, each method of computation of national income has its advantages and disadvantages. However, Census of Production Method seems to be superior as it is practical and simple. This method is mainly used in computation of national income. In India, Production and Income Method are used for computation of national income.

SHORT ANSWER TYPE QUESTIONS

Q.45. Explain briefly the income method of computation of National Income.

INCOME METHOD

The expenditure incurred on purchasing goods and services produced in a country during the year also becomes the income of the various factors

which collaborated in the production of those goods and services. We can group these factor-incomes in the following categories :

- (i) Wages and salaries of the employees,
- (ii) Incomes of non-company business,
- (iii) Rental incomes of persons,
- (iv) Corporate profits, and
- (v) Income from interest.

An aggregate of the above five categories of incomes will not be equal to the G.N.P. as estimated by the census of expenditure method. The reason is that a part of the total expenditure incurred by the community does not become available to the factors of production in the form of incomes. There are two such leakages: Firstly, indirect taxes levied by the government on goods and services and secondly, depreciation of machinery, plants and buildings. The expenditure incurred by the households (or, factors) on goods and services includes the indirect taxes levied by the government. The income from these indirect taxes goes to the government and is not available to the factors concerned. The payment on account of depreciation also does not become available to the factors in the form of income. Therefore, while estimating the G.N.P. by the income method, we have to add indirect taxes and depreciation charges to the factor-incomes.

Q.46. Explain the Expenditure Method of Computation of National Income.

CENSUS OF EXPENDITURE METHOD

The gross national product can be viewed as the nation's total expenditure on goods and services produced during the year. Each unit of goods and services produced is matched by an expenditure on that unit. Most of the goods and services produced in the country are bought by the consumers. But the unsold goods and services are regarded as having been bought by the producers who hold them as stocks or inventories. The monetary value of the total national production is equal to the total national expenditure. The total national expenditure can be split up into the following four categories—

1. **Personal Consumption Expenditure**— It includes the consumption expenditure made for both durable goods and non-durable goods in the country during the year. This also includes expenditure on services, such as, transport, education and post and telegraph services.
2. **Gross Domestic Private Investment**— This item includes private investment in capital or producer goods, such as, buildings,

machinery, plant, equipment etc. Such goods are primarily purchased by business firms. Houses are also included in this category of expenditure because they are so durable that represent, in fact, capital goods.

3. **Government's Purchases of Goods and Services**— The government also purchases from the market consumer goods, such as, paper, stationery etc., as well as investment goods, such as, machinery and equipment for their own enterprises. In addition, the government also purchases a number of different services, such as, military, police and secretarial services.

4. **Net Foreign Investment**— As is well known, the entire production of a country is not sold within the country. A part of it is exported to other countries. This part of the production should be included in the G.N.P. of the country. At the same time, the country imports some finished goods from abroad. The value of imports should be deducted from the value of exports. If the balance is positive, it should be added to the other items of expenditure. If it is negative, it should be subtracted from the sum of the other expenditure items.

Q.47. Explain Product or Value added Method of Valuation of National Income.

Product method measures national income on the basis of contributions in terms of value addition by all the producing enterprises in the domestic territory of the country during an accounting year. The money value of final goods and services produced at current prices during a year is taken into account. The value of exports is added and the value of imports is deducted. Thus, the total gross value added of an economy equals the value of its GDP. Few concepts to understand, it further

Value Addition = It is the difference between value of firms output and the value of intermediate consumption.

Value addition = Value of output (-) Intermediate consumption

Value of Output = It refers to the market value of goods and services produced by a firm during a period of one year

Value of output = Sales

(if entire output is sold during the year)

Intermediate Consumption = It is value of non-factor inputs (all inputs other than land, labour, capital entrepreneurship) used in the production. Hence, includes value of raw materials, fuel, power etc.

Change in stock (A Stock) It is measured, as the difference between closing stock and opening stock of the accounting year.

If some output remain unsold it is added to the firm's inventory stock and the same is -expressed as change in stock. Thus, the value of output in that case is,

$$\text{Value of output Sales} + \Delta \text{ Stock}$$

[If some output remain unsold during the year, change in stock (A stock) is added]

Q.48. Discuss the importance of Calculation National Income in India.

IMPORTANCE OF NATIONAL INCOME CALCULATION

Computation of national income of a country's economy is important, whether it be developed, under-developed or undeveloped. National income is a mirror in which the picture of a country's economy is reflected. Its importance for Indian economy can be made clear as under-

(1) Assistance in formation of Govt's Economic Policies- Statistics of national income of a country help the government in formation of economic policies. The government frames various plans in respect of credit, money, investment and employment on the basis of data of national income.

(2) Importance for Economic planning- Statistics of national income are very important in a planned economy as priority is given to various sectors in respect of factors of production. Data of national income help in this direction.

(3) Study of Hindrances Present in Economic Progress- Data of a country's national income help us to know the hindrances appearing in economic development. Therefore the government can face the hindrances by planned development.

(4) Knowledge of contribution of various sectors - The analysis of national income enables us to know the contribution of agriculture, industry, trade and commerce in national economy.

A study of statistical data of national income helps us to know about the relative importance of various fields of a country.

(5) Standard of living - National and per capita income of a country throws light on the standard of living of the people of a country. For example due to low per capita income of India, the standard of living is lowest in the world.

(6) Taxable Capacity- A study of statistical data of national income enables us to know the taxable capacity of the people. On this basis, the government adopts the tax system.

(7) Index of Economic Welfare- National income affects economic welfare of a country to a large extent. Therefore, the degree of economic welfare depends upon the quantity of its income.

In this way, the study of national income is important for the government, businessmen, industrialists, economists and consumers.

Q.49. Mention the difficulties regarding calculating National Income in India.

□ Difficulties in the Measurement of National Income
In measuring national income, we are confronted with certain conceptual difficulties which may be set forth below :

1. Inadequate statistics- The available statistics in India are not only inadequate but also unreliable. For example, statistics pertaining to agriculture in India are not complete. We have no reliable estimates of production costs in Indian agriculture. There are no statistics worth the name for small-scale and medium industries.

2. Non Monetized sector- The existence of a large non-monetized sector in underdeveloped countries also makes the computation of national income difficult. As is well known, quite a substantial part of the agricultural output in India does not reach the market at all. Either it is consumed at home by the agriculturists themselves or is exchanged for other goods and services in the village. This presents several difficulties in the calculation of income.

3. Not keeping of accurate accounting- The overwhelming majority of the small producers in the underdeveloped countries like India are illiterate and ignorant and are not in a position to keep any account of their productive activities. So they cannot give to the investigator information about the quantity or value of their output.

4. Ignorance of some activities- It has not been found possible to include certain categories of services performed by the citizens in the national income. For example, there is no method available to us for computing the value of the services rendered by a cultivator's family members in agricultural activities.

5. Detective evaluation system- There is no fool-proof method evolved yet to evaluate the raw materials, unfinished, semi-finished and finished goods found lying in the godowns of the business firms. Without a correct evaluation of these goods, we cannot arrive at reliable estimates of the national income of a country.

6. **Problem in correct charging depreciation**—The calculation of the total value of depreciation and replacement poses yet another difficult problem. At what rates should the depreciation be calculated for different types of machinery, plants and buildings? There cannot be a uniform rate for calculating the depreciation on all these fixed assets.

7. **Exclusion of foreign income**—Another problem which confronts us relates to the income earned by foreign firms operating in the country.

VERY SHORT ANSWER TYPE QUESTIONS

Q.50. Explain Income Method of National Income calculation.

The Income method measures the incomes arising to different factors like land, labour, capital and enterprise in the name of rent, wages, interest and profit in return for their services during an accounting year.

According to this method, National Income is estimation of sum total of factor incomes earned by the normal residents of a country during an accounting year. On the other hand, the sum total of factor incomes generated within the domestic territory of a country (by the residents or non-residents) is called Domestic Income. Net Factor Income from abroad (NFIA) is added to domestic income to find national income.

Q.51. Write a note on Expenditure Method of National Income calculation.

According to this method, national income is measured in terms of expenditure on the purchase of final goods and services produced in the economy during an accounting year.

Final expenditure is broadly classified into four categories :

- (i) Private Final consumption expenditure,
- (ii) Government final consumption expenditure,
- (iii) Investment expenditure, and
- (iv) Net exports.

Hence, it includes expenditure on final products by all the four sectors—

- (i) Households, (ii) Business sector (Producers), (iii) Government sector, and (iv) Rest of the world.

METHODS OF MEASUREMENT OF NATIONAL INCOME : OTQ

Choose Correct Option -

1. The following is method for computation of national income—
 - (a) Production method
 - (b) Income method
 - (c) Expenditure method
 - (d) All of above
2. Method of Measuring National income is—
 - (a) Real income
 - (b) Per capita income method
 - (c) Census of production method
 - (d) Monetary income
3. "National income can be measured in money" defined by—
 - (a) Marshall
 - (b) Prof. Clark
 - (c) Prof. Pigou
 - (d) Shaman Contaz
4. Which of the following equations applies under income method—
 - (a) Market price of services and goods
 - (b) Market price of goods
 - (c) Revenue + Wages + Interest + Profit
 - (d) Consumption + Surplus
5. Causes of slow rate of increasing per capita income rather than national income is —
 - (a) Poverty
 - (b) Increasing population
 - (c) Unemployment
 - (d) All of above
6. The following is deducted to obtain Net domestic production against Gross domestic product—
 - (a) Depreciation
 - (b) Indirect Tax
 - (c) Direct Tax
 - (d) Grant
7. National Income = Population
 - (a) Personal income
 - (b) Per capita income
 - (c) Per capita real income
 - (d) None of these
8. The following method for computing national income—
 - (a) Census of production method
 - (b) Census of Income method
 - (c) Consumption savings method
 - (d) All of above

9. Causes of slow rate of increasing national income of India is / are-

- (a) Slow rate of development
- (b) Agricultural based economy
- (c) Slow rate of capital formation
- (d) All of above

10. Estimation of National income in India is done by-

- (a) Finance ministry
- (b) Central Statistical Organisation
- (c) HRD ministry
- (d) World Bank

11. The formula of calculating per capita income is-

- (a) $\frac{\text{Total Production}}{\text{Total Income}}$
- (b) $\frac{\text{National Income at Factor Cost}}{\text{Total Population}}$
- (c) $\frac{\text{Total Population}}{\text{Total Production}}$
- (d) $\frac{\text{Per Capita Income}}{\text{National Income}}$

Ans. : (1) d (2) c (3) c (4) c (5) b (6) a (7) c (8) d (9) d (10) b (11) b.

□

UNIT - II • Income - Consumption Relationship, Principles of

- Income determination classical and Keynes's theory
- Consumption function Long term - Short term
- Consumption function in Indian Economy

7

INCOME- CONSUMPTION RELATIONSHIP

■ Long Answer Type Question

Q.52. Explain the Keynesian Psychological Law of Consumption.

Or

Discuss the Keynesian Law of Income Consumption Relationship.

INCOME-CONSUMPTION RELATIONSHIP

There is close relationship between income and consumption. Both are inter-dependent and affected by each other. A person earns income for consumption. A person has several types of wants. He tries to earn money for the satisfaction of wants. Relationship of income and consumption can be classified as under-

- (1) The object of earning income is to obtain money for consumption. A man earns money for the satisfaction of present and future wants.
- (2) On getting income, consumption is a natural activity.
- (3) With an increase in income, general consumption increases.
- (4) On an increase in the quantity of consumption, more efforts are made to increase income.
- (5) When the impulse or liability of consumption is reduced, efforts to earn income become less.

KEYNESIAN PSYCHOLOGICAL LAW OF CONSUMPTION

Different economists have given different views on income consumption relationship. Keynesian view is important among them. He propounded Psychological law of consumption. The following are the main points of this law-

CONCEPT OF KEYNES : PSYCHOLOGICAL LAW OF CONSUMPTION

According to Keynes, consumption increases with an increase in income, but the proportion of this increase is lower in comparison with increase in income. This law is based upon this human psychology that a man increases his consumption expenditure with the increase in income, but has a desire to save as well. Consequently, increase in income is not in the same proportion as in consumption. This tendency is called law of income-consumption relationship.

Keynes claims income-consumption relationship as fruitful. Mathematical formulae given by him is as under -

$$c = f(y) \qquad c = \text{Total consumption expenditure}$$

$$y = \text{Total Income} \qquad f = \text{Function}$$

Thus consumption function expresses that a change in income affects consumption expenditure. According to Keynes, out of a certain sum of money, that part of income spent on consumption, is called consumption function and the part saved, will be termed savings.

EXPLANATION OF PSYCHOLOGICAL KEYNESIAN THEORY OF CONSUMPTION

Keynes view of income consumption depends upon the following-

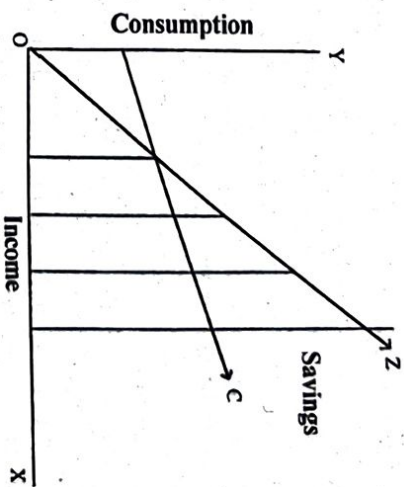
(1) **No Proportionate Increase**- With an increase in income, there is also an increase in consumption. But this increase is not proportionate, i.e., the ratio or proportion in which consumption increases with an increase in income is not the same. Increase in consumption is less than the increase in income. The main reason is that as income increases, wants are satisfied. A stage comes when a person does not think it necessary to spend additional income on consumption. It means that consumption increases with an increase in income, but not in the same proportion as income increases.

(2) **Savings and consumption go simultaneously**- An increase in income is utilised in two ways-on consumption and savings. When the whole income is not spent on consumption, it is but natural that a part of it is left as savings. Thus, consumption and savings go together. Generally a human being likes to save. Initially, a person may not be able to save due to low income, but gradually as income increases, he would like to save a part of it.

(3) **Increase in both consumption and savings with an increase in income**- According to this law, with an increase in income, there is an increase both in consumption expenditure and savings. Cases are very rare, for example, a miser who does not spend, but generally, there is a tendency among human beings that they spend more on consumption when income increases. But a person does not spend the whole of the increased income. He would like to save some part for future.

Example:

Income (₹)	Consumption (₹)	Savings (₹)
10,000	9,500	500
15,000	12,000	3,000
20,000	14,000	6,000
25,000	17,000	8,000



The above Table and Chart show that-

- (1) Consumption increases with an increase in income.
- (2) Increase in consumption is not proportionate to an increase in income.
- (3) Savings increase with an increase in income.

ASSUMPTIONS OF KEYNES LAW -

(1) **Normal Atmosphere**- The first condition for the applicability of this law is that normal atmosphere must prevail in economy. Such conditions like monetary expansion, war, revolution etc. should not exist.

(2) **No Change in Psychology**- There should be no change in the existing psychology as any change in human psychology affects consumption tendency. Price level, distribution of income, rising level of population, fashion and habits must be constant.

(3) **Capitalistic Economy**- The third assumption is that this law applies in a progressive and capitalist country. There should be free trade and industrial policy. The law does not apply in poor and backward nations.

SHORT ANSWER TYPE QUESTIONS

Q.53. What are Short and long period consumption function.

SHORT AND LONG PERIOD CONSUMPTION FUNCTION

The period of consumption of goods for the satisfaction of human wants can be divided into two parts—short period consumption and long period consumption.

- (1) Short period consumption is that consumption effect of which remains for a short period like tea, food, entertainment, etc.
- (2) Long period consumption includes such articles which are consumed for a long period like building, car, T.V.

DIFFERENCE BETWEEN SHORT AND LONG PERIOD CONSUMPTION-

- (1) Short period consumption is primarily casual and for a short period whereas long period consumption is for a long period.
- (2) Short period consumption is instantaneous whereas long period consumption is connected with a definite plan. For example, for food an immediate plan is chalked out, for a building a definite and fixed plan is made.
- (3) Want for a commodity or service in short period consumption arises again and again or several times like food, entertainment, tea, etc., whereas want for a commodity or service in the case of long period consumption does not arise again and again, but only once, e.g. Scooter, refrigerator, T.V.
- (4) No particular thing or article is necessary in short period consumption. Whichever thing or service is available at hand is consumed, e.g. If lux is not available for bath, O.K. soap is consumed. Whereas a man can wait for a thing or service of his choice in a long period. For example, If Rakesh wants to purchase a particular model of car say Zen, he will book it and wait till his turn comes up.
- (5) Certain types of articles are consumed both in short period and long period. If a person wants to consume an article several times, he would like to purchase and for casual consumption he would like to take it on hire. For example, a student or a factory worker needs a cycle for a long period and a child likes a cycle in fondness.

Q.54. Write a note on Average Propensity and Marginal Propensity to consume.

Average propensity to consume is arrived at by the ratio of total income and total consumption expenditure. Total consumption expenses are divided

by total income of the masses. The quotient arrived at is the average propensity to consume.

The formula is - $\text{Consumption} : \text{Income}$
or C/Y

For example the total annual income of the masses of a country is ₹ 10,000 crores and total consumption expenditure is ₹ 7,000 crores. Then the average propensity to consume will be 7:10 or 7/10. That is, the masses of this country spend 70% of their income on consumption.

Marginal Propensity to consume- It shows how the increased income is divided between the savings and expenditure. Thus marginal propensity to consume indicates the changes in consumption consequent on the changes in incomes. For example, if there is an increase of ₹ 100 crores and consumption increases by ₹ 40 crores, marginal productivity will be

$$\frac{\text{Increase in expenses}}{\text{Increase in income}}$$

or

$$\frac{40}{100} = 0.4$$

Thus marginal propensity to consume is 0.4 and marginal savings will be 0.6 because marginal propensity to consume and marginal savings together is equal to 1.

RELATIONSHIP OF AVERAGE AND MARGINAL PROPENSITY TO CONSUME-

- (1) An increase in income culminates in diminution of both average and marginal propensity to consume.
- (2) Marginal propensity of consumption decreases more in comparison with average propensity of consumption.
- (3) Marginal propensity of consumption is more in poor class whereas savings propensity is more in rich class.

VERY SHORT ANSWER TYPE QUESTIONS

Q.55. Mention main propositions of Keynes's Psychological Law of Consumption.

Famous economist Keynes propounded the Psychological Law of consumption regarding income-consumption relationship. According to the Law the following Propositions applicable in this regard :

- (a) With the increase in income there is also an increase in consumption, but this increase is not proportionate.
- (b) Savings and consumption go simultaneously.
- (c) Increase in both consumption and savings with in an increase in income.

Q.56. Mention the assumptions of Psychological theory of Keynes.
Keynes's Psychological theory of consumption is depend on the following assumptions -

- (1) It assumes a constant psychological and institutional complex.
- (2) It assumes the existence of normal conditions.
- (3) It assumes the existence of a laissez-faire capitalist economy.

INCOME- CONSUMPTION RELATIONSHIP : O.T.Q.

Choose Correct Option -

1. Psychological Law of consumption Propoundety-

- (a) Dr. Marshall
- (b) Keynes
- (c) Pigou
- (d) Robbins

2. According to Psychological Law of Income and Consumption-

- (a) No proportionate increase
- (b) Go simultaneously
- (c) Consumption and saving both Increase
- (d) All of above

3. Assumptions of Keynes Law of Consumption are -

- (a) Normal Atmosphere
- (b) No change in psychology
- (c) Capital economy
- (d) All of above

Ans. (1) (2) (3)

8

PRINCIPLES OF INCOME DETERMINATION

Long Answer Type Question

Q.57. Critically explain the classical theory of Income and employment.

Or

Explain J.B. Say's Law of Market. What are the chief criticisms of new economics against this law ?

CLASSICAL THEORY OF EMPLOYMENT

Under classical theory, there is choice only between employment here and there and not between employment and unemployment. It focusses on the use of a given quantity of resources by individual firms and industries within the economic system as a whole.

The classical theory starts with the assumption that an economy functions at full employment and produces an output and income corresponding to the level of full employment. Any lapse from full employment will not last long. There is a built in mechanism in the economy that makes it operate at full employment. A long period unemployment can persist only due to interference of the free play of market forces by the government or by the private monopoly. The classical thinkers, thus, do not normally examine the level of employment at which the economy actually operates.

SAV'S LAW OF MARKET

The classical theory of employment is based upon the ideas, broadly incorporated in Say's Law of Market believed to have given by J.B. Say, a French economist of the 19th century. According to this law, supply creates its own demand. In other words, production and supply of a product creates an equivalent demand for the product, so that there can never be a problem of over production. According to Say, people work and produce to enjoy the satisfaction of consumption. Work being unpleasant, no person

will work to make a product unless he wants to exchange it for some other product which he desires. In Say's words, "It is production which creates markets for goods. A product is no sooner created than it, from that instant, affords a market for other products to the full extent of its own value. Nothing is more favourable to the demand of one product, than the supply of another."

□ ASSUMPTION OF SAY'S LAW

Say's Law is based upon the following assumptions :

- (i) Whatever income the economy generates is instantaneously spent either on consumption or on capital goods. That is, income not consumed is automatically invested. There is, thus, a continuous flow of income, income becoming expenditure, expenditure creating income; and so on.
- (ii) There is perfect competition in product, factor and money markets.
- (iii) There is no government interference in the functioning of the economy.
- (iv) The amount of labour and capital can be raised to any extent in a free enterprise economy based on price mechanism.
- (v) New entrants have easy access into the market without dislocating the existing ones. They are also free to withdraw. Hence, the size of the market is expandable.
- (vi) It is a closed laissez-faire capitalist economy, which implies absence of trade or financial relationship with other economies.

□ CRITICISM OF SAY'S LAW

The classical theory of income and employment has been severely criticised by J.M. Keynes and others on the following grounds :

1. Demand and Supply May Not be Equal—Say's Law is based upon the assumption that whole income earned in the process of production is spent on the goods and services produced, thereby maintaining the economy at the full employment level. However, this assumption is both unrealistic as well as unwarranted.

2. Role of Rate of Interest—According to classical economists, the flexibility in the rate of interest equalises saving and investment. Thus, saving and investment decisions are determined by the rate of interest. Keynes did not accept this classical view. According to him, savings depend more on the level of income than on the rate of interest.

3. Function of Flexible Wages—Keynes strongly challenged the Pigou's plea that wage flexibility leads of full employment, especially at the time of depression. Keynes regards wage cuts as highly impractical in the context of the existence of trade unions, unemployment, insurance, minimum wage laws etc.

4. Practical Experience—The poor lack money to purchase consumption goods, while rich do not spend even major part of their wealth. This causes deficiency of aggregate demand in relation to aggregate supply leading to over production and unemployment in the economy. This, in fact, leads to depression. The great depression of 1930s has destroyed the belief in Say's Law.

Q.58. Discuss in brief the Keynesian Theory of Employment.

Or

"The logical starting point of employment is the principle of Effective Demand." Discuss.

KEYNESIAN THEORY OF EMPLOYMENT

J.M. Keynes was the first economist, who put forward a systematic theory of employment. Keynes introduced the concept of effective demand to explain the theory of income and employment. Introduction of this concept revolutionised economic theory. His theory has been found empirically sound. This theory explains the factors that determine the level of income and employment.

The Keynesian theory of income and employment may briefly be put as follows :

- (a) The level of income and of employment in a country at any given time depends upon the volume of effective demand
- (b) An increase in effective demand will lead to an increase in production, in income and a rise in the level of employment.
- (c) A decrease in effective demand will result in a contraction of production, of income and fall in the level of employment.

□ MAIN POINTS OF KEYNESIAN THEORY OF EMPLOYMENT

Keynesian theory is based on a short-run view. In the short, employment is determined by effective demand and the effective demand is equal to the total expenditure on consumption goods and investment goods. Employment depends on the total expenditure incurred on consumption and investment.

I. EFFECTIVE DEMAND

The Theory of effective demand is the starting point of Keynesian Theory of Employment. It was Keynes who, first of all, discovered 'lack of effective demand' as the main cause of unemployment.

Determination- According to Keynes, the point at which aggregate demand curve and aggregate supply curve cross each other, the effective demand is determined.

In a short period, if all the factors affecting supply remain equal or stagnant, practically aggregate demand becomes effective demand.

Formula of effective Demand is :

$$D = C + I$$

D = Demand

C = Consumption

I = Investments

II. PROPENSITY TO CONSUME

We have seen above that aggregate demand determining the level of employment comprises of aggregate consumption plus aggregate investments. Here, we shall discuss propensity to consume.

Meaning- Propensity to consume is that portion of a given income which is actually spent on consumption.

Factors Affecting Propensity to consume-

The following factors affect propensity of consumption-

(1) **Size of Income-** With the increase in the size of income, propensity to consume increases.

(2) **Other factors-** These factors can be divided as (a) subjective factors, e.g. nature of consumer, habits, family affection, foresightedness, etc. and (b) Objective factors, e.g. prices, rates of interest, profit, state policy, future expectations, etc.

These two factors remain unchanged during short period as they are concerned with the country's history, geography, culture, traditions, economic structure and consumer's psychological behaviour, etc. which do not change quickly.

Thus, propensity to consume is mainly affected by the size of income during short period. With an increase in the size of income, propensity to consume increases, but not in the same proportion.

III. INVESTMENT EXPENDITURE

Actual investments are very important in Keynesian Theory. Investment means formation of new Capital assets which helps in additional employment opportunities.

There are two factors affecting investments.

1. Marginal Efficiency of Capital
2. Rate of Interest

IV. MULTIPLIER

Multiplier means multiplied or several times. Investment multiplier means increase in investments by a certain sum of money. Increase in income in economy will not be equal to investments but something larger than it. In fact, it is more than the preliminary investments.

□ Criticism of Keynesian theory of employment.

Following are some of the short coming in the Keynesian system :

1. **Full employment is not attainable-** Keynes' objective of Full Employment is neither definable nor attainable, nor even desirable. Full employment in the literal sense that everyone should have a job, is not attainable.

2. **Not Comprehensive treatment of unemployment-** The Keynesian system was not comprehensive in the sense that it provided us with an overall solution of the problem of unemployment. The Keynesian theory did not tell us how to secure fair employment.

3. **Based on the assumption of perfect competition-** Like the old classical economics, the Keynesian theory is based on the assumption of perfect competition which is a highly unrealistic assumption.

4. **Wrong assumption-** There is no genuine and determinable functional relationship between effective demand and the volume of employment.

5. **Concentrates only on inducement to invest-** To expand employment opportunities, Keynes depended almost exclusively on one element, namely, the inducement to invest. For expanding employment, Keynes depended upon inducement to invest as a determinant of employment. Some economists have found fault with this view of Keynes.

6. **Ignores the long period-** An important characteristic of Keynesian Economic is that it is short-term in character. Some critics have taken Keynes to task for the short-run character of his theory.

7. Theory is based on the assumption of 'Closed Economy'. It is based on the unrealistic assumption of a closed economy.

8. **Limited application-** Keynes' Theory is not General. It is not applicable anywhere and everywhere. Its application is limited.

9. **Static model-** The Keynesian model is too static in character. It assumes the amount of capital to be fixed and the output as a function of employment only. The model fails to explain short-run fluctuations.

SHORT ANSWER TYPE QUESTIONS

Q.59. Discuss the assumption of Classical theory of Income and Employment.

The classical theory starts with the assumption that an economy functions at full employment and produces an output and income corresponding to the level of full employment. Any lapse from full employment will not last long. There is a built in mechanism in the economy that makes it operate at full employment. A long period unemployment can persist only due to interference of the free play of market forces by the government or by the private monopoly. The classical thinkers, thus, do not normally examine the level of employment at which the economy actually operates.

The assumption of the normal condition of 'full employment' by the classical economists is based on the following two factors :

- (i) Wages rates are flexible in nature and the operation of the free competition and price mechanism automatically removes unemployment by forcing the wages down.
- (ii) Increase in production increases not only the supply of goods, but also creates the demand for these goods by virtue of factor price payments. This is the essence of Say's Law.

Q.60. Mention the main points of Keynesian Theory of Employment.

The Keynesian theory of income and employment which revolutionised economic thinking in the 20th century may briefly be stated as follows :

A Summary of Keynesian Theory of Employment-

This is given below-

- (1) Employment and income depend upon effective demand.
- (2) During short period, aggregate demand is effective demand because aggregate supply remains unchanged.
- (3) Aggregate demand is determined by aggregate expenditure.
- (4) There are two types of aggregate expenditure—consumption expenditure and investment expenditure.
- (5) Consumption expenditure is determined by propensity to consume which does not increase in the same ratio as the size of income increases.

(6) Investments depend upon (i) marginal efficiency of capital and (ii) rate of interest. But the effect of former is much.

(7) The larger the marginal propensity to consume, the larger will be the effect on aggregate additional employment and income. That is, investment multiplier will be larger.

(8) During short period, marginal propensity to consume and personal propensity to consume cannot be enhanced.

(9) Therefore, the level of employment and savings must be raised by public investments. This is the most effective weapon according to Keynes.

The conclusion of Keynesian Theory of Employment is that public expenditure should be increased to solve the problem of unemployment. He has suggested digging of pits and filling them although this is an unproductive activity. Deficit financing can be adopted in this respect.

VERY SHORT ANSWER TYPE QUESTIONS

Q.61. Explain briefly J.B. Say's Law of Market.

SAY'S LAW OF MARKET

The classical theory of employment is based upon the ideas, broadly incorporated in Say's Law of Market believed to have given by J.B. Say, a French economist of the 19th century. According to this law, supply creates its own demand. In other words, production and supply of a product creates an equivalent demand for the product, so that there can never be a problem of over production. According to Say, people work and produce to enjoy the satisfaction of consumption.

Q.62. Explain effective demand.

Keynes introduced the concept of effective demand to explain the theory of income and employment.

In the short, employment is determined by effective demand and the effective demand is equal to the total expenditure on consumption goods and investment goods.

- (a) The level of income and of employment in a country at any given time depends upon the volume of effective demand
- (b) An increase in effective demand will lead to an increase in production, in income and a rise in the level of employment.
- (c) A decrease in effective demand will result in a contraction of production, of income and fall in the level of employment.

THEORIES OF INCOME AND EMPLOYMENT : O.T.Q.

Choose Correct Option -

1. **Classical theory of employment propounded by-**
 - (a) Classical economists
 - (b) Neo-classical economists
 - (c) Modern economists
 - (d) Keynes
 2. **J.B. Say was-**
 - (a) Modern economist
 - (b) Classical economist
 - (c) Neo-Classical economist
 - (d) Scientist
 3. **Keynesian theory of employment is known as-**
 - (a) Theory of effective demand
 - (b) Theory of effective supply
 - (c) Consumption theory
 - (d) Investment theory
 4. **Keynesian theory of employment is based on-**
 - (a) Full employment
 - (b) Short term employment
 - (c) A & B both
 - (d) None of these
 5. **What is not correct about Keynesian theory of employment-**
 - (a) Government interferer
 - (b) Full employment
 - (c) Short term
 - (d) Effective demand
 6. **'Supply Creates its own demand' statement is of -**
 - (a) Prof. Marshall
 - (b) Prof. J.B. Say
 - (c) Prof. Hicks
 - (d) Prof. Keynes
 7. **The General theory of employment, interest and money' book was written by-**
 - (a) Keynes
 - (b) Marshall
 - (c) Bolding
 - (d) Fisher
 8. **The course of over production and employment is according to Keynes-**
 - (a) Decreasing in savings
 - (b) Decreasing in effective demand
 - (c) Decreasing investment
 - (d) Increasing in total demand
 9. **Keynesian employment theory is-**
 - (a) Short term
 - (b) Long term
 - (c) Medium term
 - (d) All is correct
 10. **Which economist is related to law of market-**
 - (a) J.B. Say
 - (b) Pigou
 - (c) J.M. Keynes
 - (d) None of above
- Ans.: (1) a (2) b (3) a (4) b (5) b (6) b (7) a (8) b (9) a (10) a.

With an increase in income, Consumption increases but in a lesser proportion.

9

CONSUMPTION FUNCTION : SOLUTION OF SHORT AND LONG TERM CONSUMPTION FUNCTION

■ Long Answer Type Question

Q.63. What is meant by Consumption Function? Explain the theory of consumption function. Discuss its importance and determinants.

or

- (a) Explain the consumption function. Give examples.
- (b) Describe the determinants of consumption function.

or

What do you understand by propensity to consume? Discuss its determinants.

MEANING OF CONSUMPTION FUNCTION

The words consumption function are used in a special sense in economics.

Consumption function is a table which shows the amount of money spent on various articles of consumption and services at different levels of income. The gross total expenditure on consumption of all persons of a nation is called consumption function.

In simple words consumption function is a table which tells us how much money is spent on consumption at different levels of income.

DESCRIPTION OF CONSUMPTION FUNCTION

The following points are important in connection with consumption function-

- (1) Consumption function is a table or list of income and expenditure.
- (2) The table or list shows consumption expenditure at different levels of income.

- (3) The table shows the estimated prices. That is, how much consumption expenditure is likely to occur at different levels of income.

Example of Consumption Function.

Income of a Country (in crores)	Consumption Expenditure (in crores)
1000	800
1200	900
1400	1000
1600	1100
1800	1200
2000	1300

It is clear from the above table that -

- (1) With an increase in income, there is an increase in consumption expenditure.
- (2) The increase in consumption expenditure is not in the same proportion as income has increased.

IMPORTANCE OF CONSUMPTION FUNCTION.

The importance of consumption function is both theoretical and practical. In the formation of national economic plan, its importance is as follows-

- (1) **Importance in Investments.** The concept of consumption function indicates the important role of investment in determination of employment and income. Consumption function tells us that increase in consumption expenditure is less comparatively with an increase in income. It culminates in creation of savings. Therefore, it is necessary to increase investments to abridge the gap of income and expenditure. Otherwise, the total demand will decrease with a view to maintaining the level of employment and income.

(2) **Revocation of Say's Principle.** Consumption function repudiates Say's law, that is, it proves it wrong. According to Say, each supply creates its own demand. That is, no problem of decline in demand will arise. Keynes proved it wrong with the help of consumption function. He said that increase in income is not proportionate to an increase in expenditure. It results in decrease in demand. Therefore, it is necessary to increase investments.

(3) **Multiplier.** The theory of multiplier is found out with the help of consumer function. It tells us the total increase of income consequent on an increase in investments.

(4) **Marginal Productivity of Capital.** Consumption function also tells about the declining trend of marginal productivity of capital. If marginal consumption tendency is increased, the decline in marginal productivity of capital can be arrested.

(5) **Trade cycle.** We come to know the different trends of trade cycles with the help of consumption function. The increase in consumption is less than proportionate with an increase in income, with the result that savings increase. There is a fall in demand and problem of over-production arises. Consequently, a period of depression appears. This results in a decline in incomes, but does not consume as much. Consequently, demand increases again and a period of inflation starts.

Determinants of Consumption Function or Propensity to consume-

I. OBJECTIVE FACTORS

These are as follows-

1. **Monetary Income.** With an increase in monetary income of the society there will be an increase in propensity to consume and a fall in income will decrease propensity to consume. But this increase or decrease is not proportionate.

2. **Unexpected Profit or Loss.** Unexpected profits increase consumption tendency. Similarly, unexpected losses decrease propensity to consume.

3. **Change in Revenue Policy.** Govt. revenue policy also affects propensity of consumption. If indirect taxes are raised, propensity to consume goes down. Similarly, if indirect taxes are decreased, propensity to consume will increase. Government raises propensity to consume by bringing a change in income distribution.

4. **Change in Expectation.** If people forecast shortage of commodities or rise in their prices in future, present propensity to consume increases. This happens in times of war, famines and floods.

5. **High changes in Rates of interest.** With a huge increase in rates of interest, propensity to consume will decrease due to savings and vice versa.

6. **Dividend Policy.** Trading companies will give less dividends to shareholders if a large amount of profits is transferred to Reserve Funds. Thus the income of shareholders will decrease. This will result in decrease of propensity to consume. On the contrary an increase in dividend will increase propensity to consume.

7. **Distribution of wealth and income.** Propensity of poor class persons to consume is high, that is they spend more on consumption. On the other hand, propensity to consume of rich class is low because they save more.

8. Demonstration Effect or Dusenberry's Theory- Poor class persons or persons of low incomes imitate manners and methods of spending money of persons of high classes. Thus demonstration effect affects propensity to consume.

II. SUBJECTIVE FACTORS

These factors include human behaviour, habits and social customs. These are as under-

1. **Future Emergencies-** People save out of income for future purposes, like old age, education of children and marriages of daughters.
 2. **Object of Multiplicity-** People save with an object of profit by means of present investments.
 3. **Better Standard of living-** A few persons save with a view to improving their standard of living in future.
 4. **Expansion of Business-** People also save to start new business or to expand the present one by earning more from speculative activities.
 5. **Independence-** With an object of working independently people save out of their incomes.
 6. **Object of Safeguard-** Propensity to consume becomes low when a part of income is saved, for example, to meet expenses of illness and accident, etc.
 7. **Social Prestige-** A few persons save for the sake of social prestige in the society.
 8. **Miserliness-** Some people are miser by nature and save more.
- Q.64. Reconcile short and long period consumption function by way of relative income hypothesis and Permanent income hypothesis.**

TYPES OF CONSUMPTION FUNCTION

There are two types of consumption function -

- (1) Short Period consumption function, and
- (2) Long period consumption function.

Marginal consumption tendency remains unchanged under both the conditions. Under short period consumption function, average propensity to consume decreases with an increase in income, but in long period consumption function average propensity to consume remains stationary.

Economists have given several hypothesis in respect of short term and long term consumption function. A few of these thesis have been discussed here.

I. THE RELATIVE INCOME HYPOTHESIS-

First of all Dusenberry propounded the relative income hypothesis in 1949 connecting short term and long term consumption function. His theory depended upon the following two assumptions-

The Ratchet effect - The findings of Prof. Dusenberry in respect of Ratchet effect are worth noting. According to him, a person is not only affected by the present income in consumption but also by the past standard of living. His consumption expenditure will decrease with a decrease in income, but not in the same proportion as it is difficult to go below the accustomed life. The consumers do not find it possible to bring a decrease in consumption commensurate with a decline in income. They do not decrease consumption consequent on a decrease in income. This is due to maintenance of status and position among the neighbours. A survey of family budgets has disclosed that decrease in consumption is comparatively not lower than the decrease in income.

Thus, consumption proportionately increases with an increase in income, but not in case of decrease in income. This shows no result. Therefore, it is called Ratchet effect.

Demonstration effect- An additional truth has emerged from Prof. Dusenberry's hypothesis. According to him, consumers do not depend upon permanent income, but only on expected income.

For example permanent income of a few families is Rs. 8,000 per month per family, whereas the income of a few families is Rs. 6,000 per month per family. Under such circumstances, the latter families should spend less than the former families. That is different families of different incomes should spend according to their incomes. This is called fixed tendency.

But, according to Dusenberry, it is not so. Consumers do not spend independently according to their taste, but according to the taste of their neighbours. They endeavour to show that they can spend as much as their neighbours can. This tendency is called "demonstration effect" in the words of Dusenberry.

II. PERMANENT INCOME HYPOTHESIS

Milton Freedman substituted hypothesis of permanent income in place of common hypothesis of current income.

Characteristics of Theory-

1. Division of Income- Freedman has divided income into two parts -Permanent income and Transitory income. Thus there are three concepts of income-

- (a) Current
- (b) Permanent
- (c) Transitory

The main element which determines consumption is permanent income and not temporary income. Therefore, in fact, major part of current consumption is permanent consumption.

It means that although changes can take place in consumption each year, consumption expenditure will relatively be stationary because it depends mainly on permanent income. In other words, temporary consumption is not related to temporary income.

2. Division of Consumption- Freedman divided consumption into two parts- permanent and temporary.

Likewise income, there are three concepts of consumption :-

- (a) Current
- (b) Permanent
- (c) Temporary

Permanent consumption is that part of consumption which a consumer treats permanent. It shows that the remaining part of consumption is temporary.

It is clear from the above description that-

- (i) Permanent consumption depends upon permanent income,
- (ii) There is no relation between temporary expenditure and temporary income,
- (iii) There is no relation between permanent income and temporary income,
- (iv) There is no relation between permanent consumption and temporary consumption.

III. ABSOLUTE INCOME HYPOTHESIS

The Absolute Income Hypothesis presupposes an assumption that consumers freely undergo consumption expenditure according to their taste and choice and do not imitate neighbours. Arthur, Smithoe, James Town and other economists have given their own hypothesis on the basis of absolute income theory. According to them, the basic long period consumption income relation (CY) being disproportionate goes down with increases in incomes.

According to the absolute income hypothesis, the ratio of consumption and income *C/Y* goes on diminishing in a long period as income goes on increasing. That is this relation is disproportionate. But time series conclusions do not show such relation between consumption and income. That is, the relation is proportionate. The reason is with the passage of time, non-proportions lead towards consumption function.

SHORT ANSWER TYPE QUESTIONS

Q.65. Explain Consumption function with the help of Table (Schedule) and graph.

The consumption function refers to income consumption relationship. It is a functional relationship between two aggregates i.e. total consumption (c) and total income (y). Where C is dependent and Y is independent variable i.e. C is determined by Y Thus, Consumption function is the ratio that measures the functional relationship between income and consumption :

$$C = f(Y)$$

Where, C = Consumption expenditure,
f = Function and Y = Income

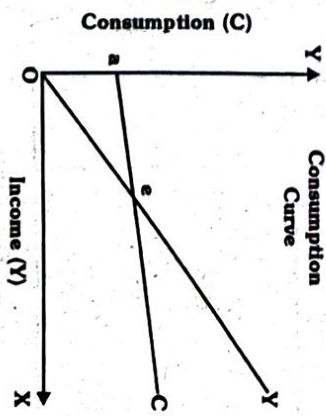
This function indicates the amount of income spent on the consumption by the people on various goods and services in order to satisfy their wants.

Consumption Schedule : A consumption function is a schedule that shows various amount of consumption expenditure to different levels of income.

The relation between consumption and income can be expressed as -

Consumption Schedule

Income (Y)	Consumption (C)
0	40
100	120
200	200
300	280
400	360
500	440



IMPORTANT OBSERVATIONS FROM THE SCHEDULE AND GRAPH

1. Nature of Consumption- Consumption exists even when there is no income. Hence, as a result, C curve starts from Y axis implying of as the autonomous consumption at zero income.

2. Slope of Consumption Curve- C curve has a positive slope showing positive relation between C and Y The proportionate increase in C is less than the proportionate increase in Y.

3. At equilibrium

Before $e \Rightarrow C > Y$, here $S = -ve$

After $e \Rightarrow C < Y$, here $S = +ve$.

$e \Rightarrow C = Y$, here $S = 0$

4. Nature of Saving- (i) When $C = Y$, i.e. at the equilibrium point saving is Zero.

(ii) When $C > Y$, before equilibrium point, saving is negative i.e. past savings are used to satisfy the desires of the consumer.

(iii) When $C < Y$, after equilibrium point, saving is positive i.e. a rational consumer does not spend all the income on consumption but saves some part to be used in future.

Q.66. Discuss the Marginal propensity to consume.

MARGINAL PROPENSITY TO CONSUME

MPC refers to the ratio of change in consumption that takes place due to change in income. MPC explains what proportion of change in income is spent on consumption. According to Keynes, "The ratio of change in aggregate consumption to the change in aggregate income is called the marginal propensity to consume."

$$\text{Hence, } \text{MPC} = \frac{\text{Change in Consumption } (\Delta C)}{\text{Change in Income } (\Delta Y)}$$

Let us understand MPC with the help of a schedule -

Income (Y)	Consumption (C)	MPC = $\frac{\Delta C}{\Delta Y}$
0	40	-
100	120	0.80 (80/100)
200	200	0.80 (80/100)
300	280	0.80 (80/100)

Observations -

- MPC varies between 0 and 1.
- MPC of poor is more than that of rich, as poor people spends a greater percentage of increase income on consumption.
- MPC falls with an increase in income.
- MPC remains constant during short period.

$$\text{MPC} = \frac{\Delta C}{\Delta Y}$$

Q.67. Discuss the Permanent Income Hypothesis or Theory.

PERMANENT INCOME THEORY

This theory was propounded by Milton Friedman. He substituted the hypothesis of permanent income in place of general hypothesis of current income.

Characteristics of Theory- The main elements of Friedman's

Theory of Permanent income are as follows-

1. Division of Income- Friedman has divided current income into two parts- (i) Permanent, and (ii) Transitory.

Thus there are three views about income.

- Current income,
 - Permanent income,
 - Temporary income.
- (i) **Current Income-** Current income is that income which is obtained by a person in a year.

(ii) **Permanent Income-** Permanent income represents that amount which a consumer expects to obtain during a long period. According to Friedman, permanent income is the most important determinant factor of consumption expenditure.

A person has certain wealth or property in a year. This is obtained by two sources-

- One part of this wealth is obtained by human mind or income from human wealth. This is also called non-property income.
- Another part of wealth will comprise of financial property, permanent physical property or property obtained from non-human property. This is also called property income.

Thus total income obtained from human and non-human endeavour, in future, will be called permanent income.

Therefore, a person tries to obtain income both from human and non-human resources. The total of income obtained from both the sources will be termed permanent income for a particular person.

(iii) **Temporary Income-** Temporary income is that amount which a person gets suddenly or unexpectedly. This income does not affect consumption at all or affects very little.

Temporary income may be positive, negative or zero. For example, a worker gets an unexpected special bonus in a year and does not expect to get any such bonus in the coming years, this will be termed positive temporary income.

2. Division of Consumption- Freedman has divided consumption into two parts - (i) Permanent consumption, and (ii) Temporary consumption. He gives three concepts of consumption-

- (i) Current consumption,
- (ii) Permanent Consumption, and
- (iii) Temporary Consumption.

CONCLUSION :

It is clear from the foregoing discussion that :-

- (i) Permanent consumption depends upon permanent income.
- (ii) There is no relation between temporary consumption and temporary income.
- (iii) There is no relation between permanent income and temporary income.
- (iv) There is no relation between permanent consumption and temporary consumption.

CRITICISM OF PERMANENT HYPOTHESIS

There are certain shortcomings in this theory which are as under -

- (1) Freedman says there is no relation between temporary income and temporary consumption. But this assumption is not real. It has been seen in business that if there is any temporary increase in income, like a large sum received from lottery, he would like to spend a part of this income on consumption rather than deposit the whole of it with the bank. Similarly, if there is a sudden decline in income or there is temporary heavy decline in income, he will reduce his consumption a little. Therefore, Freedman's assumption that there is no relation between temporary income and temporary consumption is not real.
- (2) Freedman's assumption that average propensity of consumption of all types of families - rich and poor, remains the same in the long period, is also not correct. It has been observed that in real life, average propensity to consume of both types of families does not remain same.
- (3) Various study reports do not fully support Freedman's Theory.

CONCLUSION :

In spite of certain drawbacks, Freedman's Theory of Permanent Income occupies an important place in economic field. According to M.K. Evans, Freedman's Theory has given new shape and direction for researches in the function of consumption.

Q.68. Critically examine Dusenberry's Relative Income Hypothesis regarding Short period and Long period Consumption function.

DUSENBERRY'S RELATIVE INCOME THEORY

Dusenberry propounded the theory of relative income in respect of consumption- expenditure. There are two aspects of this theory-

(1) Consumption-expenditure depends upon relative income

of persons- According to this theory, people do not only spend according to their tastes and choice but also looking to the tastes of others. Consumption expenditure is influenced by the rich class neighbours, friends, and persons connected with the same occupation and others. It means consumption expenditure is not independent but it is influenced by the relative incomes of others. Poor persons or persons of low incomes have a tendency to copy similar consumption attitude of rich class persons. Dusenberry has called this relative income theory as demonstration theory.

According to this theory, the diversity of incomes determines consumption expenditure in the society. Average propensity to consume among lower income groups is high as they have to spend a major part of their income. On the contrary, average propensity to consume of rich class is low as they spend a small part of income with a view to maintaining consumption standard high. Thus, high propensity of consumption of the poor class and low propensity of consumption of richer class become equal in the long run.

(2) Assumption of Past income hypothesis- The second aspect of Dusenberry's theory depends upon the assumption of past income hypothesis. According to this assumption, when the society adopts a particular standard of living, it becomes difficult to decrease consumption in a period of depression. At a time when there is a fall in income, people start to spend out of the past savings. This is resorted to with a view to maintaining the standard. Thus, there is no fall in the propensity to consume in a short period. It is very difficult to reduce propensity of consumption or lower standard of living of which he is accustomed. That is to say, it is not easy to bring down propensity of consumption with a fall in income. Therefore, a man tries to maintain his standard of living either without undergoing savings or by spending out of past savings.

CRITICISM OF RELATIVE INCOME THEORY-

This theory has been criticised from the following points of view-

(1) Ratio of Increase in income and expenditure is wrong -

The assumption of this theory that propensity of consumption increases in the same proportion as income increases is wrong. It is because due to a large increase in income, consumption does not increase in the same proportion.

(2) **Changing behaviour of Consumer-** This assumption that a consumer tries to maintain standard of living even when there is a fall in income, is incorrect. A consumer has to change his attitude at a certain stage.

(3) **Neglect of Other factors-** Other factors have been neglected in this theory like availability of new articles of consumption, to make reserves, development of cities, etc.

(4) **Assumption of Imitation is wrong-** The assumption that people imitate their neighbours and friends is not entirely correct. It may be true partially.

VERY SHORT ANSWER TYPE QUESTIONS

Q.69. Give the Meaning of Consumption Function.

CONSUMPTION FUNCTION

The consumption function refers to income consumption relationship. It is a functional relationship between two aggregates i.e. total consumption (c) and total income (y). Where C is dependent and Y is independent variable i.e. C is determined by Y.

Thus, Consumption function is the ratio that measures the functional relationship between income and consumption:

$$C = f(Y)$$

Where, C = Consumption expenditure,

$$f = \text{Function and } Y = \text{Income}$$

This function indicates the amount of income spent on the consumption by the people on various goods and services in order to satisfy their wants.

Q.70. Mention the determinants of the consumption function.

The determinants of consumption function or propensity to consume are of two types-

- (1) Objective Factors
- (2) Subjective Factors

We see that both the factors - objective and subjective affect - consumption function, but in short period no change takes place in subjective factors. Therefore, mostly objective factors affect consumption function. Because consumption tendency during short period remains stationary or unchanged, state interference and investment increase both are necessary to increase production and employment. Thus, Keynes concept of consumption function is a great contribution in economic analysis.

Q.71. Mention the properties or technical attributes of consumption function.

There are two properties or technical attributes of consumption function.

AVERAGE PROPENSITY TO CONSUME

APC refers to the ratio between total consumption expenditure and total income. According to Kurhara, "The average propensity to consume is the ratio between consumption expenditure to any particular level of income."

$$\text{Hence, } APC = \frac{\text{Total Consumption (C)}}{\text{Total Income (Y)}}$$

MARGINAL PROPENSITY TO CONSUME

MPC refers to the ratio of change in consumption that takes place due to change in income MPC explain what proportion of change in income is spent on consumption. According to Keiser, "The ratio of change in aggregate consumption to the change in aggregate income is called the marginal propensity to consume."

$$\text{Hence, } MPC = \frac{\text{Change in Consumption } (\Delta C)}{\text{Change in Income } (\Delta Y)}$$

CONSUMPTION FUNCTION : O.T.Q.

Choose Correct Option -

(1) AD schedule shows the relationship between :

- (a) AD and Y
- (b) C and I
- (c) C and S
- (d) None of these

(2) Domestic economy includes:

- (a) Household sector
- (b) Product sector
- (c) Government sector
- (d) All of these

(3) AD is :

- (a) Positively related to Y
- (b) Negatively related to Y
- (c) Not related to Y
- (d) Always equal to Y

(4) Average Propensity to Consume =

- (a) $\frac{C}{Y}$
- (b) $\frac{\Delta C}{\Delta Y}$
- (c) $\frac{Y}{C}$
- (d) $\frac{\Delta Y}{\Delta C}$

(5) Consumption depends on -

- (a) Income
- (b) Saving
- (c) Investment
- (d) None of these

Ans. (1) a (2) d (3) a (4) a (5) a

Theory of consumption function applies only on one third population of India.

10

CONSUMPTION FUNCTION IN INDIAN ECONOMY

■ Long Answer Type Question

Q.72 Write a note on 'Consumption Function' in Indian economy.

or

Give your views in regard to operation of Consumption Function in India.

CONSUMPTION FUNCTION IN INDIA

Consumption function indicates a special relation between income and consumption. Consumption function implies changes in consumption consequent on changes in income level. The human tendency is to increase consumption with an increase in average income but this increase is low comparatively to the increase in income. That is, increase in consumption is not in the same proportion as income increases. With an increase in income, marginal consumption tendency goes on diminishing or marginal saving tendency goes on increasing. Keynes theory of consumption function applies mainly on developed and rich countries. In an under-developed country like India, this theory applies to rich and high income groups of persons, but not on poor and lower income groups of persons.

Per capita income in developed countries is comparatively higher. There people consume articles of comfort and luxury. Therefore, on an increase in incomes of these persons, a large part of their income is spent on industrial goods, and a little part on necessities and foodstuffs. Money on durable articles of comfort and luxury is spent only once and not again and again. On the contrary, income of Indians is very low and they find it difficult to spend even on articles of necessity.

One third of India's population is below the life line and about one-third hardly satisfies necessary wants. Thus, theory of consumption function applies only on one third of the population.

Marginal and average propensity to consume in India is very high. It increases further with an increase in income. But marginal saving

propensity does not increase. Here, Keynes theory applies to a small extent. The main reason is very low standard of living.

The reason for the inapplicability of Keynes theory and discrepancies in propensity to consume in India can be seen from the following discussion-

(1) Per Capita Income- Keynes theory of consumption function describes the effect of rising income on consumption. According to this theory, on an increase in income, propensity to consume declines. But this is not so in India. Per capita income in India is about Rs. 3,000 per year. This is very low. It is difficult to obtain articles of necessity whereas rate of inflation is highly increasing.

(2) Inequalities in Income and Consumption- Per capita income is very low. At the same time, there are inequalities in incomes in India. On the one hand, there is a large group of persons which finds it difficult to satisfy bare necessities of life. On the other hand, there is a small group of persons holding possession of a large part of income and property. The income of 80% of families is equal to the income of 20% of families in the country.

It appears that Keynes theory of consumption function does not apply on a major part of population. This theory may apply on highest income group of persons to some extent, but here also income is below the average income of developed countries. Besides it, this group does not save but spends on luxurious items.

(3) Consumption Pattern- When we look to the consumption pattern, the real picture of consumption function of India becomes clear before us. From the consumption pattern we come to know the proportionate expenditure incurred on various items. An analysis of national sample survey has shown that a large part of income say 60% is spent on food (cereals, milk and vegetables), whereas a very small part of income say 40% is spent on articles other than food, like garments, education and health, when the income of poor persons increases, they spend more on better articles of food. In rural areas, almost 70% of total income is spent on articles of food.

(4) Price Trends- After independence, money circulation increased fast due to deficit financing in India. There was a rise in price about 10% yearly, with the result that increased income became ineffective. Purchasing power of the masses showed no significant rise. Sometimes, negative tendency has been found in purchasing power. Under these circumstances, the question of application of consumption function does not arise. In the end, it can be said that Indian economics has not matured till now to the extent for the acceptance of the Keynes theory. However this kind of conclusion applies only on a poor class of persons which forms about 50%

of the total population and for the remaining part of economy, it cannot be rejected.

In fact, consumption function applies only in case of rich class of persons which is presumed 50% by us. Therefore, whenever increase in income of these persons takes place, consumption increases in this class of persons. But the increase in consumption is proportionately less than the increase in income. It is clear from this statement that Keynes consumption function does not apply on all the classes of persons, only on rich class or higher income group of persons population of which does not comprise of more than 50%.

SHORT ANSWER TYPE QUESTIONS

Q.73. Give the Suggestions to Increase the propensity to consume in India.

PROPENSITY TO CONSUME IN INDIA

India is predominantly an agricultural country. It is an under-developed nation. Here propensity to consume is low comparatively to other countries. It is due to poverty and illiteracy. The following suggestions are given to bring about increase in propensity of consumption-

(1) Economic Irregularities- Propensity of consumption can be increased by removing economic irregularities and equal distribution of wealth. Per capita income can be raised by providing more employment opportunities, progressive taxation and by spending more public expenditure on poor class of persons. It will enhance propensity of consumption.

(2) Advertisement and expansion of Publicity- Propensity of consumption can be raised by effective advertisement and transmission of publicity. T.V., newspapers and radio are the best media of advertisement. The public is encouraged for the use of new articles.

(3) Social Security- Uncertainty of income of the masses can be removed by social security measures. Propensity to consume can be increased by means of unemployment insurance, crop insurance, old age pension, etc.

(4) Wage Policy- By increasing minimum wages and salaries, propensity to consume can be increased. At the same time, efficiency of labour must be also increased.

(5) Facilities- In a country like India, Propensity to consume can be increased by providing credit and other facilities. If scooter, T.V., Radios and Fridge, if available on instalment basis, people will easily purchase them, with the result that consumption will increase.

(6) Urbanisation- Urbanisation also increases propensity to consume. Propensity to consume of urban areas is higher than that of rural areas.

Thus, the above steps can help in raising propensity to consume in India.

CONSUMPTION FUNCTION IN INDIAN ECONOMY : O.T.Q.

Choose Correct Option -

1. **Keynes theory of consumption theory applies in-**

(a) Developed countries	(b) Under developed countries
(c) Poor countries	(d) All of above
2. **Main cause of in application of consumption in India-**

(a) Low per capital income	(b) In equalities in income
(c) Consumption Pattern	(d) All of above

Ans. (1) a, (2) d.

UNIT - III

- Monetary theories • Quantity theory of money
- Demand-Supply theory of money
- Price theory of money • Liquidity theory of money
- Keynes's money Income theory

11

MONETARY THEORIES

■ Long Answer Type Question

Q.74. What do you understand by value of Money? Explain the Demand and Supply theory of money.

Or

"Money is only one of the many economic things. Its value is, therefore, determined primarily by exactly the same two factors as we determine the value of money as any other thing, namely the conditions of demand for it and the quantity of it available." Discuss.

Or

- (a) What do you mean by demand of money.
- (b) Mention the factors affecting the supply of money.

MEANING OF VALUE OF MONEY

Just as the value of goods and services is measured by money, similarly, the value of money is expressed by its purchasing power. That is called the purchasing power of money. For example, one rupee note can purchase 200 grams of wheat or 100 grams of sugar. This will be called the purchasing power of money. The purchasing power is the value of money.

According to **Seligman**. "Value of money implies its purchasing power which can be known by the general level of prices of commodities and services."

In the words of **Fisher**, "Purchasing power of money is its indicator index of level of prices. Therefore, study of purchasing power of money is equal to the study of price level."

Robertson states that, "Value of money means quantity of commodities which are exchanged generally by one unit of money." When the prices rise, the value of money diminishes, when the prices go down, the value of money goes up.

DETERMINATION OF THE VALUE OF MONEY

Now-a-days, it has been accepted that the value of money is determined by the common forces of demand and supply like other commodities and services. In the words of **Robertson**, "Money is one of the economic goods. Therefore its value is primarily determined by demand and supply."

□ Demand for Money

Money is not a means but power. Money has no direct utility. Money is a medium of exchange of commodities and services and thereby helps us in the purchase of goods and services. Therefore, demand for money in a country depends upon the goods and services available for exchange. The following factors affect the demand for money-

- (1) **Factors of Production**- If there are large number of factors of production in a country, demand for money will be large and less in case of less factors of production.
- (2) **Efficiency of Factors of Production**- If the factors of production are more efficient in a country, production will increase and with it demand for money will increase. On the other hand, if the factors of production are less efficient, production will decrease and demand for money will also decrease.
- (3) **Scale of Production**- Demand for money will be more in case of large scale production as exchange system will expand. In case of small scale production and cottage industries, demand for money will decrease.
- (4) **Medium of Exchange**- If goods are supplied direct to consumers, demand for money will be less. In case of more means of distribution, demand for money will be more.
- (5) **Other Factors**- There are other factors as well which affect the demand for money, like population, size, natural resources, industrial development etc.

□ Supply of Money

Supply of money includes paper money, coins and instruments of credit. The following factors influence supply of money-

- (1) **Issue of notes and coins**- Supply of money depends mostly on the issue of currency by the government and/or Reserve Bank of India.
- (2) **Credit Money**- If credit money is more in circulation, supply of money will increase, because of less use of money.

(3) Velocity of circulation of Money- If the velocity of circulation of money is high, less money will serve the purpose. On the contrary, if velocity of circulation of money is slow, supply of money will be low.

(4) Reserve Fund- Supply of money will be less if banks make huge reserve funds. It will increase, if less reserve funds are made.

(5) Goods and Services- If the quantity of goods and services are increased, more quantity of money will be required for exchange purposes.

Thus, it is clear that the exchange value of money is determined by the quantity of goods and services as well as supply of money. Any change in either of the forces will bring a change in the value of money. Since the demand for money in short period remains almost constant or unchanged, the value of money is mainly determined by supply of money. General rule of value of money applies in the determination of value of money as in the case of goods and services.

Q.75. Critically examine the State Theory of Money Value Determination.

STATE THEORY OF MONEY

According to this theory, the value of money is determined by the state. This theory was propounded by Knapp. He said, "Soul of money in circulation does not lie in the material of its units connected, but in the legal orders which regulate its utility."

It has been said in this respect that in modern age issue, regulation and the determination of quantity of money is done by the state. It is due to state power that the public brings it into use willingly. Not only this, sometimes the state fixes up the prices of different commodities. In short, the state influences value of money under the following circumstances-

(1) Lawful Acceptance- The state creates confidence in public on the basis of lawful acceptance. Due to lawful acceptance and confidence, money is the medium of all transactions.

(2) Determination of Price of commodities- Sometimes by determination of price of commodities (Distribution and Rationing), the State determines the value of money.

(3) Change in Quantity- The state makes changes in circulation of money according to a certain policy and thereby affects the value of money indirectly.

Criticism of State Theory of Money

This theory has been criticised on the following grounds-

(1) Lawful acceptance alone not sufficient- The state cannot grant any material a form of money by lawful acceptance alone. It is

essential that the public must accept the material as money. If the public does not accept the material, despite legal acceptance the material cannot perform the function of money.

(2) Supply alone does not determine value- It is not substantial to say that value of money is determined by regulation of its issue. However, the state can increase or decrease the value of money by the increase or decrease in its supply. But, the fact is that supply of money affect the value of money. The state is only the media of making change in the supply of money. The value of money is directly determined by the changes in the supply of money.

(3) Price of commodities control policy is less effective- Price control of commodities of the state policy has a little effect on the value of money. The reason is that the state brings a few commodities under control. Besides, these commodities are sold in the black market at a very high price than the control price. Thus, the state policy of price control of commodities does not influence the value of money much.

However, inspite of the above stated criticism, the theory is true to some extent. Whereas it is correct to say that the state cannot influence fully the value of money, even then it can influence to a reasonable extent. Therefore, this theory is not absolutely useless.

SHORT ANSWER TYPE QUESTIONS

Q.76. What do you mean by Demand of Money mention factors affecting.

This statement represents the cash balance approach to the Quantity Theory of Money. The value of money, like the value of an ordinary commodity, is also determined by the demand and supply of money. The Quantity Theory states that the demand for money remaining the same, the value of money varies inversely with the supply of money. The Quantity Theory of Money is, therefore, only an elliptical way of stating the demand and supply theory of value.

Demand for Money

Money is not a means but power. Money has no direct utility. Money is a medium of exchange of commodities and services and thereby helps us in the purchase of goods and services. Therefore, demand for money in a country depends upon the goods and services available for exchange. The following factors affect the demand for money-

(1) Factors of Production- If there are large number of factors of production in a country, demand for money will be large and less in case of less factors of production.

(2) Efficiency of Factors of Production- If the factors of production are more efficient in a country, production will increase and with it demand for money will increase. On the other hand, if the factors of production are less efficient, production will decrease and demand for money will also decrease.

(3) Scale of Production- Demand for money will be more in case of large scale production as exchange system will expand. In case of small scale production and cottage industries, demand for money will decrease.

(4) Medium of Exchange- If goods are supplied direct to consumers, demand for money will be less. In case of more means of distribution, demand for money will be more.

(5) Other Factors- There are other factors as well which affect the demand for money, like population, size, natural resources, industrial development etc.

Q.77. Explain the term 'Supply of Money.'

Supply of money includes paper money, coins and instruments of credit. The following factors influence supply of money-

(1) Issue of notes and coins- Supply of money depends mostly on the issue of currency by the government and/or Reserve Bank of India.

(2) Credit Money- If credit money is more in circulation, supply of money will increase, because of less use of money.

(3) Velocity of circulation of Money- If the velocity of circulation of money is high, less money will serve the purpose. On the contrary, if velocity of circulation of money is slow, supply of money will be low.

(4) Reserve Fund- Supply of money will be less if banks make huge reserve funds. It will increase, if less reserve funds are made.

(5) Goods and Services- If the quantity of goods and services are increased, more quantity of money will be required for exchange purposes.

Q.78. Explain clearly the Value of Money and Price Level.

The relationship between the quantity of money and the price-level is direct. An increase in the quantity of money, other things remaining constant, results in an increase in the price-level. But other things seldom remain constant. The volume of trade may change. If the supply of money doubles, and the volume of trade also doubles, there will be no increase in the price-level.

MONETARY THEORIES : O.T.Q.

Choose Correct Option -

1. Quantity of commodities which are exchanged generally by one unit of money is called-

(a) Value of money	(b) Demand of money
(c) Both of above	(d) None of above
2. Money theory is based on-

(a) Quantity and Price of Money	(b) Supply of money
(c) Demand of money	(d) Purchasing power of money
3. From classical point of view demand of money for -

(a) Exchange purpose	(b) Measure of value
(c) Speculation purpose	(d) Value collection

Ans. (1) a (2) a (3) a

12

QUANTITY THEORY OF MONEY

■ Long Answer Type Question

Q.79. Critically examine the Quantity Theory of Money.

Or

Critically examine Fisher's vision in respect of Quantity Theory of Money.

Or

- (a) What do you understand by Quantity Theory of Money?
 (b) Describe the assumptions of Quantity Theory of Money.
 (c) Give the criticism of Quantity Theory of Money.

QUANTITY THEORY OF MONEY

Quantity Theory of Money occupies an important place among the theories of determination of value of money. This theory was first of all propounded by the Italian Economist Dawanajati. Later on, amendments were made by other economists. But the systematic form was given by an American Economist Irvin Fisher.

The main definitions of this theory are as follows –

According to Prof. Taussig, "Other things being equal, of quantity if money is doubled, prices will be double and value of money will be half. Similarly, other things remaining the same, if the quantity of money is reduced to half, prices will be half and value of money will be double."

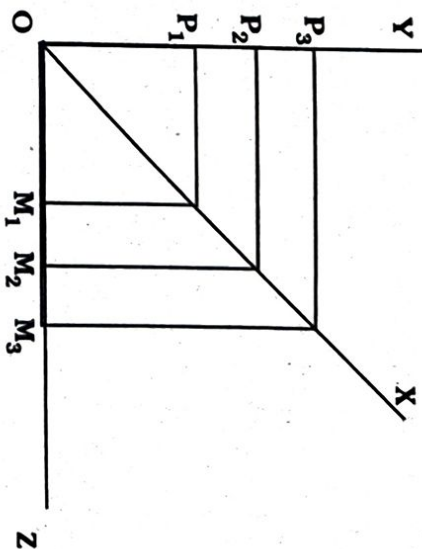
In simple words, according to the Quantity Theory of Money, value of money falls with an increase in its quantity and prices of commodities also increase. Thus every change in the quantity of money has an opposite effect on its value.

Example :

The Quantity Theory of Money tells us that with an increase in the quantity of money, there is a fall in its value (or purchasing power and prices of commodities rise.)

For example, one crore of rupees are in circulation in the country in the year 2015. Thus, value of one unit will be rupee one. If units of money are increased to two crores of rupees in the year 2017, value of money will

be half and prices will be double, because a commodity which was purchased for one rupee, two rupees will have to be paid for it.



It is clear from the above table that the increase in price is in the same proportion (P_1, P_2, P_3) with an increase in its quantity (M_1, M_2, M_3)

□ Assumption

Quantity Theory of Money is one of the principles of economics. Therefore, like other principles, there are certain shortcomings in this theory. This theory applies under some assumptions which are as under :

(1) **Quantity and Demand for Money**—One of the important assumptions of this theory is that with an increase in the quantity, there should be no increase in demand for money. Value of money will change according to its supply if there is no change in the quantity of goods and services.

(2) **No Barter System**—Another assumption of this theory is there should be no barter system in the country. That is all purchases and sales should be through exchange of money.

(3) **No change in credit money**—These should be no change in credit instruments, i.e., cheques, bills, etc. If any change takes place in credit instrument the theory will not apply.

(4) **Velocity of Circulation of Money**—Each unit of money is used several times in the purchase of goods and services. The use of the unit is called velocity of circulation of money. There should be no change in the velocity of circulation of money. For example, a 10 rupee note is transferred from one person to another three times in a day. If it becomes four times, velocity of circulation will increase and this rule will not apply.

(5) **Ratio of credit money and legal tender must remain the same**—In every country, banks usually keep a small amount of deposits in cash reserve and lend the balance to the public.

□ **Equation**

Formulae—Prof. Fisher has given the following formula of the quantity theory of money—

$$P = \frac{MV + M'V'}{T}$$

or

$$MV + M'V' = PT$$

Whereas,

$$M = \text{Money} \\ V = \text{Velocity of circulation of Money}$$

$$M' = \text{Credit Money}$$

$$V' = \text{Velocity of circulation of Credit Money}$$

$$P = \text{Price level}$$

$$T = \text{Total Transactions}$$

Thus, if we know the value of $MV + M'V'$ and T , general price level (P) can be found out easily. On this basis, the purchasing power of money is known.

CRITICISM OR LIMITATIONS OF QUANTITY THEORY OF MONEY

The Quantity Theory of Money can be criticised on the following grounds :

(1) **Assumptions untrue and Impractical**—The Quantity Theory of Money is based upon untrue and unusual assumptions. Actually demand for money, size of population, quantity of production, habits and fashions, consumption function, quantum of trade, velocity of circulation of money and credit and their ratio do not remain the same.

(2) **To measure the velocity of circulation of money difficult**—As velocity of circulation of actual money, credit money and its quantity and the actual calculation of ratio of money and credit money cannot be ascertained exactly, the purchasing power of money cannot be ascertained.

(3) **No Reasons of velocity of circulation**—Prof. Marshall says that no reasons for the velocity of circulation are mentioned in the theory.

(4) **Correct measurement of Purchasing Power not possible**—It has been assumed that demand for money is equal to one unit and demand for goods and services is elastic, whereas under certain conditions the purchasing power of money itself influences its demand and supply.

That is, the Rule of Demand and Supply affects determination of the value of money.

(5) **Effects of Trade Cycles ignored**—The theory fails to explain as to why trade cycles occur in capitalistic economy.

(6) **Stagnant Economy Imaginary**—Prof. Keynes says the theory applies only when other things are equal whereas social structure is changing.

In spite of the above criticisms, the Quantity Theory of Money has its importance. Robertson says, "To understand the value of money, it is a strange truth to understand quantity theory of money. In actual life, a relation between the quantity of money and the price of goods and services is essential."

SHORT ANSWER TYPE QUESTIONS

Q.80. **Mention the assumptions of Fisher's Quantity Theory of Money.**

ASSUMPTIONS OF QUANTITY THEORY

Quantity Theory of money applied under some assumptions which are as under —

(1) **Quantity and Demand for Money**—One of the important assumptions of this theory is that with an increase in the quantity, there should be no increase in demand for money. Value of money will change according to its supply if there is no change in the quantity of goods and services.

(2) **No Barter System**—Another assumption of this theory is there should be no barter system in the country. That is all purchases and sales should be through exchange of money.

(3) **No change in credit money**—These should be no change in credit instruments, i.e., cheques, bills, etc. If any change takes place in credit instrument the theory will not apply.

(4) **Velocity of Circulation of Money**—Each unit of money is used several times in the purchase of goods and services. The use of the unit is called velocity of circulation of money. There should be no change in the velocity of circulation of money. For example, a 10 rupee note is transferred from one person to another three times in a day. If it becomes four times, velocity of circulation will increase and this rule will not apply.

(5) **Ratio of credit money and legal tender must remain the same**—In every country, banks usually keep a small amount of deposits in cash reserve and lend the balance to the public.

Q.81. Mention any five criticism of Quantity Theory of Money.

CRITICISM OR LIMITATIONS OF QUANTITY THEORY OF MONEY

The Quantity Theory of Money can be criticised on the following grounds:

(1) **Assumptions untrue and Impractical.**—The Quantity Theory of Money is based upon untrue and unusual assumptions. Actually demand for money, size of population, quantity of production, habits and fashions, consumption function, quantum of trade, velocity of circulation of money and credit and their ratio do not remain the same.

(2) **To measure the velocity of circulation of money difficult.**—As velocity of circulation of actual money, credit money and its quantity and the actual calculation of ratio of money and credit money cannot be ascertained exactly, the purchasing power of money cannot be ascertained.

(3) **Correct measurement of Purchasing Power not possible.**—It has been assumed that demand for money is equal to one unit and demand for goods and services is elastic, whereas under certain conditions the purchasing power of money itself influences its demand and supply. That is, the Rule of Demand and Supply affects determination of the value of money.

(4) **Stagnant Economy Imaginary.**—Prof. Keynes says the theory applies only when other things are equal whereas social structure is changing.

VERY SHORT ANSWER TYPE QUESTIONS

Q.82. Give the Definition of Quantity of theory of money.

DEFINITION OF THEORY OF QUANTITY

According to Prof. Taussig, "Other things being equal, of quantity if money is doubled, prices will be double and value of money will be half. Similarly, other things remaining the same, if the quantity of money is reduced to half, prices will be half and value of money will be double."

In simple words, according to the Quantity Theory of Money, value of money falls with an increase in its quantity and prices of commodities also increase. Thus every change in the quantity of money has an opposite effect on its value.

Example :

The Quantity Theory of Money tells us that with an increase in the quantity of money, there is a fall in its value (or purchasing power and prices of commodities rise.)

Q.83. Explain the Equation of Quantity Theory of Money.

Equation

Formulae—Prof. Fisher has given the following formula of the quantity theory of money—

$$P = \frac{MV + M'V'}{T}$$

or

$$MV + M'V' = PT$$

Whereas,

M = Money

V = Velocity of circulation of Money

M' = Credit Money

V' = Velocity of circulation of Credit Money

P = Price level

T = Total Transactions

QUANTITY THEORY OF MONEY : O.T.Q.

Choose Correct Option -

1. Quantitative theory is related to—

(a) Commodity price determination (b) Interest rate determination

(c) Money value determination (d) All of above

2. Price level of money affected by in Fisher's equation—

(a) Non-Active money (b) Active money

(c) Active and Non-Active money both

(d) None of above

3. The equation of quantity theory of money according to Fisher—

(a) $MV = PV \times M'V'$ (b) $PT = \frac{MV + M'V'}{T}$

(c) $P = \frac{MV + M'V'}{T}$ (d) $MV = M_1V_1$

4. According to Fisher's equation the relationship between money and credit money is—

(a) Certain (b) Opposite-

(c) Convertable (d) Optimum

Ans. (1) c (2) b (3) b (4) a.

MODERN LIQUIDITY THEORY OF MONEY

■ Long Answer Type Question

Q.84. Explain the modern liquidity theory of money.

Or

What do you mean by Liquidity of Money ? Describe liquidity theory of money.

The name of Milton Friedman has almost become synonymous with monetarism in modern economics. According to him, the dominant factor that shapes economic events is the amount of money in circulation. By suggesting this, he was trying to defend the quantity theory of money which had come under heavy fire from the Keynesians in recent years. He not only defended the theory but also rehabilitated it with certain modifications. He revived the Fisher Equation of the old quantity theory, but made it more sophisticated in content.

In his General Theory (1936), J.M. Keynes had launched an attack on the conventional version of the quantity theory of money. He clearly pointed out that changes in the general price-level were not entirely due to changes in money supply. Nor were changes in prices the sole determinant of changes in the demand for money. As a result of this attack, the quantity theory of money retreated into the background and remained there till the beginning of the sixties when once again it came into the forefront as a result of the serious efforts made by Milton Friedman and his fellow-economists at the University of Chicago. The present-day popularity of the quantity theory of money is, thus, to be attributed to the sincere efforts made by economists at the Chicago School in the U.S.A.

According to Friedman, the quantity theory of money is primarily a theory of the demand of money. He then proceeds to discuss the factors which go to determine the demand for money in a community. There are four factors, according to him, which determine the demand for money. They are as follows :-

- (i) The general price-level,
- (ii) The magnitude of real income (or, the total output of goods and services) in the economy,

- (iii) The current rate of interest, and
- (iv) The rate of increase in the general price-level.

Of the four determinants of the demand for money, the first two, namely, changes in the price-level and changes in the real income, produce direct changes in the demand for money. The last two determinants, namely, changes in the rate of interest and changes in the rate of increase in the price-level cause inverse changes in the demand for money.

Friedman's version of the Quantity Theory of Money has been mainly criticized on two grounds :

1. **Wrong argument**—Friedman argued that the rate of interest did not play a crucial role in determining the demand for cash balances in the community. This argument cannot be accepted by us. The rate of interest does play a significant role in influencing the demand for cash balances. A rise in interest rates will undoubtedly raise the cost of holding cash balances by the community and reduce the demand for money. It will, on the contrary, increase the volume of bank deposits in the country, because the people would now like to put their savings in the banks to take advantage of the higher interest rates. The raising of interest-rates on time-deposits in India in recent years has led to a phenomenal expansion of such deposits. This proves that deposits are not interest inelastic as believed by Friedman.

2. **Supply of money is not independent variable**—Friedman assumed that the supply of money in a community was independent of changes in the income and price-levels. In other words, the supply of money, he believed, was not influenced by changes in incomes and prices. On the contrary, it was the supply of money which determined prices and incomes in a community. Empirical experience, however, proves that money supply was not an independent variable and that the supply of money was equally influenced by changes in incomes and prices in the economy.

Despite this criticism, Friedman's Quantity Theory marks an improvement over the traditional Quantity Theory insofar as it has furnished a more detailed and penetrating analysis of the demand for money than the earlier theory. Further, his analysis of the demand for money is not altogether devoid of empirical validity. He actually tested the validity of his theoretical formulations pertaining to the demand for money through empirical research.

Critics, however, point out that monetary policy based upon Friedman's Quantity Theory of Money has not proved wholly successful, wherever adopted, particularly in Great Britain and the U.S.A. The economists, even those of the Chicago school are therefore, having second thoughts on the practical usefulness of this theory.

Q.85. Explain the Cambridge or Cash Balance Equation of the Quantity Theory of Money.

Or

Examine the Cambridge Equation of the Quantity Theory of Money. Is it an improvement over Fisher's Equation ?

Or

examine Critically the Cambridge version of the Quantity Theory of Money.

CAMBRIDGE VERSION OF CASH BALANCE

Economists of Cambridge were not satisfied with Fisher's quantity theory formula. They have given version of Cash Balance. Thus they have produced a new point of view in this respect. Marshall, Pigou, Cannon, Harvety and Robertson of Cambridge presented Cash Balance Equation in place of Quantity Theory of Money.

Characteristics of Cambridge Version

The main characteristics of the Cambridge Theory are as follows :

(1) To keep deposit of cash a part of income- According to Fisher, money has no utility. It is used for exchange purposes. He assumed in his equation, demand of money is equal to the value of transaction of goods and services, but in actual life it is seen that people demand money for deposit as well. Therefore, there is no accurate equilibrium between income and expenditure.

(2) Dependence of Demand of Money on Liquidity Preference- The largest liquidity is in the wealth kept with a person because he can use it immediately for any purpose desired by him. It is a human instinct that a man likes to keep with him money in liquid form so that he can utilise it as per the need arisen and satisfy his wants.

(3) Effect of other factors- There are other factors as well which affect demand of money. These are as under -

(a) Period of Receivable Income- The more period of getting income, the more will be the demand for money.

(b) Prices of Commodities- Demand of money also depends upon the prices of commodities in the market.

(c) Business Conditions- Trade cycles also affect demand of money. Producers reduce production in times of deflation. On the contrary, in a period of rising the producers invest more money. They take loans also from the banks and expand their business.

(d) Population- Population of a country also affects demand of money. The higher population, the more will be the demand of money because people keep more money with them to meet daily expenses.

(e) Distribution of Wealth- The more equitable distribution of wealth in a country, the more will be the demand of money because a man keeps some money with him. In case of inequitable distribution of wealth, the demand of money is low, because rich class of persons invest their funds and the poor class of persons find it unable to keep money with them.

Marshall's Explanation

Marshall is an eminent economist among Cambridge economists. While commenting on the quantity theory of money, people in a country do not spend the whole of their income but keep a portion of it as cash money in reserve fund.

The study of Marshall's comments tells us that people keep a part of their yearly income in the form of cash reserve. Thus, that part of money which people demand is a fixed ratio of total yearly income and property. Marshall has given the following equation in this respect-

$$\begin{array}{l} M = KY = KA \\ M = \text{Quantity of Money} \\ Y = \text{Money Income} \\ K = \text{Ratio of money income kept as reserve} \\ A = \text{Value of Total Assets} \end{array}$$

Thus there are two points of Marshall's equation - Income and Assets.

Prof. Pigou has given the following equation :

$$P = \frac{KR}{M}$$

R = Represents wheat which indicates actual annual income which is used in the society in a particular time.

K = Represents ratio of actual income which people would like to keep with them.

M = Represents total quantity of money.

P = Represents value of money or purchasing power.

Pigou says that the purchasing power of money declines in the same proportion with an increase in its quantity.

Besides this Prof. Cannon, Robertson etc. of Cambridge have given their amended equations.

Criticism of Cash Balance Equation

Although cash balance equation is superior to cash trading or Fisher's equation, even then it is not free from shortcomings. Its main criticism is as under-

- (1) **Indifference in Price Tendency**—The equation does not explain the changes in the tendency of prices.
- (2) **Avoidance of exhaustive form of money**—This equation does not explain all the determinants of demand for money. It does not throw light on the demand of money which arises for the purpose of speculation and is important in determining the demand of money.
- (3) **Factors of Equation are Temporary**—Like cash trading equation, K and T have been assumed unchanging in Cash Balance Equation. Therefore, all the criticisms levied on cash trading equation apply to Cash Balance Equation.
- (4) **Effects of changes in Quantity of Money Not Clear**—Cambridge economists have failed to analyse the effect of changes in quantity of money on prices and production.

SHORT ANSWER TYPE QUESTIONS

Q.86. Explain the Cambridge Equation in brief.

Economists of Cambridge were not satisfied with Fisher's quantity theory formula. They have given version of Cash Balance. Thus they have produced a new point of view in this respect. Marshall, Pigou, Cannon, Harvrey and Robertson of Cambridge presented Cash Balance Equation in place of Quantity Theory of Money.

□ Main of Cambridge Version

The main characteristics of the Cambridge Theory are as follows :

- (1) **To keep deposit of cash a part of income**—According to Fisher, money has no utility. It is used for exchange purposes. He assumed in his equation, demand of money is equal to the value of transaction of goods and services, but in actual life it is seen that people demand money for deposit as well. Therefore, there is no accurate equilibrium between income and expenditure.
- (2) **Dependence of Demand of Money on Liquidity Preference**—The largest liquidity is in the wealth kept with a person because he can use it immediately for any purpose desired by him. It is a human instinct that a man likes to keep with him money in liquid form so that he can utilise it as per the need arisen and satisfy his wants.
- (3) **Effect of other factors**—There are other factors as well which affect demand of money. These are as under –
- (i) The more period of getting income, the more will be the demand for money.
 - (ii) Demand of money also depends upon the prices of commodities in the market.

- (iii) Trade cycles also affect demand of money. Producers reduce production in times of deflation. On the contrary, in a period of rising the producers invest more money. They take loans also from the banks and expand their business.
- (iv) Population of a country also affects demand of money. The higher population, the more will be the demand of money because people keep more money with them to meet daily expenses.
- (v) The more equitable distribution of wealth in a country, the more will be the demand of money because a man keeps some money with him. In case of inequitable distribution of wealth, the demand of money is low, because rich class of persons invest their funds and the poor class of persons find it unable to keep money with them.

Superiority of Cambridge Equation—Cambridge equation is superior to Fisher's equation. It also points out the effect of changes in short period, whereas Fisher has given importance to long period changes only. For example, in deflation, according to Cambridge equation, people start keeping cash balance with them which leads to an increase in demand for money which in turn increases its value or prices fall. Similarly, in a period of inflation, people keep less reserve of cash with them or prices rise, but these factors of short period do not come within the field of Fisher's equation. Fisher's equation gives importance only to changes in long period.

VERY SHORT ANSWER TYPE QUESTIONS

Q.87. Give Classification of money on the basis of liquidity.

The modern economists include under the supply of money not only currency notes and Bank Currency, they include the following –

- (1) Currency Notes issued by the Government and Central Bank.
- (2) Bank money i.e. bank deposits.
- (3) Bonds, securities, Debentures, Treasury Bills, Insurance policies etc.

Q.88. Explain views of Liquidity Theory of Money.

Under full employment, an increase in the quantity of money will result in a proportionate increase in the general price-level because there is already full employment of resources and there is no possibility of any increase in output. Under less than full employment, in response to an increase in the quantity of money, the price-level will either not increase at

all or will increase in a proportion less than the increase in the quantity of money. The reason is that expansion of money supply before the point of full employment goes to increase output and employment rather than the general price level.

LIQUIDITY THEORY OF MONEY : O.T.Q.

Choose Correct Option -

1. Liquidity theory of money propounded by-
 (a) Keynes (b) Tobbin
 (c) Gurle and Shaw (d) Bamol
 2. Report of Redcliffe committee report was published in the year-
 (a) 1952 (b) 1959
 (c) 1948 (d) 1957
 3. Which is the feature of liquid asset-
 (a) Easily disposable (b) Transferable
 (c) Capital certainty (d) All of above
 4. The following is lesser liqued asset demand-
 (a) Bank demand deposits (b) Currency
 (c) Fixed deposit (d) All of above
 5. Important contribution in presentation of liquidity theory of money-
 (a) Keynes (b) Redcliffe commethi
 (c) Prof. Gurley & Show (d) b & c Both
 6. Which is nearest money-
 (a) Fixed deposit (b) Demand deposit
 (c) Coins and Currency (d) All of above
 7. Which money affects the price level-
 (a) Active money (b) Unactive money
 (c) Active & Non active money both
 (d) None of above
- Ans. (1) c (2) b (3) d (4) c (5) d (6) a (7) a.

KEYNES THEORY OF MONEY AND PRICE

■ Long Answer Type Question

Q.89. Discuss the Income Theory of Money as propounded by Keynes. In what respects is it superior to Fisher's Quantity Theory of Money ?

Or

Discuss Keynes Savings Investment Theory.

Keyens Income Theory of Money

Income Theory of Money was propounded by famous economist Keynes. It is also called savings and investment theory. Keyens theory is based upon this fact that different economic changes take place due to changes in income and they affect prices. According to Keynes, "In the study of prices, size of expenditure and not the quantity of money should be given importance."

Description of Theory of Income

Keynes propounded a new equation by means of amendment in Cambridge equation in respect of value of money. Keynes made a further amendment and propounded a new theory of income. According to Prof. Keynes, "Value of money is not affected by its quantity but by the income, capacity to save, savings and investment of the masses." Keynes has given a simple equation of his theory in his book General Theory of Employment, Interest and Money published in 1936. The equation is :

$$Y = C + S$$

$$Y = C + I$$

$$C + S = C + I$$

$$\therefore S = I$$

Y	means	Total Income or National Income
C	means	Consumption
S	means	Savings
I	means	Investments

As is clear from the above equation, national income has been used on two heads - firstly, consumption, secondly savings. Therefore $Y = C + S$. Keynes says savings and investments always remain the same, that is

savings are equal to investment. The reason is that a part of income not spent on expenditure is deposited with the bank or invested in the purchase of shares and securities. Therefore $Y = C + I$ or national income will be equal to total consumption + Total investments. Thus, according to Keynes when savings are equal to investments, there is equilibrium in the country, but when there is disparity between savings and investments, disequilibrium takes place.

□ **Characteristics of Income Theory of Money**

The main characteristics of Keynes Theory are—

(1) **Dependence of Value of Money**— Value of money depends on the one hand on monetary income and expenditure and quantity of exchange commodities or actual income on the other hand.

(2) **Flow of Money and Income**— Flow of monetary income depends upon the quantity and velocity of circulation of money, whereas supply of commodities depends upon the quantity of capital and expected profits.

(3) **Effect on the Supply of Money**— Supply of money is effected by several factors in a country, for example, standard of monetary form, monetary policy of the government, development of banks and credit.

(4) **Velocity of circulation of Money**— Velocity of circulation of money depends upon expectation of profit in industries, production expenditure, period of manufacture etc.

(5) **Quantity of Commodities**— The quantity of money income is equal to the price of commodities produced in that particular period. But it is possible, the amount of money available in the market for the purchase of commodities produced may be more or less than the income of money because hoarding of money is sometimes more and sometimes less. Simultaneously, new currency comes in vogue and old currency goes out of circulation.

(6) **Savings**— Savings means that part of income not spent on new commodities in a particular period and investments means a part of monetary income spent on the purchase of capital goods. Total income spent on both consumption and capital goods may be more or less. The reason is a part of income is saved or withdrawn from unreserved funds.

(7) **Savings and Investments**— Savings and investments are not always equal. The price level falls if savings are more than investments. The price level rises if savings are less than investments.

□ **Criticisms or Defects of Income Theory of Money**

(1) **Savings and investments are not equal under all conditions**— Keynes has assumed savings and investments equal. According to Leonitief, this assumption gives only a theoretical satisfaction.

In fact, it is very difficult to find out whether savings and investments are equal.

(2) **Impractical**— According to Lutz, the definitions of savings and investments given by Keynes are useless, as they are not practical.

□ **Conclusion**

The above discussion leads us to conclude that both the quantity theory of money and income theory of money are useful to us. Quantity theory of money deals long term value of money, whereas income theory of money throws light on short term value of money. Crowther has said, "Quantity theory of money deals average level of ocean whereas income theory of money deals with ups and downs of ocean."

SHORT ANSWER TYPE QUESTIONS

Q.90. Explain the equation of savings Investment theory of Keynes.

EQUATION OF THEORY OF INCOME BY KEYNES

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$$Y = C + S$$

$$Y = C + I$$

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Y means Total Income or National Income
 C means Consumption
 S means Savings
 I means Investments

As is clear from the above equation, national income has been used on two heads – firstly, consumption, secondly savings. Therefore $Y = C + S$. Keynes says savings and investments always remain the same, that is savings are equal to investment. The reason is that a part of income not spent on expenditure is deposited with the bank or invested in the purchase of shares and securities. Therefore $Y = C + I$ or national income will be equal to total consumption + Total investments. Thus, according to Keynes

when savings are equal to investments, there is equilibrium in the country, but when there is disparity between savings and investments, disequilibrium takes place.

Q.91. Why Keynes's Income theory is better than Quantity Theory of Money.

Keynes income theory of savings and investment is considered superior to quantity theory of money. It is because-

(1) **Expensive and Literal-** It lays more emphasis on price determining factors. It not only gives importance to money in the society, but also demand and supply of goods and services. It also explains these factors coordinate in a state of unemployment. In the words of Keynes, "A change in the value of money is due to difference between savings and investments."

(2) **Simple and Practicable-** As compared to other equations, this equation is more reasonable, simple and practical. This equation gives equal importance to all the factors affecting economy. This fact has been kept in mind that changes in the quantity of money alone do not affect its value.

(3) **Trade Cycles-** Keynes in his equation has clarified that price level falls if investments fall below the savings. On the other hand, if investments exceed savings, the price level goes up. Thus Keynes has shown a path of controlling trade cycles. Keynes has given importance to government's efforts of control in times of inflation and deflation.

(4) **Effect on Economy-** Keynes equation is more real in comparison to other equations because they do not discuss effects on other fields of quantity of money, whereas Keynes has done so. He has also explained the reasons and effects.

(5) **Extensive and Comprehensive-** As compared to quantity theory of money, the income theory of money is more wide. According to quantity theory of money, supply of money alone affects its value. Whereas, according to this theory, income, expenditure, savings, investments and reserves also affect the value of money.

VERY SHORT ANSWER TYPE QUESTIONS

Q.92. Give the meaning of Keynes' Income theory of money.

KEYNES INCOME THEORY OF MONEY

Income Theory of Money was propounded by famous economist Keynes. It is also called savings and investment theory. Keynes theory is based upon this fact that different economic changes take place due to

changes in income and they affect prices. According to Keynes, "In the study of prices, size of expenditure and not the quantity of money should be given importance."

Q.93. Give the equation of Keynes's Income theory.

Keynes propounded a new equation by means of amendment in Cambridge equation in respect of value of money.

$$Y = C + S$$

$$Y = C + I$$

$$C + S = C + I$$

$$\therefore S = I$$

Y	means	Total Income or National Income
C	means	Consumption
S	means	Savings
I	means	Investments

KEYNES THEORY OF MONEY AND PRICE : O.T.Q.

Choose Correct Option -

- Velocity of money is related to-**
 - Quantity theory of money
 - Income theory
 - Theory of interest
 - Inflation
- If savings is more than investment then the value of money-**
 - Decreased
 - Increased
 - Stable
 - None of above
- Relationship between liquidity preference and money demand-**
 - Direct
 - Indirect
 - Direct and Indirect
 - No relation
- Total Moeny supply in Fisher's equation is-**
 - MV
 - MV + M¹ V¹
 - M
 - None of above
- According to Pigoue the Cambridge equation in value of money is-**
 - $P = \frac{KR}{M}$
 - $\frac{RV}{T}$
 - $\frac{MV}{T}$
 - None of above

Ans. (1) b (2) a (3) a (4) a (5) a.

UNIT- IV

- Economic Development - Concept of economic growth and its ingredients
- Factors affecting economic development
- Theories of economic development
- Stages of economic growth
- Balanced and Imbalances growth

15

CONCEPT OF ECONOMIC DEVELOPMENT AND ECONOMIC GROWTH AND DETERMINING FACTORS

■ Long Answer Type Question

Q.94. Explain the concept of Economic Development. What are its basic ingredients ?

Or

What do you understand by "Economic Development" ? Explain the characteristics of Economic Development.

MEANING OF ECONOMIC DEVELOPMENT

Today, each nation wants to go ahead in the race of economic development. The world is divided into two parts of nations at present - developed and undeveloped. Each nation is anxious to proceed on the path of economic development. Both the under-developed and undeveloped nations are making efforts towards economic development with a view to getting rid of poverty and backwardness. The developed nations want to become all the more developed.

In the present age, the words "Economic Development" are very important. The concept of economic development has been defined by economists in different ways. The definitions are given as under -

I. Increase in national Income

(1) According to **Mayor and Bauldwin**, "Economic development is a process in which real income of a nation increases in a long period."

(2) According to **Paul Albert**, "The best definition of economic development can be given by its main object which is obtained by a nation

with the use of all the factors of production in order to increase its income." From the above definitions, it is clear that emphasis has been laid on increasing national income with the economic development. The increase is not short term but long term.

II. Increase in Per Capita Real Income

(1) According to **Williams and Betrick**, "Economic development is a process in which the nation or the residents continuously increase per capita goods and income by means of all available resources in the country."

(2) According to **Crown**, "Economic development indicates economic progress in the economy the main object of which is to raise per capita level of real income."

(3) According to **Rostow**, "Economic development is a relation between the increased capital, working capital and population which helps in increase of per capita productivity."

The above definitions make it clear that by economic development, per capita real income must increase. If the national income increases, still there is no per capita increase in income, it can not be called economic development.

III. Increase in General Welfare

Some authors connect economic development with an increase in general welfare of the masses :

(1) According to **Bright Singh**, "Economic development is a manifold concept. There is an increase not only in monetary income in it, but also an improvement in actual habits, education, public health, sufficient leisure and all types of social and economic life."

(2) According to **U.N.O. Report**, "Development does not only mean material human development but all social conditions making progress in life. Economic development is not only economic progress, but it also includes social, cultural, institutional and economic changes."

This definition takes view that economic development does not only imply increased per capita income, but an around increase in general welfare of the society.

Conclusion

The above definitions show that various authors have given their views in different ways. A simple definition, however, can be given as under :

Economic development is a process in which the national and per capita income increases and there is also an increase in social welfare. Consequently, the public leads a progressive and comfortable life.

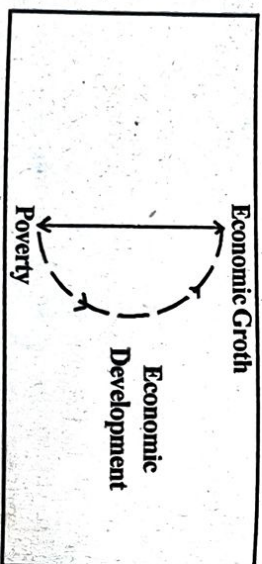
CONCEPT OF ECONOMIC GROWTH

Although both the economic development and economic growth are generally synonyms, but the word economic growth is somewhat different from economic development.

The definitions of economic growth are as under-

- (1) According to **Schumpeter**, "Economic growth means hereditary, automatic and regular development."
- (2) According to **Hicks**, "Economic growth is related to developed countries resources of which are known and which have been developed to a large extent."
- (3) According to **Berger**, "Economic growth means only more production, whereas economic development means coordination of more production, new technique and institutional improvements."

Diagram



Ingredients or Characteristics of Economic Development

The following features or characteristics of economic development discussed below-

1. Continuous Process- Continuous changes in the different sectors of an economy is called continuous process. The changes take place due to changes in the supply of sources and demand for goods and services. Changes in the supply of sources take place due to increase in population, productivity and capital. Changes in demand occur due to changes in the size of population, habits and tastes of consumers and change in income level. These changes can be divided into two parts.

2. Increase in National Real Income - Another reason of economic development is an increase in the national real income. Real national income implies increase in the net value of goods and services during a particular period in a country. For example, monetary value of national income can increase due to inflation. It will not be called increase in real income. But there should be continuous increase in the production

of goods. For example, in India, national income is continuously increasing due to inflation, but this is an artificial increase. It cannot be called real development.

3. Increase in Per Capita Income- There should be a simultaneous increase in per capita income with an increase in the real national income. It means that with an increase in real national income, or population shows a rising trend with no increase in per capita income, or increase in per capita income is disproportionate.

4. Long Term Increase- Another important characteristic of economic development is the continuous increase in the real national income as well as per capita income. If the increase is time being or temporary, it will not be called economic development. For example, if there are good harvests in a particular year or prices of commodities rise due to war and later on the increase goes down, this will not be characterised as a state of economic development. Therefore, economic development must be continuous of long term tendency.

5. High Standard of living and Increase in Economic Welfare- With an increase in national and per capita income, the standard of living of the masses becomes high. If a large part of increase goes to a few persons and there is no improvement in the economic condition of a common man, it will not be called economic development. For example, after Independence, in India national income has highly increased, but only a few persons have got the benefit. Thus the gap between the rich and the poor is going to be widened. There has been no improvement in the standard of living of the common man. Therefore, high standard of living of the common man is a necessary condition for economic development.

Thus, it is clear from the above discussion that there is an increase in national and per capita income. This is a long term increase. Further, it increases economic welfare. In the words of Mayor and ? ouding, "Economic development leads to an increase in real national income and it depends upon all the changes occurring therein.

Q.95. What do you mean by economic development? Discuss the factors affecting economic development.

Or

(a) Explain the factors affecting economic growth.

(b) Explain the non-economic factors affecting growth.

Or

What are the determinants of economic development of a nation?

MEANING OF ECONOMIC DEVELOPMENT OR ECONOMIC GROWTH

Economic development or growth is a constant process by which a nation marches towards development by making maximum and efficient utilisation of human and natural resources and increases national and per capita income. The standard of living rises and social welfare increases.

Thus-

- (1) Economic development is a constant process.
- (2) National income and per capita income increases therein.
- (3) Standard of living of the masses rises. Social welfare increases.

Factors Affecting Economic Development

Different authors have described the various factors affecting economic development in various ways. For an easy way of study, these factors can be divided in two ways-

- (i) Economic factors
- (ii) Non-Economic factors

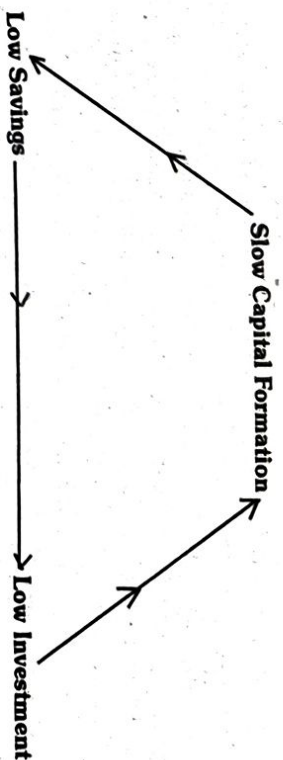
(I) ECONOMIC FACTORS

Economic factors affecting economic development are as follows-

1. Natural Resources- Natural resources affect economic development of a country to a large extent. There is a rapid economic growth in a country whose natural resources like forests, minerals, water, land and favourable climate are found in plenty as these are the basic requirements for the development of agriculture, industry and trade. At the same time human power must be efficient.

2. Man-Power- This is another important factor affecting economic development of a country. Adequate man power must be available for proper utilisation of natural resources. Population of a country must consist of working class of efficient labour.

3. Capital Formation- The rate of capital formation and investments also affect economic development of a country. The larger the rate of capital formation and investment, the rapid is the economic growth, because industrial progress depends upon capital formation. The rate of capital formation is comparatively slow in India and so is the rate of investments. That is why there is no rapid economic growth in the country. Capital is required for industrialisation, modernisation of agriculture, transportation and commercial services. Therefore, capital formation should be high in the country.



4. Technical Know-how- The present is the scientific age. Today, a nation can make progress only when it is equipped with technical knowledge. Technical know-how is must for rapid industrialisation and modernisation of agriculture. Developed countries make rapid progress due to technical knowledge. On the other hand, under-developed and undeveloped countries remain backward due to lack of technical knowledge which is essential for mobilisation of natural resources.

Technical knowledge does not only help in increasing production but it brings about standard in quality. Thus this factor influences economic development of a country to a greater extent.

5. Entrepreneurship and Promotion Efficiency- Enterprising capability is also necessary for proper exploitation and utilisation of available resources. Industrialists and their activities influence the economic development of a country. There is rapid economic growth in a country where industrialists adopt latest and modern methods of production.

6. State Economic policy- Economic policy of the state affects economic development of a country. There is rapid growth in a country where the government encourages investments and starts new industries. A country is industrialised where both the countrymen and foreign industrialists play their role in public and private sector. On the other hand, if the state policy is negative, capital will be invested outside the country.

(II) Non-Economic Factors

Non-economic factors also affect economic development of a country. They are as under-

1. Social environment- Social environment has a great influence on the economic development of a country. There is rapid economic growth in a country where there is peace, safety and security. There should be no class conflict in the country. The inhabitants must come forward with zeal and vigour for the economic development of the country. The country cannot make progress if social environment is not satisfactory.

2. Political Stability- Political stability also affects economic progress of a country. The country will make economic progress provided there is internal peace. In the absence of political stability, investment will

be low and new industries will not be started. Therefore, industrialisation will suffer.

3. Religion—Religious factors also affect economic development of a country. The economic growth is retarded in a country citizens of which follow traditional and old customary ceremonies. For example, Indians are spiritual and do not follow modern techniques.

4. International Environment—Economic development of a country depends on international environment in general, and international aid in particular. Modern tools and machinery can be imported from foreign countries. Manufactured goods and raw materials are also imported and exported on favourable terms. Due to improved means of transport and communication, foreign countries are connected with each other. Therefore, international trade relations and agreements have a great bearing on economic development of a country.

Thus, it is clear from the above discussion that economic and non-economic factors affect economic development of a country in several ways. Rapid growth of development is possible in a country having plenty of natural and human resources as also the man-power well equipped with modern technical know-how. At the same time, political stability and favourable social environment also help in rapid growth of development.

Q.96. Discuss the factors inhibiting economic development.

Each nation wants to make economic progress in modern age. But there are a number of hurdles in the path of economic development of an under-developed country. These are economic, social, administrative and political. Some of the problems are as under—

(1) Absence of Basic Facilities—There are no basic facilities like transportation, power resources, finances and organised market in under-developed countries. That is why there is slow economic development. For example, in India, even after 50 years of Independence, transport, finance and power resources are not satisfactory. Economic development is therefore, not fast in this country.

(2) Lack of Financial Resources—Finance is an essential element of economic development. National and per capita income of an under-developed country is very low. Therefore, savings are very low. Capital formation and investments are low. This causes slow development of industries. Foreign aid is not available in time on reasonable conditions.

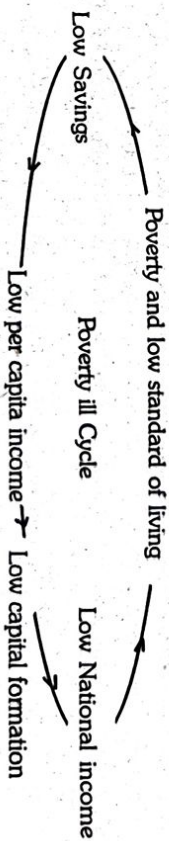
(3) Obsolete Methods of Production—In under-developed countries, methods of production in agriculture and industry are old fashioned. Modern techniques of production are used very late. Consequently, the quality of products is low and cost of production is high. There countries cannot compete in the field of foreign trade. The countrymen like to consume foreign articles.

(4) Limited Market—The purchasing power of under-developed countries is limited. Therefore, they have limited markets. There is no market for new commodities. The pace of economic development is slow.

(5) Lack of Adequate Structure—The next handicap in economic development is lack of adequate transport facilities. Goods cannot be sold without adequate means of transport.

(6) Incomplete Market—Incomplete market means stability of resources, in elastic economic infrastructure and monopoly which are responsible for inefficiency in production nor proper exploitation of resources is possible.

(7) Trade Cycle of Poverty—According to Nurkse, "A country is poor because it is poor." It means if countrymen are poor, savings are very low due to which investments are low. Therefore, economic development is not possible due to lack of investments. Thus ill poverty cycle rotates.



(8) Lack of Modern Enterprise and Management—According to Prof. Schumpeter, "Able enterprise and management is a great drawback in economic development." The reason is that here is lack of favourable economic and social environment, whereas in modern times efficient management is essential.

(9) Modern Technique—Little use of modern technique is another drawback of economic development. The reason is lack of knowledge and conservatism. Therefore, productivity in agriculture and industry is low. Mineral resources are not fully exploited.

(10) Labour and Management—There is no shortage of labour in under developed countries, but human labour is uneducated and unskilled. There is also lack of efficient managers in these countries, with the result that there is absence of industrial environment. Industrial unrest also exists in these countries which affect production adversely.

(11) Political Drawbacks—Generally, instability in politics prevails in the country and terrorism exists to a great extent, with the result that industrial and trade environment is not favourable. Unpractical policies are adopted to eradicate poverty and remove economic irregularities. Fear of nationalisation rules over private companies. A number of restrictive trade policies are levied against them.

(12) International Circumstances- These are also responsible to retard growth of economic development. Under-developed countries depend upon foreign countries in several ways, eg., tools and implements and latest technology. The foreign countries dictate their own terms. Sometimes, foreign countries create political disturbances for the sake of domination.

(13) Imbalanced Economic Set up- Economic structure usually remains unbalanced in under-developed countries. Consumer goods industries are in plenty whereas engineering industries are few. Progress is made only in a few regions whereas other regions remain undeveloped. Thus there is regional imbalance.

(14) Problem of Population- Population problem exists in under-developed countries and with the increase in population, several other problems arise which adversely affect economic development. For example, a large part of population is uneducated and inactive. Thus, it is a burden on economy. Industrial progress is lagging behind due to fast increasing population in India. Economic plans fail due to rising growth of population.

(15) Social Environment- Sometimes social circumstances are also drawbacks in economic development of under-developed countries. Social structure is in a backward state in these countries. The society is divided into castes and religions. People are conservative and follow old traditions and customs. Usually citizens of backward countries are not anxious to undergo new developments. Generally, people take up hereditary professions and hesitate to adopt new and modern professions. Thus social structure is a drawback in the path of economic development of under-developed countries.

(16) Lack of Able Entrepreneurs- In under-developed countries, there is lack of able and efficient entrepreneurs. The industrialists hesitate to take risk in starting new industries, with the result that large scale and key industries are not given any importance. Old techniques of production are in vogue. Natural and human resources are not properly utilised, with the result that the country does not march towards economic development. Sometimes foreigners start new industries and take away earned profits with them.

Thus, it is clear from the above discussion that there are several economic, social and political drawbacks in the path of economic development of under-developed countries. Although, efforts are made to remove the hurdles, success is obtained only to a limited extent.

SHORT ANSWER TYPE QUESTIONS

Q.97. Discuss the importance and disadvantages of economic development.

IMPORTANCE OF ECONOMIC DEVELOPMENT

On the basis of satisfaction of human wants, the importance of economic development is as follows :

(1) Increase in Capital formation and Investments- With the increase in production, national and per capita income, we can increase savings which help in the increased capital formation and investments. According to A.K. Das Gupta, "If we start the system of increasing per capita income, there will be more than proportionate increase in capital formation."

(2) New Industries- New industries are started due to economic development. Due to profit earning the rate of investment and capital formation is increased. Thus mobility of capital increases. It helps to increase capital formation in future. It is because the main object of economic development is to increase capital reserve including knowledge and capabilities."

(3) Broad Field of Selection- Economic development helps to widen the field of selection. New industries provide opportunity to the public to work in new fields. It helps in the selection of field which becomes wider.

(4) Less Dependence on Agriculture- 10% of the population of developed countries and 70% population of under-developed countries depend upon agriculture. Economic development helps to reduce dependence on agriculture. Thus a large part of population can be engaged in other fields of activities. They can produce more commodities and render more services.

(5) Exploitation of Natural Resources- Due to economic development, efficient and economic exploitation of natural resources becomes possible. It results in increased production at a lower cost. Small scale industries also develop due to the availability of raw material at low rates.

(6) Social Services- With economic development, social activities like education, health and recreation expand. It lowers down the death rate and increases average age.

(7) Natural Calamities- Formerly, a human being had to face a lot of difficulties in order to earn livelihood. Natural calamities were the main hurdles. Now with economic developments he has got victory to overcome difficulties in meeting natural calamities. He can get food stuffs with minimum labour.

(8) **Adequate Social Security**— In the absence of adequate means in the country, social competition and conflicts remain in existence. A section of society finds it unable to get articles of necessity. The Government gives more attention to arrange more means, increase of per capita income and supply of articles of necessity in sufficient quantity. Social sector can be developed by means of economic development.

(9) **Freedom**— The people have now become more free in their work than before due to economic development. In undeveloped countries, women lead a life of slavery. They are confined within the four walls of the house and they are compelled to perform all types of household duties. Whereas in other developed countries, they are more free. Complicated tasks have been made simple with the advent of modern machinery. Both the male and female workers have been able to work efficiently according to their capacity to work.

(10) **Social Peace**— Army power depends upon industrial peace and social peace can be maintained more effectively.

(11) **Agriculture by Modern Methods**— With economic development, modern methods of operation can be adopted in agriculture. Infertile land can be brought under cultivation with the help of modern tools and implements and production per acre can be increased. Pressure of increasing population can be reduced.

(12) **Savings**— After satisfying human wants, people can save for a rainy day and help the poor class.

(13) **Efficiency**— A worker gets work according to his choice with the result that he works with more interest. This increases his efficiency and production of the country.

(14) **Industrialisation**— With economic development, there is an increase in the pace of industrialisation. Income of the masses increases and taxation capacity also increases. The government spends more on economic welfare with the help of collected funds from the public.

(15) **Employment**— A large number of new industries are started or old ones are expanded. This factor helps to solve unemployment problem.

Q.98. Discuss the defects of economic growth.

DEFECTS OF ECONOMIC DEVELOPMENT

Though economic development is must but it has some adverse impacts. Some evils of economic development are as follows —

(1) **Uninteresting**— A man has to work like a machine. He repeats the same work. After some time, he loses interest.

(2) **Materialism**— Economic development is fast in nations where the public tries to raise income or reduce cost of production in order to earn

more. Efforts are made to bring economy in production. It gives rise to materialism. Other classes are exploited to increase income.

(3) **Localisation of Industries and Pollution**— Due to economic development, industries tend to localise and with it several problems occur like pollution, dirty houses and shortage of houses.

The labourer becomes the servant of machines.

(4) **Small Scale and Cottage Industries**— Small scale and cottage industries face downfall due to development of large scale industries. The products of latter industries are cheaper than the former types of industries. Moreover, they cannot face competition with large scale industries.

(5) **Capitalistic Trend**— The capitalists exploit the public with centralised power and wealth in their hands.

(6) **Infidelity**— The power of arguments and logic increases among the masses which leads to infidelity.

(7) **Conflict between Capital and Labour**— Capitalists pay less wages to workers and thereby exploit them. Disputes sometimes result in strikes and lockouts. Economic and social peace is disturbed.

(8) **Personal Tastes Overlooked**— Cheap goods are supplied to the public in large scale production. Personal tastes and choice are given no attention.

(9) **Monopoly**— Due to large scale production, monopoly develops in several areas. It leads to exploitation and concentration of wealth.

(10) **End of Large Families**— Due to economic development, population of cities increases. People migrate from rural areas to cities wherefrom it is difficult to migrate to villages. They do not care for their home town because they establish with families in cities.

(11) **Atmosphere**— Industries tend to localise with the pace of economic development. Workers work in a large number. It creates housing problem. Pollution spreads, slums are developed, diseases spread. These have an adverse effect on the mind and physical health.

VERY SHORT ANSWER TYPE QUESTIONS

Q.99. Distinguish between Economic Development and Economic Growth.

Generally, there is no difference between economic development and economic growth. Both are synonyms. But a minute observation reveals the following differences —

(1) **Use**— The word economic growth is used for developed countries whereas the word economic development is used for under-developed countries.

- (2) **Process**—Economic growth is a common process, whereas economic development is a process based upon planned and new techniques.
- (3) **Production**—Economic growth takes only more production, whereas in economic development, besides more production, are technical progress and social welfare.
- (4) **Efforts**—Developed countries do not make special efforts for economic growth. It goes on itself. Whereas, under-developed countries strive for economic development.
- (5) **Stage**—Economic growth is the highest stage of progress, whereas economic development is the middle stage of highest and lowest level of progress. It can be seen from the following diagram.

Q.100. Mention characteristics of economic development.

CHARACTERISTICS OF ECONOMIC DEVELOPMENT

- (1) Economic development is a continuous process.
- (2) Real national income increases in economic development.
- (3) An increase in per capita income.
- (4) This increase is constant during a long period.
- (5) There is uplift in standard of living and economic welfare.

ECONOMIC DEVELOPMENT AND ECONOMIC GROWTH : O.T.Q.

Choose Correct Option -

1. **Economic development and Economic growth-**
 - (a) Same
 - (b) Minor Different
 - (c) Separate
 - (d) Synonym
2. **Feature of Economic development is/are-**
 - (a) Increase in National Income
 - (b) Increase in per capita income
 - (c) Increase in living standard
 - (d) All of above
3. **Factors affecting economic development-**
 - (a) Economic factors
 - (b) Social factors
 - (c) Political factors
 - (d) All of above
4. **Non-economic factor affecting economic development-**
 - (a) Capital Formation
 - (b) Technological knowledge
 - (c) Political Stability
 - (d) National resources

Ans. (1) b (2) d (3) d (4) c.

CLASSICAL AND MODERN THEORIES OF ECONOMIC DEVELOPMENT

■ Long Answer Type Question

Q.101. Critically examine Adam's Theory of Economic Growth.

Or

Discuss the main features of Economic Theory of Adam Smith..

ADAM SMITH'S THEORY OF ECONOMIC GROWTH

Adam Smith is called the Father of Economics. He has thrown sufficient light on the problem of development in his book on "Various Forms of Properties and Causes of their Enquiries of Nations." Although he has propounded no particular theory of economic development but presented his scattered economic thoughts of that time in a chronological and scientific manner.

According to Adam Smith, economic development of a country must be measured according to the increase in national and per capita income.

MAIN FEATURES OF ADAM SMITH'S THEORY OF GROWTH

(1) **Division of Labour**—The starting point of Adam Smith's Theory of Economic growth is the division of labour. According to Adam Smith, economic development of a country depends upon the quantity of production. Division of labour increases the efficiency of labour which increases quantity of production and improves the quality of product. There is saving of time in production. Inventions and new researches are made with the result that production increases. Division of labour widens the scope of market. It helps in broadening the inland and foreign market. This helps in economic development of the country.

(2) **Determination of Priorities**—Priorities of development are determined for economic development. There are two grounds of economic development agriculture and industry. According to Adam Smith, economic development must be commenced with the development of agriculture and cottage industries. Therefore, attention should be given towards

industrialisation. He has given the following arguments in this respect: (a) If the farmers are engaged in industries instantly, they will not give as much production as they gave in agriculture.

(b) If development is started with industrial development, buyers will not be available for industrial goods.

Thus, being a conservative follower of industrialisation, Adam Smith gave preference to agriculture for economic development so that it may be the foundation for industrial growth.

(3) **Human Resources**—Labour is the most important and active factor of production. Therefore, Adam Smith has called the labour "Ambassador of development." According to Smith, human resources play an important role in economic development of a country. Agriculturists, industrialists and traders are the important elements of economic progress. But, at the same time, he has laid a check on inefficient labour force.

(4) **Free Trade Policy**—Adam Smith laid emphasis on free trade policy. He said trade goes on smoothly without state intervention. The state should not interfere in free economic development of the country so that economic progress is made continuously. Freedom should be given to each individual in order to face competition. He shall make economic progress and in turn the country will make economic progress.

(5) **Process of Development**—Process of development must be continuous. There is rapid growth of capital formation if the demand for goods and services is incessant. It gives rise to division of labour and the level of production goes up. The market is widened and real income is increased. It leads to capital growth and ultimately to economic growth.

(6) **Labour-Price** Theory—Adam Smith says price of a commodity is equal to labour. He is in favour of the law of demand and supply and wage fund theory which determine wages. Thus there is contradiction in labour price and wages in his views.

(7) **Rent, Profit and Interest**—Adam Smith says rent is the monopoly income of landlord. According to him profit and wages are opposite to each other. Profits should increase for development. The rate of interest should be low for development. It is because there is development with reduction in interest. Profits are increased.

MERITS OF THEORY OF ADAM SMITH

(1) **Free Trade Policy**—Adam Smith has laid emphasis on free trade policy for economic development. No restrictions are thereby imposed on industrial and trade development. It encourages standard and quality.

(2) **Capital Formation**—The theory has given importance to capital formation. In fact, capital formation is the basis of economic development.

(3) **Priority**—Adam Smith has given priority to development of agriculture and cottage industries over industrial development. This priority is essential in the sense that industrial development cannot take place without the development of agriculture and cottage industries as these are the suppliers of raw material for industries.

(4) **Balanced Development**—The Theory lays emphasis on balanced development. A slow, balanced development is better than a fast imbalanced development.

(5) **Economy**—Adam Smith has laid emphasis on economy for raising savings and capital formation. It is all the more necessary for underdeveloped countries.

(6) **Division of Labour**—Division of labour is given much importance in the theory. It is correct to say that division of labour is an essential element to increase production.

CRITICISM OF ADAM SMITH'S THEORY OF GROWTH

(1) **State Overlooked**—The theory has ignored the importance of state whereas balanced economic development is not possible without state intervention and help.

(2) **Non-interference Policy is Wrong**—Adam Smith has advocated a free trade and noninterference policy for economic development. This policy is not fit in present day economy. Underdeveloped countries cannot stand in competition with developed countries in free trade policy. Thus they will remain backward.

(3) **Trade Cycles ignored**—No attention has been given in the theory about trade cycles. A theory which does not take causes and their solutions of trade cycles into consideration has no utility in economics.

(4) **All classes are not benefited**—According to the theory, only well-to-do and rich class of persons get benefit. No attention has been given towards the progress of poor and middle class of persons. These classes of persons cannot make any progress in the absence of state intervention as also in free trade policy.

(5) **Ignorance of Enterprise**—No importance to enterprise has been given in the theory, whereas an entrepreneur occupies an important position in economy.

(6) **Pessimistic View**—Adam Smith's view was pessimistic. He was afraid of immobilised economy. He feared that when resources will be fully utilised, development will be stagnant and law of diminishing returns will apply and the economy will be in destitute.

Q.102. Critically examine Ricardo's Theory of Economic Growth. Or Point out the main features of Ricardian Theory of Economic Growth.

RICARDIAN THEORY OF ECONOMIC GROWTH

There were several drawbacks in the Adam Smith's Theory of Growth. Ricardo tried to remove the drawbacks of Adam Smith's Theory. A discussion of Ricardian Theory of Growth is as under-

(1) Population Growth and Economic Development.

According to Ricardo, with the economic development demand for labour increases and its supply decreases. Consequently, wages increase. With increased wages, population rises. On the other hand, food supply does not increase in the same proportion. Profits of capitalists decrease. Capitalists do not seem interested to increase production due to low profits. The result is bottleneck of economic development.

(2) Law of Diminishing Returns-According to Ricardo, with the constant use of factors of production, law of diminishing returns operates. The fertility of the soil diminishes and efficiency of labour decreases. Wages are just equal to or sufficient to meet the two ends. Profits also decrease. Capital formation is stagnant. Under such circumstances, economic development is stopped.

(3) Capital Formation-Ricardo lays emphasis on capital formation for economic development. Capital growth comes out of savings and economy is essential to increase savings. Capitalists effect economy in the utility of different factors of production and increase capital growth. They think profit is the main source of capital. Large profits are required for capital formation. Wages should be reduced to a level sufficient for livelihood. With the reduction in wages, profits will increase. The capitalists will invest more and increase production. This will result in more economic development.

Thus, Ricardo's views in respect of economic development are as follows-

- (a) Capital formation is essential for economic development. To achieve this object, wages should be decreased and profits should be increased.
- (b) Capitalist helps the country in economic development ;
- (c) Free trade and non interference policy should be adopted.
- (d) Taxation must be minimum so as to increase production and consumption. **Advantages of Ricardian Theory of Economic Development**

MERITS OF RICARDIAN THEORY OF ECONOMIC DEVELOPMENT

- (1) **Importance of Agriculture**- Ricardo has given importance to agriculture. He has suggested tax free rent.
- (2) **Free Foreign Trade**- He has advocated free foreign trade so that cheap and quality products may be available for consumption.
- (3) **Savings**- Ricardo has laid emphasis on increased savings for capital growth.
- (4) **Check on the Growth of Population**- Ricardo says a check on the rising population is necessary for economic development.
- (5) **Importance of Profits and Capital Reserves**- Ricardo has suggested to increase profits and make huge capital reserves.

CRITICISMS OF RICARDO'S THEORY OF ECONOMIC DEVELOPMENT

- (1) **Pessimistic view**- Ricardo was much worried about the growing population and low production.
 - (2) **Ignorance of labour and Technique**- Ricardo overlooked the importance of labour and technique whereas both play an important role in economic development of a country.
 - (3) **More Emphasis on Profits**- Ricardo has given more emphasis on profits whereas profits are not the index numbers of economic growth.
 - (4) **Free Trade Policy is impractical**- In modern age, free trade policy is not beneficial for economic advancement of a country.
 - (5) **Exploitation of labour**- Ricardo proposed low wages. This view ignores the labour class and exploits the workers.
 - (6) **Rigidity**-In fact, Ricardo's theory of economic growth is not a theory of economic development. It is a rule of rigidity. He has assumed economy without development.
 - (7) **Law of Diminishing Returns**- His fear of law of diminishing returns has proved a failure. Modern technique of agriculture has enabled increase in production.
- Thus, it is clear that Ricardo has presented no constructive thought, but only a pessimistic view.

SHORT ANSWER TYPE QUESTIONS

Q.103. Point out the main features of Schumpeterian theory of economic growth.

Or

Critically examine the Schumpeterian Theory of economic growth.

Schumpeter has thrown light on economic growth in his book entitled 'Principles of Economic Growth.' The main elements of his theory are as follows-

(1) Economic development is due to uncoordinated ups and downs- According to Schumpeter, economic growth is not a regular and uniform process but it is due to exploitation of modern investment sectors. New entrepreneurs in large numbers are active in economic development. A key structure is formed by entrepreneurs by investments in various sectors. Transport, communication, banks, electricity and the like facilities expand. The society gets products.

(2) New Promotions- New promoters help in economic development. Schumpeter has given the following forms of promotion.

- (i) To bring new product in trade.
- (ii) To adopt new techniques of production.
- (iii) To discover new sources of raw material.
- (iv) To bring about improvement in the organisation and management of industries.

(3) Importance of Entrepreneur- Entrepreneur is the most important rather central point of economic development. A promoter conceives of size, organisation and production and then collects and coordinates factors of production. He takes the help of technicians. He makes inventions of new techniques. Thus, as a captain of the ship he manages and directs the tools of economy.

(4) Foundation of Banking Development-Capital is necessary for development. A promoter takes loans from banks. He does not possess sufficient funds with him to meet the whole financial requirements. Therefore, banks must be developed in large numbers. Bank credit creates new purchasing power. It helps mobilisation in economy.

(5) Process of Development- According to Schumpeter, changes take place in a circle. The situation changes. In the beginning, economy remains fixed. Later on, new entrepreneurs invest funds to increase production and they earn profits. With the attainment of success, they repeat the process. When supply falls short, prices rise. With the rise in price, economic activities expand. Consequently, new enterprises come into existence, production increases so also supply increases. But there is no proportionate increase in demand with the result that depression starts. Thus economy rotates within the circle of *teji and mandi*.

CRITICISM OF SCHUMPETER'S THEORY OF ECONOMIC GROWTH

(1) Incomplete description of new promotion- The description of new promotions given by Schumpeter is incomplete. He has failed to note the reasons of irregularities in economy.

(2) Unnecessary emphasis on new enterprises- Schumpeter has given undue emphasis on new enterprises for development. New enterprises

alone do not help economic development, but by collective efforts of the society.

(3) Bank Credit is short term- For financial requirements, bank loans have been given emphasis. Bank loans are generally short term loans, whereas long term finances are required for industries.

(4) Undue importance of Promoter- Schumpeter has given more importance to entrepreneur in his theory than what is necessary. He has given no importance to other factors of production.

(5) Trade Cycles- No relationship between economic development and trade cycles is seen in the theory.

Q.104. Critically examine the growth model of Karl Marx.

Or

Discuss the main points of the Marxian Theory of Economic Development.

Karl Marx was an eminent author of economic development. He occupies an important place in economic development. He wrote a famous book "Das capital" in which he has analysed economic thoughts. His views about economic development are as follows-

MAIN POINTS OF MARXIAN THEORY OF ECONOMIC GROWTH

(1) Materialistic description of History- Marx has given materialistic description of human history. He studied history of main countries of the world and derived a conclusion that the foundation of human development is economic. Economic factors create moral, economic, social and political consciousness among the masses.

(2) Rule of Additional Value-Marx's theory of growth is based on theory of growth of additional income. Population is divided into two parts in capitalistic economy - capitalist and labour. The worker is not paid full wages by the capitalist for the work done by him for example, if a worker works for eight hours, the capitalist pays for six hours. The production of two hours is the saving of capitalist. Thus the capitalist earns profit by paying less wages.

(3) Downfall of capitalism- The destruction of capitalism is due to its rules. Big capitalists save more and make greater use of modern plants and machinery. They enter into cut throat competition with small capitalists and exploit them. As the saying goes a big fish swallows small ones. The big capitalists drive out small capitalists and compel them to act as workers. A stage comes when man power is organised and there is a downfall of capitalism.

(4) **Cyclic Changes**— The main element of Marx's theory of growth is cyclical changes. There are three reasons for this :

- (i) Lower rate of profit
- (ii) Overproduction
- (iii) Less consumption.

Rapid changes take place in economic activities due to cyclic changes. With an increase in investments, short term full employment takes place. This leads to increase in wages. Profits become low and economic distress occurs.

(5) **Stages of Development**— Marx has given the following stages of development—

- (i) **Primitive Stage**— There is no class of persons in it.
- (ii) **Slavery Stage**— Agricultural activities are done by slaves.
- (iii) **Feudatory Stage**— Workers are employed on wages in this stage.
- (iv) **Capitalism**— Capitalists earn profits by exploitation of workers.
- (v) **Imperialism**— The highest stage of capitalism is found in imperialism. Rich countries exploit the poor countries.
- (vi) **Socialism**— All the resources of production of the country are within state control.
- (vii) **Bolshevism**— Labour is the main factor. There is no need of state administration. It is also called a stage of equilibrium.

CRITICISMS OF THE THEORY OF MARXISM

- (1) **Wrong Assumption**— Marx's assumption that equilibrium commences after capitalism is not correct.
- (2) **Labour Disputes**— Labour disputes are common not only in capitalism but also in socialism.
- (3) **Population Problem**— According to Marx, the problem of population is the problem of capitalist countries, whereas this is the main problem of socialist and developing countries.
- (4) **No destruction of capitalism**— Marx's forecast that capitalism will come to an end one day in the world, proved failure. Capitalism, on the other hand, is expanding.
- (5) **Undue importance to Labour**— Marx has given too much importance to labour. Whereas the contribution of capital and enterprise is not less.
- (6) **Condition of Labour is not Pitiable**— According to Marx, the condition of workers becomes pitiable in capitalism. It is not correct to say.

VERY SHORT ANSWER TYPE QUESTIONS

Q.105. Mention main elements of Adam Smith's development theory.

The main elements of Adam Smith's Theory of Growth are as follows—

- (1) The basis of development is division of labour.
- (2) Agriculturists, capitalists and manufacturers undertake productive activities.
- (3) Agriculture is given priority for balanced development.
- (4) Free Trade Policy and non interference are necessary for development.
- (5) The process of development should be continuous.
- (6) The rate of interest must be low so that investments may increase.
- (7) Low wages and high profits lead to capital formation and economic development.

Q.106. Give any five names of economic development theory.

Various economics propounded different theories of economic development, some famous theories are —

- (1) Adamsmith's theory of economic development.
- (2) Ricardian theory of economic development.
- (3) Keynes's theory of economic development.
- (4) Marxist theory of economic development.
- (5) Schumpere theory of growth.

CLASSICAL AND MODERN ECONOMIC DEVELOPMENT : O.T.Q.

Choose Correct Option -

1. Adam Smith's development theory is -
 - (a) Traditional
 - (a) Modern
 - (a) Classical
 - (a) Conservative
2. Base of Marxian theory of development is -
 - (a) Capitalism
 - (a) Communism
 - (a) Socialism
 - (a) Democratic
3. Keynesian theory of development is -
 - (a) Classical
 - (a) Modern
 - (a) Based on full employment
 - (a) None of above

Ans. (1) b (2) c (3) c.



"Just as by one single jump, destination cannot be reached, similarly the object of economic development cannot be achieved by a single manoeuvre, but the development has to pass through several stages of progress."

17

ROSTOW'S STAGES OF ECONOMIC GROWTH

■ Long Answer Type Question

Q.107. What are the various stages of economic growth according to Prof. Rostow ?

Or

What is a take off stage ? What are the pre conditions to achieve the take off stage ? Has India achieved this stage ?

ROSTOW'S STAGES OF ECONOMIC GROWTH OR DEVELOPMENT

A nation cannot reach in an instant at the highest level of growth. It has to pass through several stages of development. These stages are called the stages of economic growth. Different authors have classified these stages of growth in different ways. Rostow's views are scientific and logic in this respect. According to this American economist, the following are the five stages of economic growth or Economic Development.

1. Hereditary society (Traditional Society)
2. Pre-condition to take off
3. Self Sufficient Stage (Take off)
4. Stage of Maturity
5. High standard of consumption

1. STAGE OF TRADITIONAL SOCIETY

According to Rostow, the first stage of economic growth is the stage of traditional society. He has called this stage as the stage before Newton because with Newton scientific inventions had commenced. Scientific researches were started in the field of agriculture and industry. The following are the elements of a traditional stage of society-

- (i) Predominance of agriculture. Old methods are used in agricultural operations.

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- (ii) The number of industries is few,
 - (iii) Backward means of transport and communication.
 - (iv) Scientific methods are not used in production.
 - (v) Social environment is in a backward stage. Landlords dominate.
 - (vi) The future of the persons depends upon the stages and professions of their ancestors.
- This stage is called a pre-scientific stage. \

2. STAGE OF PRE-CONDITION TO TAKE OFF

This is the second stage of economic growth. This is a stage between traditional society of stage and take off stage. Environments for development in this stage are favourable. The important characteristics of this stage are as follows-

- (i) The various factors of production are collected for take off stage and technical knowledge is developed.
- (ii) Facilities pertaining to banks, insurance and transportation are developed.
- (iii) Industrial development is given preference to agriculture. The burden of population on agriculture is reduced.
- (iv) Production on large scale with modern methods is carried out.
- (v) Political supremacy of landlords is reduced.

Thus, these are the preparations to reach the take off stage, on the basis of which a nation feels the necessity of economic growth.

3. TAKE OFF STAGE

This is the most important stage of economic growth. This is also called a self - fly stage. A normal and popular environment is created for economic growth in this stage. The following are its chief characteristics-

- (i) The rate of investment is increased. Per capita productivity is also increased.
 - (ii) Improved changes take place in production. Modern techniques and methods are used in production.
 - (iii) New and key industries are developed.
 - (iv) The burden of population on agriculture is reduced.
 - (v) Large scale production is seen in agriculture and industry. Consequently, there is a stage of take off.
 - (vi) Foreign aid is not required for economic growth.
 - (vii) Changes take place in the nature of imports and exports.
- Thus there is regular development of agriculture and industry and take offstage ushers in.

4. STAGE OF DRIVE TO MATURITY

There is continuous national economic growth in this stage. The following are the characteristics of this stage-

- (i) The form of industrial development is changed. Use of modern techniques of production is a common feature.
- (ii) The rate of investment and savings is increased. 10% to 20% of national income is invested.
- (iii) The rate of increase in production is higher than the growth rate of population.
- (iv) The dignity of a nation becomes superior in the international field.
- (v) Exports exceed imports.
- (vi) There is full utilisation of resources by modern techniques.

5. STAGE OF HIGH MASS CONSUMPTION

Economic growth is at its highest level in this stage. The main characteristics of this stage are-

- (i) More emphasis is given on consumption because there is no shortage of production.
- (ii) People consume luxurious goods like articles of necessity.
- (iii) The economy becomes perfectly modern. Industrial development reaches its highest level.

CRITICISM OF ROSTOW'S THEORY OF ECONOMIC GROWTH

A large number of economists have agreed with the views of Rostow in respect of stages of economic growth. But there are certain limitations in the theory. A few criticisms are given as under-

1. Adoption of Serial Order not necessary. It is not necessary for a country to follow each stage in serial order. A country can cross one stage and reach in another stage. For example, due to a rise in price of oil, Asiate-countries have reached unexpectedly in a stage of high mass consumption.

2. Incomplete Basis. Rostow's views in respect of the rate of investment are not logical. An increase in the rate of investment alone cannot allow to reach stage of take off. A check on the growth of population is also necessary.

3. Agricultural economics neglected. Several predominant agricultural countries are in a stage of take off and maturity. Economic growth is possible even without industrialisation.

4. Other factors neglected. Besides economic factors, cultural, social and geographical factors also affect economic growth.

Rostow's views in respect of economic growth are one sided. Economic growth is not possible by industrial development alone. There should be an increase in national and per capita income as well. At the same time, there should be no unequal distribution of wealth.

6. Time limit incorrect. Division of stages of economic growth on the basis of time is incorrect from practical point of view.

Thus, there are certain drawbacks in Rostow's theory of economic growth. However, he has given scientific view in respect of stages of economic growth. These stages enable us to know the economic condition of a nation.

Q.108. Describe the main characteristics and essential conditions of the take off stage.

ROSTOW

An American economist, has mentioned five stages of economic growth in his book

"Stages of Economic Growth" and the stage of take off is one of them. This stage is known as the important stage of economic growth. Its description is as follows-

MEANING OF TAKE-OFF STAGE

In simple words, "Take off is a stage in which economy becomes self sufficient and independent for essential commodities without foreign aid."

The rate of investment and savings is increased. New industries are started. New techniques of production are used. New opportunities of exports are discovered. The nature of imports gets changed.

CHARACTERISTICS OF TAKE-OFF STAGE-

(1) Increase in rate of investments. More investments are made in industries in this stage.

(2) Increase in per capita production. With an overall increase in production, per capita productive capacity increases. Proportionate increase in production is more than the increase in population.

(3) Change in Methods of Production. Important changes are made in the methods of production. New techniques are used in production and obsolete ones are replaced. There is a large use of self operating machines.

(4) Development of Key Industries. Key industries like iron and steel, cement, mining and engineering are developed in the country.

(5) Less burden of population on agriculture. With the development of industries, a large number of workers are employed in

industries with the result that a less percentage of population is engaged in agriculture.

(6) **Change in the nature of imports and exports-** A change occurs in the nature of imports and exports. Manufactured articles are exported and machines are imported.

(7) **Less foreign Aid-** Barring a few exceptions, dependence on foreign aid is reduced. Foreign assistance is not sought but foreign investments are encouraged.

(8) **Increase in agricultural production-** Agricultural production is increased with a view to meeting the demand of raw material for industries.

(9) **Increase in employment opportunities-** New employment opportunities are created due to increase in industrial and agricultural development. The problem of unemployment is solved.

(10) **Self-dependent Economy-** Take off stage economy ultimately reaches the goal of self dependence. Essential Conditions for Take off Stage

The following conditions are essential for take off stage-

(1) **Increase in the rate of investment-** A sufficient increase in the rate of investment is essential for take off stage. The rate of investment should be around 10% or more of national income. Proportionate increase in production must be higher than population.

(2) **Adequate increase in Agricultural productivity-** This is another condition essential for take off stage so that sufficient food stuff may be available at cheap rates to the masses and raw material in large quantity to the industries.

(3) **More Exports and less imports-** Foreign exchange is essential for economic growth of a country. For this purpose, exports must exceed imports.

(4) **Development of Key Industries-** Development of key and capital goods industries is also an essential condition for take off stage. In the absence of development of machine industries, no industrial development can be made.

(5) **Transport, Communication and Power-** Industrialisation is necessary for economic growth. Developed means of transport, communication and power lead to industrial growth.

(6) **Promoters-** Enterprising and promising promoters are required for economic development of a country. This class of executives gives a new direction for the country to march on the path of development.

(7) **Social and Political Environment-** Social and economic environment also plays an important role in economic growth. Political stability is essential for material peace.

SHORT ANSWER TYPE QUESTIONS

Q.109. Explain fully the stage of take off as given by Rostow. Has India reached the stage of take off? India and Take off Stage

There is difference of opinion among economists about the stage of India's economic development. Prof. Rostow had accepted that India reached the stage of take off between 1952 and 1962. It has entered the stage of maturity since 1962. The following arguments are given in this respect-

- (1) New industries have started during the plan period.
 - (2) There has been an increase in the rate of investment and capital formation.
 - (3) There has been a vast expansion in post and telegraph services, transport and communication.
 - (4) Development of key industries alongwith traditional industries has taken place. Large scale industries iron and steel, chemicals, ores etc. have been set up.
 - (5) Per capita income and per capita productivity has increased.
 - (6) Dependence on agriculture has gone down. A large part of population has started working in industries.
 - (7) Methods of production have changed. Use of modern machines and tools, new technique of production are now widely used. Specialisation and self operations have become normal features now-a-days.
 - (8) The country has become self-sufficient in respect of several chief products.
 - (9) Agriculture has made progress. Maturity has been achieved in respect of food grains.
 - (10) A change in the nature of exports and imports is noticed. The industrial and petroleum products are the main items of imports whereas consumers goods are exported. Arguments against it
- Although the country has made progress in industrialisation and agriculture, some economists are not in favour to say that the country has reached the take off stage. Their arguments are as under-
- (1) The rate of investment in the country is very low. It should be 10% or more for take off stage but it is only 5% in India.
 - (2) There is slow industrial development in the country whereas the population is rapidly increasing.

- (3) No rise in per capita income is seen. More than 40% of the population lives below the life line.
- (4) There is no diminution in foreign loans. On the other hand, foreign loans and foreign aid is increasing.
- (5) Imports are more than exports. Balance of trade is unfavourable.
- (6) The country is still an agricultural country. Agriculture is comparatively in a backward stage.
- (7) Unemployment is increasing day by day.
- (8) Standard of living of the masses is not rising.
- (9) Social and political environment is backward.
- (10) There is partial modernisation in industries.

Q.110. Discuss the essential conditions for obtaining take off stage.

CONDITIONS NECESSARY FOR TAKE OFF

The following conditions are essential for the take off stage-

1. **Increased Investment Rate-** Adequate increase in the rate of investment is essential for take off stages. It should be 10% or more of the national income. To achieve this target, production should be comparatively higher than the growth of population.
2. **Adequate increase in agricultural production-** There should be adequate increase in production so as to enable the rising population to get foodstuffs in sufficient quantity at cheaper rates and raw material may be available for industries.
3. **More exports and less imports-** Foreign exchange is essential to reach take off stage for economic growth. Therefore, there should be more exports and less imports.
4. **Development of Key Industries-** Development of key and capital goods industries is also essential in a take off stage for economic growth of a nation. Industrialisation is not possible in the absence of such industries.
5. **Development of means of transport and communication-** Industrialisation is essential for rapid economic growth. Industrial development depends upon the means of transport, communication and power. Therefore, their development is essential.
6. **Entrepreneurs-** Efficient and promising entrepreneurs are required in a take off stage for economic growth. This class gives new directives in matters of production.
7. **Social and Political Conditions-** Favourable Social and political conditions are also essential for a take off stage. The awareness and enterprise are essential among the masses for economic

VERY SHORT ANSWER TYPE QUESTIONS

Q.111. Give serial number of Rostow's Stages of economic growth.
Famous American economist Rostow divided the stages of growth in the following 5 categories -

1. Hereditary society (Traditional Society)
2. Pre-condition to take off
3. Self Sufficient Stage (Take off)
4. Stage of Maturity
5. High standard of consumption

ROSTOW'S STAGES OF ECONOMIC GROWTH : O.T.Q.

Choose Correct Option -

- (1) The most important name in the field of stage of economic development -

(a) Marshall	(b) Keynes
(c) Rostow	(d) Carl Marx
- (2) Number of Sale of economic development -

(a) Two	(b) Three
(c) Five	(d) Many
- (3) Serial number of take-off stage is -

(a) Second	(b) Third
(c) Fourth	(d) Fifth
- (4) Analysis of stages of economic development -

(a) Mill	(b) Grass
(c) Rostow	(d) All of above

Ans. (1) c (2) c (3) b (4) d.

"Concept of balanced growth lays emphasis on the growth and development of all sectors whereas unbalanced growth lays emphasis on a few related sectors."

18

STRATEGY OF BALANCED AND UN-BALANCED DEVELOPMENT

■ Long Answer Type Question

Q.112. Explain comparatively the concept of "Balanced Growth" and "Unbalanced Growth" with reference to economic growth or development.

Or

Explain the views of "Balanced Growth" and "Unbalanced Growth" as modern approaches to Economic Growth.

MODERN APPROACHES TO ECONOMIC GROWTH

Different economists have given different views, concepts and theories for economic growth of under-developed or developing nations. A few economists have given emphasis on balanced growth and some on unbalanced growth. Which of the two views will be appropriate for an under-developed nation, it will be decided by a comparative study.

□ APPROACH OF BALANCED GROWTH

Balanced growth implies an overall economic growth or development. This type of growth encompasses balanced development of both agriculture and industry.

Balanced growth has been defined as under - According to Prof. **Loius**, "All the sectors must be developed simultaneously under development programmes so that there may be adequate balance between agriculture, industries and cottage industries as also production relating to exports."

According to Prof. **Ghosh**, "Planned economic development implies development of all sectors of economy in the same proportion so that consumption, investment and income may increase at the same rate."

In simple words, concept of balanced growth can be defined in the following way - Balanced growth implies an around coordinated and balanced development or an overall development of agriculture, industry and regional prosperity is called balanced development.

□ CHARACTERISTICS OF BALANCED GROWTH

1. Attention is given on modernisation of agriculture alongwith industrialisation.
2. Both consumer goods and key industries are established.
3. Both the public and private sectors are important.
4. Industries are started in backward areas also so that they may be developed alongwith cities.
5. There is coordination between large and small scale industries. Cottage industries are also protected.
6. Agriculture is developed in a professional way. Attention is given towards the development of food grains and cash crops.
7. Policy of export and import should be chalked out in such a way as to influence agriculture and industry favourable and consumption may be balanced.
8. Demand and supply are well balanced in balanced growth. Thus attention is given to all regions in balanced growth.

□ APPROACHES OF UNBALANCED GROWTH

Among the critics, Prof. **Hirschman** is the most important economist against balanced growth and he supports unbalanced growth economy. The concept of unbalanced growth is based on this assumption that first of all only a few particular regions of economy should be developed so as to pave the way of development for other regions.

According to Prof. **Singer**, "A good plan of balanced growth will be that the available resources are utilised in the regions which help economy to be more elastic and expand rapidly accentuated by the increasing demand of the market."

According to Prof. **Hirschman**, "Ordinarily, development policy must be such as to maintain unbalanced growth rather than to remove them. Profits and losses are the main elements of unbalanced growth of economy in competition. If economy is to make continuous progress, the main objects of development must be tension, disproportion and unbalanced features."

□ CHARACTERISTICS OF UNBALANCED GROWTH

1. Attention is given to development of a few particular regions.
2. Investments are made only in profitable channels.
3. State intervention is less. Economic independence persists.
4. Private enterprise is predominant.
5. Capital concentrates in a few hands.
6. Urban areas develop rapidly.

7. Unprofitable units are closed down automatically.
8. Industrialisation is aimed at in economy.

Comparison between Balanced and Unplanned Economy

S. No.	Basis of difference	Balanced Economy	Unbalanced Economy
1.	Balanced Economic	Attention towards balanced economic growth of a country growth is given in it. Special attention is given towards backward regions.	In the absence of government control, development is unplanned. It is unbalanced and unarranged.
2.	Utilisation of Resources	Human and natural resources are utilised in a rational way without wastage.	Resources are not utilised in the best manner.
3.	Priorities	Priorities are determined.	No priorities are determined. There is no order of development. People start industries according to their choice. There is no fixed programme of the government.
4.	Objectives	Maximum social welfare is the main object. Rapid and balanced growth is its object so as to provide benefit to each citizen of the country.	No particular object in it. Personal benefit instead of social benefit is its object.
5.	Economic Equality	Efforts are made to set up socialistic pattern of society by removing disparities. Economic welfare of the poor class is aimed at.	No effort is made to fill up the gap between the rich and the poor, poorer.
6.	Scope	The field of development is broad. Programmes of development are prepared keeping in view all the sectors of the country.	There is state control in planned economy.
7.	View	The view of development is broad and long term. Care of future is also taken into consideration.	The view in it is to solve the present problem only. There is no consideration of future activities.

8.	State Intervention	Economic activities are under Inter-state control. Agriculture, industry and trade are governed by the government.	No state control over economic activities. Free trade policy exists in the country.
9.	Coordination	Human and natural resources are utilised on the basis of coordination of production, distribution and consumption.	No attention is paid towards coordination. There is no coordination between different factors of production.
10.	Social Welfare Plans	Social welfare plans are given attention in it like health, safety, sickness, unemployment, education and housing.	No attention is given to these plans. Therefore, social cost of industrialisation is high.
11.	Savings and Investments	Savings are invested for the benefit of the nation. There is Investments direct coordination between savings and investments.	There is no direct coordination between savings and investments.
12.	Efficiency	Maximum technical efficiency is found in it.	It is not found in it.
13.	National Objective	Planned economy aims at achieving national objects	No national object exists in it. Individual objects the target in it.

CONCLUSION-

After a comparative study of both the concepts of growth, it is concluded that the developed nations should adopt a mid way of the two concepts for economic development. In view of balanced growth, profitable and useful regions should be attended to for development.

SHORT ANSWER TYPE QUESTIONS

Q.113. What do you mean by Balance Growth ? Discuss advantages and disadvantages of Balanced growth.

APPROACH OF BALANCED GROWTH

Balanced growth implies an overall economic growth or development. This type of growth encompasses balanced development of both agriculture and industry advantages and disadvantages of Balanced growth has been discussed us under-

ADVANTAGES OR IMPORTANCE OF BALANCED GROWTH

1. **Exhaustive Development.** A plan of balanced development envisages the development of both agriculture and industry. They create demand of products of each other. It helps an overall development.
 2. **Development of backward regions.** Industrialisation in balanced growth is done in such a way that new industries are started in backward regions so that they are economically developed.
 3. **Establishment of different industries.** Both types of consumer goods and key industries are started in balanced growth. It covers various types of industries. It leads to overall development.
 4. **Modernisation of Agriculture.** Attention is also given towards the development and modernisation of agriculture side by side with industrial development so that with the increase in production, income and purchasing power of the farmers may increase. Agricultural products supply raw materials for industries.
 5. **Increase in per capita income.** With an increase in national income, per capita income also increases in balanced growth. The development is primarily socialistic. Therefore, efforts for improvement are made in the condition of poor and middle class of persons.
 6. **Increase in opportunities of Employment.** Balanced growth presupposes the development of urban and rural areas, cities and villages, large scale and small scale industries, transport and communication, poor and rich class of persons. So to say, balanced development gives emphasis on the development of all the regions. It gives rise to employment opportunities.
 7. **End of Poverty.** Both demand and supply are limited in under-developed countries. Poverty exists in these countries. Balanced growth helps to minimise poverty. It gives rise to both demand and supply. Economic activities become more active. Economic condition of the masses improves.
 8. **Balance of Trade.** A large number of various commodities are produced in large quantities in a country. Import and export become completely well balanced. It helps to maintain favourable balance of trade.
- **CRITICISM (SHORTCOMINGS) OF BALANCED GROWTH**
 Prof. Hirschman and other economists have criticised the concept of balanced growth as under-
1. **Concept is not Practical.** Practically, the programme of balanced growth cannot be implemented. The reason is, it is not possible to give equal attention towards the development of all regions with limited resources at one and the same time.

2. **Unsuitable for under-developed countries.** The resources of under-developed and undeveloped countries are limited. Simultaneous development programmes cannot be implemented for the development of industries and agriculture with limited financial resources. Industries cannot be started in all the regions. These countries lack technical know-how and managerial efficiency. Therefore, large programmes of development are not implemented in these regions.
 3. **Increase in Industries Undergoing Losses.** Balanced growth enables establishment of industries in backward regions. Cost of production is increased due to absence of facilities. Goods are not sold easily on reasonable prices, with the result that the industries go under loss and are ultimately closed down.
 4. **State Intervention.** In order to develop industries and agriculture, state intervention is largely increased. Private sector is mostly affected whereas public sector adversely affects economy of the country.
 5. **Haphazard Development.** Under balanced growth, neither industries are developed nor is agriculture. The result is balanced growth does not give its contribution in the development of a nation.
 6. **Burden of Key industries.** A huge amount of capital is invested in key industries by under-developed countries. Financial arrangements are made from local and foreign assistance with the result that interest on loans increases and losses produce adverse effects on economy.
 7. **Ignorance of the Principle of Comparative cost.** According to this principle, only those articles must be produced within a country, the cost of which is low, but the concept of balanced growth overlooks the principle of comparative cost. It also emphasises the manufacture of the goods which are not gainful.
 8. **Poverty.** Under balanced growth, there is no improvement in the conditions of poor class of persons, but the condition of rich class goes down. Economic condition of the country as a whole is weak. Thus, we see that the concept of balanced growth is theoretically good, but not practically.
- Q.114. Discuss the merits and demerits of unbalanced development.
- ADVANTAGES (IMPORTANCE) OF UNBALANCED GROWTH**
- The propounders of unbalanced growth have mentioned the following advantages in support of their views-
1. **Development of essential regions.** Under unbalanced growth economy, only those regions are developed which are considered essential and profitable.

2. Full utilisation of resources- Resources of under-developed countries are limited. They are fully utilised for profitable purposes.

3. Rapid Development- Under unbalanced growth economies, there is a rapid growth in a few particular regions. This gives impetus to other objects for development.

4. Set up of Profitable Channels- Only profitable industries are started in this economy. Unprofitable units are automatically closed down, efforts are also made to meet their losses.

5. No state interference- There is no state interference in unbalanced economic growth. Industrialists are free to start any industry anywhere.

6. Capital Formation- Capital concentrates in the hands of rich class of persons. Therefore, there is a rapid growth of capital formation. Savings of the capitalists are invested in industries.

7. Competition- There is free competition in different regions and among industrialists. This helps to lower down the cost and price of the product.

□ CRITICISMS (DISADVANTAGE) OF UNBALANCED GROWTH

1. Capitalistic View- This concept is capitalistic. It is based upon exploitation and one sided development.

2. One sided Development- In this economy, development is one-sided. A few regions get developed whereas others are neglected and remain undeveloped.

3. Disequilibrium in demand and supply- Imbalance is found in demand and supply in this economy. With the development of a particular industry or industries, production is increased but there is no increase in demand in the market.

4. Unemployment- This principle does not solve the problem of unemployment. Unemployment rather increases because unprofitable units are closed down.

5. Dependence- Only selected commodities are produced in the country with the result that we have to depend on other countries for other commodities.

6. Backwardness of Agriculture- Adequate attention on development of agriculture is not given in unbalanced economic growth.

Thus, we see that unbalanced growth economy is not favourable for an overall development of a country.

VERY SHORT ANSWER TYPE QUESTIONS

Q.115. Compare planned and unplanned economy. Why is a planned economy considered superior to free enterprise economy?

Planned Economy- Planned or balanced economy means an economy by which economic and social growth of a country is well planned for the achievement of particular objectives. Resources, natural and human, both are fully utilised in a rational manner. Emphasis is laid on balanced and permanent basis for economic development. The main object of planned economy is maximum social welfare.

Unplanned Economy- Unplanned or unbalanced economy is one in which there is no particular end in view for development. No attention is given towards efficient and rational use of resources. There is no government control over economic operations. Personal benefit is given attention instead of social welfare.

Q.116. Discuss the thought of prof. Nurkse on balanced development.

PROF. NURKSE'S VIEWS ON BALANCED GROWTH

Prof. Nurkse has given a wide description of balanced growth.

(1) In a country where farmers are incapable of growing foodgrains more than their requirements, there is no or less impetus for industrialisation. The reason is farmers will have no additional foodgrains in their godowns. Thus they will have no money to purchase other articles. Under such circumstances, demand for industrial products will be low and industrial development will be slow.

(2) If non agricultural region of economy is backward, there will be no agricultural development. It means if there is no industrial development in a country, demand for cash crops will be low and there will be no agricultural development.

(3) Therefore, to avoid this contradiction, efforts for development of both the sectors must be made because slow development of one sector will affect the development of another sector. Nurkse was staunch supporter of balanced growth. He has compared balanced growth with balanced diet like this "Just as balanced diet is required for body, similarly balanced growth is necessary for a country."

STRATEGY OF BALANCED AND UN-BALANCED DEVELOPMENT : O.T.Q.

Choose Correct Option -

(1) In planned economy adopted -

(a) Balanced development (b) Unbalanced development

(c) Spedly development (d) Continents development

(2) The following sector is developed in balanced development-

(a) Industrial development (b) Agricultural development

(c) Infrastructure development (d) All of above

(3) The following included in balanced development-

(a) Development of backward area

(b) Development of infrastructure industries

(c) Co-ordination between public and private sector

(d) All of above

Ans. (1) a (2) d (3) d

UNIT - V • Inflation • Deflation • Stagflation

Inflation is an invisible dacoit who plunders everyone.

19

CHANGES IN THE VALUE OF MONEY : INFLATION, DEFLATION

■ Long Answer Type Question

Q.117. What do you understand by 'Inflation' and 'Deflation' ?

Distinguish between them.

Or

"Inflation is unjust and deflation is inexpedient. Of the two, perhaps deflation is the worse". Discuss.

Or

What do you understand, by 'Inflation' and 'Deflation' ? Compare them.

MEANING OF INFLATION

Inflation in simple terms means span or spread of money. In other words, when circulation of money is more than its demand, it is called a state of inflation. During inflationary period, prices rise and value of money falls. Thus inflationary trend is a state of affairs when the supply is more than the demand for money.

In the words of Growther, "Inflation is a state of affairs when prices rise and value of money falls."

MEANING OF DEFLATION-

Deflation is opposite of inflation. When the supply of money is less than its demand it is called deflation. Deflation exists in metallic monetary standard or when the representative paper money exists in circulation, or when there is less metallic money in reserve.

In the words of Crowther, "During deflation, prices fall and value of money rises."

Distinction in Inflation and Deflation

S. No.	Bases of Difference	Inflation	Deflation
1.	Supply of Money	Supply of Money is more than its demand	Supply of money is less than its demand.
2.	Value of Money	Value of money falls because purchasing power goes down.	Value of money rises up because purchasing power goes up.
3.	Prices	Prices rise.	Prices fall.
4.	Production	Production increases.	Production decreases.
5.	Industrial development	New industries are started and old ones are expanded.	Industries are closed down.
6.	Employment	Increase in employment opportunities.	Unemployment increases.
7.	Consumption	Prices of consumption goods rise.	Cheap consumption are available to consumers.
8.	Public expenditure	State can spend more on welfare activities by adopting deficit financing.	Both rich and poor classes of persons stand to lose as income declines.
9.	Economic Development	Economic development is more. Production, employment, savings and trade develops.	Economic development is stopped and no progress is made.

INFLATION WHY UNJUST?

Keynes has called inflation unjust because of the following reasons-

(1) **Invisible Taxation**-When the government adopts the policy of deficit financing, it has to increase supply of additional money. This additional flow of money is just like invisible taxation which affects the purchasing power and standard of living of tax payers. Thus, Prof. C.N. Vakil has compared inflation with a legal dacoit who plunders the whole society.

(2) **Bad Effect on Poor class**-Inflation adversely affects mostly the poorest class of persons because heavy rise in prices takes place in articles of necessity.

(3) **Economic Irregularities**-During inflationary period, rich becomes richer and poor poorer. Thus inflation creates a gap between rich and poor class of persons.

(4) **Demonetisation**-Inflation gives birth to artificial progress. Inflation once started reaches its climax. If the government fails in checking inflationary trends, it ultimately, resorts to demonetisation. It disturbs millions of people in the country.

DEFLATION : WHY INEXPEDIENT?

According to Keynes, deflation is inexpedient due to the following reasons :

(1) **Depression**-Depression disturbs the industries and trade of the country. The labour class undergoes unemployment.

(2) **Loss of Revenue**-In depression period, producers, traders, businessmen, investors and creditors meet losses. Poverty and crimes increase, consequently, there is a decline in government revenue.

(3) **Uncontrollable**-Deflation once started does not stop till it reaches its climax. With the result that disequilibrium appears in the entire economic structure.

(4) **Unemployment and Poverty**-There is widespread unemployment and poverty in deflationary period. The purchasing power of the masses goes down to such an extent that they find it difficult to purchase commodities even at cheaper rates.

(5) **No Economic Development**-Industries and factories are closed down. No efforts are made to increase production. Economic development is stopped.

According to Keynes, deflation is worse. It is due to the following reasons-

(1) Production increases in inflation whereas it decreases in deflation.

(2) Standard of living of the masses goes up in inflation whereas it lowers down in deflation.

(3) Employment opportunities increase in inflation whereas unemployment increases in deflation.

(4) Government revenue increases in inflation whereas it decreases in deflation.

(5) The condition of poor class of persons becomes worse in deflation.

(6) Economic development flourishes in inflation whereas it is stagnant in deflation.

Thus it can be asserted that inflation is unjust and deflation is inexpedient.

Q.118. What do you mean by Inflation ? Point out its causes and effects. How can it be controlled ?

Or

What is Inflation ? Under what circumstances, does inflation become justifiable and to what extent ?

MEANING OF INFLATION

In simple words, inflation means spread of money. That is to say, where the supply of money is more than its demand, it is called inflation. Prices of commodities increase and value of money falls.

In the words of Crowther, "Inflation is a state of affairs when the value of money falls or prices of goods increase."

CAUSES OF INFLATION

Inflation is more in paper money than metallic money. The following are the main causes of inflation :-

(1) **Deficit Financing**- When the government finds it unable to raise funds from other resources for the purchases of expediting economic plans during paper money standard, it resorts to deficit financing. It results in inflation. To recoup difficult financing, it prints notes and thus money circulation increases.

(2) **Increasing Demand of Money**- Another reason of inflation is its increasing demand for money. When the government resorts to more paper money, prices of goods and services increase. The government arranges further circulating of money to meet the increasing public demand. This tendency leads to inflation.

(3) **Credit Flow**- Flow of credit is the reason of inflation. Banks reduce their cash reserves and create credit. It increases monetary income of the people.

(4) **Fall in Production**- Inflation arises when there is a fall in production, although additional supply of currency is not made.

(5) **War and Emergency**- Inflationary trends develop during war time. Similarly, supply of currency is increased with the increase in population. But the increase in production does not take place in the same proportion and inflation ushers in.

(6) **State Trade Policy**- With a view to earning foreign exchange, the government increases exports of commodities. When exports of commodities are increased, shortage of goods is created in the market. It results in the rise of prices and inflation appears.

EFFECTS OF INFLATION

Inflation affects the economy and the public of a country. According to Prof. C.N. Vakil, "Inflation is like a dacoit. Both snatch the rights, but

the difference is that the dacoit is visible whereas inflation is invisible. A dacoit plunders a few persons at one time, while inflation attacks the whole society. A dacoit can be sent to jail whereas inflation is legal."

FAVOURABLE EFFECTS OF INFLATION

The following are the favourable effects of inflation :-

(1) **Increase in Production**- Inflation leads to an increase in production. It is because of large profits due to rising prices and producers are encouraged to enhance production. Besides this, demand for goods, and services increase due to an increase in monetary income. This also helps in increasing production.

(2) **Employment Opportunities**- Inflation also helps to provide more employment opportunities. It is because new industries are started and old ones are expanded due to an increase in production.

(3) **More Public Expenditure**- The government resorts to deficit financing with the help of inflation, and spends more money. It increases welfare activities of the public.

(4) **A rise in Standard of living**- Due to increased monetary income, the consumers purchase more commodities of good quality and thereby raise standard of living.

(5) **Fast Economic Development**- Inflation helps in fast economic development of a country. Economic activities are fast due to increase in production, consumption, public expenditure and employment.

(6) **Development of Banking and Insurance**- During inflationary period, monetary income of persons is increased. It helps in the development of banks and insurance business. New banks are started and deposits increase.

ADVERSE EFFECTS OF INFLATION

(1) **Decrease in Real Income**- Due to decrease in the purchasing power of money, the real income of the people decreases. It happens particularly to poor and medium class of persons.

(2) **Dearness**- The main problem of price rise and its cause is inflation. The value of money falls and prices of commodities rise. Thus dearness is the acute problem in India.

(3) **Harassment to Savings**- Due to a fall in the value of money, people, have no faith in savings. They spend more on consumptions and property and do not save. Thus there is no accumulation of wealth in the country.

(4) **Invisible Taxation**- Adoption of deficit financing in inflation is a sort of invisible taxation. The government puts a burden on the public by printing additional note currency. It has an adverse effect on the poor class.

(5) **Loss to Investors**—People who invest in shares or deposit in banks and post offices stand to lose as the purchasing power of money goes down.

(6) **Economic Instability**—Inflation gives rise to economic disequilibrium. A number of economic and social problems arise out of it. Costly commodities are available and the market faces short supply of goods.

Thus there are both favourable and adverse effects of inflation. If inflation is cautiously adopted it can prove useful as a medicine. It can be poisonous if it is resorted to unwisely.

□ HOW TO CONTROL INFLATION ?

Inflation can be controlled in the following ways :-

(1) **Increase in Production**—Agricultural and industrial production should be increased so that demand for money may increase and prices fall.

(2) **Encouragement of Savings**—Consumption should be discouraged and savings encouraged.

(3) **Increase in Taxation**—The government can decrease purchasing power by increasing taxation. Deficit financing should be finished.

(4) **Credit Control**—Banks should control credit by several ways.

(5) **Decrease in Expenditure**—The government should decrease expenditure on unproductive activities and increase on productive ones.

(6) **Price Control**—The government should resort to rationing and price control. Besides, budgets should be well balanced. Additional purchasing power should be snatched from the hands of public by issue of public loans.

(7) **Demonetization**—When all the efforts to control inflation fail, the government should resort to the policy of demonetization, i.e., cancel the old currency and issue new currency.

Conclusion—Inflation arises due to issue of large money and less production. The solution is to increase production and further issue of currency and credit should be arrested.

Q.119. What is deflation ? What are its causes ? How does it affect the different classes of society ? How can it be checked ?

MEANING OF DEFLATION

Deflation is opposite to inflation. When the supply of money is less than its demand, it is called deflation. Deflation often arises in metallic standard of money. It also exists when representative paper money is in circulation or there is less metallic money in reserve fund.

As Crowther says, "Deflation is a state in which value of money rises or prices fall."

□ WHY DEFLATION ARISES ?

The main reason of deflation is the shortage of metal in metallic standard. When circulation depends upon gold or silver, demand for money increases and the government fails to increase its supply. This leads to deflation. There is no possibility of deflation in inconvertible paper money standard. Some are of the opinion that deflation also arises when the Central government checks deflation by means of different policies.

ECONOMIC EFFECTS OF DEFLATION

Economic effects of deflation as compared to inflation are more adverse. Prices of goods and services fall in deflation and the purchasing power of money increases. Consequently, industries and trade suffer losses. Unemployment spreads. Government revenue falls and the whole economic system becomes hotch potch. Deflation affects different sections of society in different ways. Deflation affects in the following manner :-

(1) Due to a fall in prices of commodities, industrialists and businessmen suffer heavy losses. Several mills and factories are closed due to losses.

(2) Consumers stand to gain because they get articles of necessity comparatively at cheaper rates, but they cannot afford to purchase cheap articles due to low incomes.

(3) Persons with fixed incomes also stand to gain in deflation because due to increased purchasing power, they can raise standard of living.

(4) The labour class is adversely affected by deflation because due to depression, unemployment spreads in industry and trade. Although there is a general fall in prices, they are compelled to lead a miserable life due to absence of purchasing power.

(5) Creditors gain due to increase in purchasing power whereas debtors suffer loss.

(6) Investment is adversely affected by deflation because the investment sector becomes limited.

(7) Deflation checks the spread of the growth and development because it adversely affects production, employment, income and consumption.

(8) The government has to face a great difficulty in creating additional money during a period of emergency like war, flood and famines.

CONTROL ON DEFLATION

The following measures are suggested to control deflation :-

- (1) Circulation of money should be increased.
- (2) Deficit budgets can be prepared by expanding public expenditure and exemption of taxes. Keynes says if the government cannot provide employment in productive channels, it can do so in unproductive channels.
- (3) The Central bank can reduce the bank rate. The government can expand credit by purchasing government securities in the open market.
- (4) The government can increase production by providing financial aid and lowering tax rates on producers.
- (5) Weakness of the situation can be faced by payment of old debts by the government.
- (6) A suggestion to weaken the situation of deflation has been given -destruction of old products manufactured earlier.
- (7) Exports should be encouraged and imports discouraged.

Q.120. Discuss the effects of Inflation and Deflation on various classes of society.

EFFECTS OF INFLATION ON VARIOUS CLASSES

Inflation affects various classes of society in different ways. A person comes under different categories. For example, a producer is a consumer as well. He stands to gain as producer and loses as a consumer.

We shall examine effects of inflation on producers, investors, salaried class, consumers, debtors and creditors.

(1) Producers—Producers may be farmers, businessmen, traders and industrialists. Generally, this class of person stands to gain. The reason is gains accrue due to rising prices of commodities. The producer gets profit in these ways.

(i) Due to inflation, demand is more than the supply of goods, with the result that prices rise. The goods are immediately sold and capital is not blocked.

(ii) The cost of production does not increase in the same proportion as the prices rise. That is, cost of production is proportionately lower than the rise in price. It is because it takes time for production. The raw material is purchased at low cost. When it is ready, its cost increases. Thus the producer stands to gain.

(iii) As it is well known in the race of prices and wages, wages lag behind. That is wages do not rise in the same proportion as prices of manufactured goods rise. The producer stands to gain in this respect. Traders also stand to gain like producers. At the time when they purchase goods, prices are low. But when they sell, the prices go up.

(2) Investors—The class of society which invests money in business and trade comes in this category of investors. Investors are of two types :-

(i) Investors whose income from investment is fixed.

(ii) Investors whose income from investment changes due to **teji** or **mandi**. Inflation affects both the classes of investors. Fixed income investors are those persons who purchase debentures of companies having mixed capital or who purchase government securities. They get fixed income. They are in loss by inflation. The reason is that their income is fixed, whereas purchasing power of money goes down.

Flexible income investors are those who purchase shares of companies having mixed capital. Income of such investors depends upon **teji** or **mandi**. During inflation, they get more income and in depression, it goes down. Thus during inflation they stand to gain as they get more dividend.

(3) Salaried class—This class comprises of persons who sell their services for money, e.g., farm workers, factory labourer, employees of offices and teaching etc. This class of persons stands to lose by inflation. The reason is salaries and wages lag behind the prices. That is, salaries and wages rise disproportionately to prices. Besides it, due to a rise in price level, real income of salaried class goes down. Therefore, salaried class always stands to lose in the period of inflation. However, this class gets encouraged. Demand for labourers increases and it increases employment.

(4) Consumers—Consumers always stand to lose in inflation. Due to a rise in price, purchasing power of money goes down, with the result that consumers purchase comparatively, less commodities. Besides this, shortage in necessary articles is experienced, with the result that a consumer has to face a lot of difficulties. There are two types of consumers - firstly the consumers whose income is flexible, that is during inflation, it rises and secondly, those investors whose income is fixed. They suffer a lot from inflation.

(5) Debtors and Creditors—Inflation affects debtors and creditors as well. Inflation is advantageous to debtors and disadvantageous to creditors. The reason is that value of money goes down in inflation whereas the rate of interest is fixed. Therefore, the real purchasing power of creditor becomes low in the form of interest. Besides it, if debtors repays loan to the creditor during inflation, the debtor stands to gain and the creditor loses. The reason is that due to a fall in the value of money, the debtor returns

less purchasing power. But from another point of view, inflation is advantageous to a creditor. The reason is, the demand for money to expand business increases and this results in an increase in the rate of interest. On the contrary, the debtor stands to lose because he has to pay high rate of interest on new loans and he also faces difficulty in obtaining them.

EFFECTS OF DEFLATION ON VARIOUS CLASSES

Deflation affects the entire economic life.

Its effects are as under -

(1) Producers and Traders-Producers and traders stand to lose by deflation. There are three reasons therefor (i) Cost of production is comparatively slow than price fall. For example, rent, interest and wages cannot be reduced with a fall in prices. (ii) A producer has to pay more for raw material. When he sells goods in the market, cost of raw material further falls down and he is compelled to sell his manufactured articles at low price. Moreover, demand for goods falls during deflation. It results in bulk of commodities in stock and capital is blocked. (iii) Producers are required to pay more at the time of purchase of raw material but the time the manufactured goods are ready for sale, the price goes down further. The farmer also stands to lose in inflationary period, particularly small farmers are the most sufferers.

(2) Investors-There are two types of investors (i) The investors who have fixed income (ii) Those investors whose income is flexible. Deflation affects both types of investors. Fixed income investors stand to gain. It is because their income is fixed but price level goes down. They are in a position to purchase more goods and services. Debenture holders of mixed capital companies and bond holders of government stand to gain much as their income is fixed. On the contrary, investors getting flexible income stand to lose. It is because their income goes down.

(3) Salaried and Labour Class-Salaried and labour class stand to gain by deflation. The reason is that it is not easy to decrease salary and wages at the time when prices fall. The trade unions oppose reduction in wages. Similarly, salaries cannot be decreased. Consequently, both the class of persons stand to gain in deflation. But they also stand to lose from another point of view. Producers suffer losses due to deflation, with the result that production decreases. A few undertakings are closed down. Salaried and labour class of workers are retrenched. Unemployment spreads. Unrest ushers in among labourers. Generally, trade unions oppose

retrenchment. It results in strikes and lockouts and industrial peace is disturbed in the country.

(4) Consumers-Sometimes consumers get benefit from deflation. The reason is consumers can purchase more commodities due to a fall in price. Thus their purchasing power is increased. There are two types of consumers-

- (i) Those consumers whose income is fixed in deflationary period, e.g., salaried consumers, and
- (ii) Those investors whose income is flexible and fall during this period. The first category of consumers stands to gain.
- (5) Debtors and Creditors-**Creditors stand to gain and debtors lose during deflation. The creditors stand to gain because their purchasing power is increased. Besides it, if principal is returned, even then they stand to gain because they can lend it again with increased purchasing power. Demand for money increases and it can be lent out at a desired rate of interest. Thus a creditor stands to gain. But the debtor stands to lose particularly the farmer who suffers most.

SHORT ANSWER TYPE QUESTIONS

Q.121. Write short notes on 'Reflation' and 'Disinflation'.

REFLATION

Reflation is similar to inflation. According to Prof. G.D.H. Cole, "When inflation is deliberately resorted to, to lessen the shortcomings of depression, it is called reflation.

In other words, reflation is a sort of controlled inflation. When there is excessive deflation and prices fall to a great extent, the government resorts to reflation, that is the government increases circulation of money with a view to raising up the price level. This course helps in bringing up the price level to a normal level.

HOW TO RESUME REFLATION

- (1) The government can increase circulation of money by means of deficit budgets.
- (2) The government should spend more on construction work and increase its speed.
- (3) The government can make credit cheap by lowering down the rates of interest. It helps in increasing circulation of money in the market.

- (4) More finances can be provided to increase production. It will encourage businessmen and industrialists to invest more funds.
- (5) Exemption in taxes can be given for capital investments.

DISINFLATION

Disinflation is an activity when deflation is wilfully resorted to under the conditions of excessive inflation and to remove its defects.

Disinflation checks the rising price level and helps to bring it upto normal level. After the world war II, prices of commodities had risen to a very high level due to inflation in almost all the countries of the world. Thus, when prices rise very fast, the rising trend of price level is checked by disinflation.

METHODS OF DISINFLATION

- (1) The state or government tries to withdraw money from circulation by issue of debentures and levy of new taxes.
- (2) Savings are also encouraged. It helps to lessen circulation of money.
- (3) Exploitation of additional money is resorted to by increasing production.
- (4) A large part of old currency is destroyed.

Q.122. Distinguish between demand-pull inflation and cost-push inflation. Why is it difficult to separate one from the other?

Write short notes on -

(a) Demand-Pull Inflation, and (b) Cost-Push Inflation.

Broadly speaking, there are two main causes of inflation :

- (1) Increase in aggregate demand for goods and services which causes demand-pull inflation, and (2) increase in cost of production which leads to cost-push inflation.

DEMAND-PULL INFLATION (EXCESS DEMAND

THEORY OF INFLATION)

According to demand-pull inflation theory, inflation refers to a situation in which aggregate demand at the existing price-level far exceeds aggregate supply of goods and services. In other words, this theory maintains that it is the excess of aggregate demand over aggregate supply that pulls up the general price-level and causes inflation. Before full employment when aggregate demand increases, there is increase in output also. But after full employment level, increase in aggregate demand does

not evoke any increase in aggregate supply. Hence, prices begin to rise. Thus, inflation occurs when aggregate demand exceeds the full employment level.

(1) According to Peterson, "Demand Pull Inflation Theory holds that inflation is caused by an excess of demand (spending) relative to the available supply of goods and services at existing prices."

(2) In the words of Shapiro, "According to Demand Pull Inflation, the general price level rises because the demand for goods and services exceeds the supply available at existing prices."

COST PUSH INFLATION (SELLER'S INFLATION OR MARK-UP INFLATION)

The cost-push theory of inflation (also called seller's inflation or mark-up inflation) explains that inflation occurs not so much due to excess demand but essentially due to autonomous increase in some important items of cost of production, and this increased cost being passed on the final buyers in the form of higher prices. In brief, inflation is caused by increase in 'cost'. The basis of this theory is that organised groups, both business and labour fix higher prices for their products or services. Under cost-push inflation, is a rise in prices on the one hand and fall in output and employment on the other.

In simple words, the cost-push theory of inflation states that-

- (i) The real source of inflation is the increase in cost of production.
- (ii) The increase in cost is free from demand conditions.
- (iii) The push forces operate through main cost components, such as wages, materials, profits etc.

which is passed on to the buyers in the form of higher wages. Higher prices, in turn, leads to demand for higher wages in the other sectors of the production causes an around increase in wages.

Q.123. What do you mean by Inflation ? Discuss character of inflation in India.

MEANING OF INFLATION

In simple words, inflation means spread of money. That is to say, where the supply of money is more than its demand, it is called inflation. Prices of commodities increase and value of money falls.

In the words of Crowther, "Inflation is a state of affairs when the value of money falls or prices of goods increase."

Present Inflation rate about 7% Due to adopting deficit financing policy inflation exist continuous after independence.

CHARACTER OF INFLATION IN INDIA

Inflation in India as a developing economy is slightly different from inflation in an advanced country. As pointed out by Keynes, inflation in an advanced-economy generally sets in only after the point of full employment is reached. But, in a developing economy, inflation generally sets in earlier than the point of full employment. In an advanced economy, increases in money supply result in the mobilization of idle resources instead of leading to a rise in the price-level. But, in a developing economy, due to the limited and inelastic supply of the resources, increases in the money supply invariably result in a rise in the price-level. Keynes calls it the bottle-neck inflation which sets in even before the point of full employment is reached. There are certain additional causes for the early setting of inflation in a developing country :

(i) A developing country like India generally incurs huge public expenditure to quicken up its planned economic development. The emphasis is generally laid on heavy basic industries and social overheads rather than on the development of consumer goods industries. Since the output of consumer goods does not keep pace with the expansion of money income, it invariably results in an inflationary rise in the price-level.

(ii) The marginal propensity to consume of the people in India is generally high with the result that the farmers in these countries do not bring the entire agricultural surpluses to the market for sale. The high demand for consumer goods naturally pushes up the prices of these goods. Further, a good part of the primary products of these countries is exported to foreign countries, creating, additional shortage of these goods.

(iii) In India the large magnitude of disguised unemployment and underemployment that prevails there. Unfortunately, this disguised unemployment and underemployment is not so readily responsive to an expansion of money supply. Despite the increase in the supply of money, the output of goods and services does not increase so readily on account of the existence of disguised unemployment and underemployment.

Q.124. What do you mean by Stagflation ? Under what circumstances does stagflation come into existence.

At present, inflation has reappeared in a strange manner in the form of stagflation. It is also called inflationary recession. Stagflation is formed

of two words stag and flation. Stag means stagnation and flation means inflation.

MEANING OF STAGFLATION

If inflation exists and development is stagnant, it is called stagflation. It can be defined as under -

"When economic structure is below the level of employment and does not encourage inflation, employment and production, but conversely, employment production and level of development is stagnant or is checked from further progress, it will be called stagflation."

In other words, stagflation exists when inflation exists simultaneously with stagnant economic development. During inflation, prices continuously rise, but production, income and employment remain stagnant. In the words of Prof. Samuelson, "Stagflation is a new name of a new disease. During stagflation, with the increase in prices and rates of wages, unemployment spreads and manufactured goods become unsealable." It is clear that stagflation is a state when prices of commodities and rates of wages increase but their demand falls.

It can also be said that during stagflation, money illusion arises. It means there is illusion in the minds of public that their real income is increased with the increase in their monetary income. Monetary wages, no doubt, increase but the purchasing power of increased wages decreases more than previously. This state of affairs appears when the rate of growth is zero in comparison to rising prices.

Causes of Stagflation-

- (1) With the rising price of oil and other goods there is adverse change in the business condition.
- (2) A great increase in the quantity of labour power.
- (3) Strong Trade Unions have compelled to increase wages very high, more than its productivity.

Stagflation does not appear only in developed countries. It is experienced in India and other countries as well. Production of cloth, steel, tyre, tractor, transport vans, engineering etc. is declining and unemployment is increasing whereas inflation is increasing. In India, causes of stagflation are - increase in administrative prices, increase in international oil, corruption, etc.

VERY SHORT ANSWER TYPE QUESTIONS

Q.125. Make difference between disinflation and deflation.

Disinflation is an attempt aiming at reducing the abnormally high prices. Disequilibrium caused by inflation is sought to be corrected through disinflation by bringing down the prices. However, if disinflation persists for long, it may transform itself into deflation.

Deflation and disinflation resemble each other in two ways :

(1) In both, supply of money increases. (2) Both lead to a fall in the price-level. But there are some basic differences between the two.

Difference Between Deflation and Disinflation

S. No.	Basis of Difference	Deflation	Disinflation
1.	Meaning	Deflation refers to a situation of general fall in price-level and wide spread unemployment caused by deficiency of effective demand.	Disinflation is a process aiming at reversing inflation without causing any decline in income, output and employment.
2.	Cause	It may occur due to certain natural causes or may be the result of a deliberate policy of the government.	It is always the direct result of a deliberate policy of the government.
3.	Change in Price Level	Under it, prices may fall below the normal level. There is no limit to fall in prices.	Its objective is to bring down prices to the normal level.
4.	Effect on Economy	It generally creates depression in the economy. Hence, it affects the economy adversely.	It affects the economy favourably as its aim is to reverse the process of inflation.
5.	Time of Occurrence	It occurs before the level of full employment.	It occurs after the level of full employment.

Q.126. Distinguish between :

- (a) Inflation and Reflation
- (b) Deflation and Disinflation.

Difference between Inflation and Reflation

S.No.	Inflation	Reflation
1.	It can arise by human efforts or natural factors.	It arises always by wilful human efforts.
2.	Prices of goods and services rise speedily.	Prices are allowed to rise slowly and steadily.
3.	A period of Teji starts in inflation.	Reflation is resorted to resume depression.
4.	Economic infra-structure is destroyed in the absence of reasonable control.	Reflation is resorted to with a view to bringing about an improvement in economy.

Difference between Deflation and Disinflation

S.No.	Deflation	Disinflation
1.	It is man made or natural.	It is always man made.
2.	Prices of commodities go down very much.	Prices of goods and services are allowed to go down slowly.
3.	In a period of deflation, depression in trade cycles arises.	Disinflation is resorted to with a view to bringing improvement in the rising trend.
4.	In the absence of control on deflation, unemployment disturbs the whole economy to a great extent.	While adopting disinflation, it is borne in mind that unemployment is checked.

**CHANGES IN THE VALUE OF MONEY:
INFLATION, DEFLATION : O.T.Q.**

- Choose Correct Option -
- (1) Change of value of money affected by-
 - (a) Inflation
 - (b) Deflation
 - (c) Above 'a' and 'b'
 - (d) Policy of RBI
- (2) Inflation value of money is-
 - (a) Increased
 - (b) Decreased
 - (c) Stable
 - (d) No Impact

- (3) Value of money in deflation is-
 (a) Increased (b) Decreased
 (c) No Impact (d) Any of above
- (4) Cause of Inflation is are-
 (a) Deficit financing (b) Increasing demand of money
 (c) Expansion of credit (d) All of above
- (5) In India.... is-
 (a) Inflation (b) Deflation
 (c) Above both (d) None of above
- (6) Price Level is... due to inflation-
 (a) Increased (b) Decreased
 (c) No effected (d) Controlled
- (7) Inflation and deflation are-
 (a) Both are not good (b) both are good
 (c) Inflation is lesser than deflation
 (d) Both are necessary
- Ans. (1) c (2) b (3) a (4) d (5) a (6) a (7) c.

❖ For Immediate Revision of the Subject

APPLIED ECONOMICS

At a Glance (B.Com. II Year)

■ UNIT- I

● Meaning of Micro economics

● Scope of Economics

● Importance of Micro Economics

● Limitations of Micro Economics

● Meaning of Macro Economics

● Characteristics of Macro Economy

● Importance of Macro Economics

● Limitations or disadvantages of macro economics

Micro economics can be defined, as an economic analysis which studies individual persons, units, firms etc.

- (1) In the field of Consumption (2) In the field of Production (3) In the field of Exchange (4) In the field of Distribution.

- (1) From individual to aggregate (2) 'Help' in taking Decisions (3) Personal knowledge (4) Evaluation of economic policies (5) Determination of Remuneration (6) Knowledge of individual (7) Helpful for Macro Economics (8) Predictions (9) Economic Welfare.

- (1) No Knowledge of Whole Economy (2) Not Applicable on Aggregate (3) Unreal Assumptions (4) Some Problems Remain Unsolved (5) Full Employment not possible.

It covers the study of whole economy. It studies large units concerned with aggregate economy, e.g. National income, total savings, total employment, etc.

- (1) Study of aggregate economy, (2) Study Material, (3) Broad view, (4) Mutual inter-dependence.

- (1) Exhaustive scope, (2) Assists in the formation of economic policies (3) Helps in formation of plans (4) Valuation of aggregate behaviour, (5) Importance in distribution of resources, (6) Helpful in understanding contradictions, (7) Helps micro economics.

- (1) Decisions are doubtful (2) Difficulties in measurements (3) Variations in items of group (4) Portions of groups overlooked.

<ul style="list-style-type: none"> ● Meaning or concept of National income ● Different parts of concept of National income ● Methods of measurement of national income ● Difficulties in measurement of national income 	<p>National income is the aggregate of total production of all factors obtained in a country.</p> <p>(1) Gross national production, (2) Net national Production (3) National income (4) Per capita income (5) Consumption incomes.</p> <p>(1) Census of production method (2) Census of income method (3) Census of savings consumption method, (4) Census of occupational method, (5) Social accounting method.</p> <p>(1) Absence of reliable statistics (2) Difficulty to express in terms of money, (3) Duplucacy in calculation, (4) Remaining out of calculation, (5) Absence of measuring rod, (6) Illiteracy (7) Incomplete instructions.</p>
<p>UNIT- II</p> <ul style="list-style-type: none"> ● Consumption Function ● Keynes view of Income Consumption Relationship ● Keynesions theory of employment 	<p>The consumption function refers to income consumption relationship. It is a functional relationship between two aggregates i.e. total consumption (c) and total income (Y). Where C is dependent and Y is independent variable i.e. C is determined</p> <p>(1) No Proportionate Increase (2) Savings and consumption go simultaneously (3) Increase in both consumption and savings with an increase in income.</p> <p>The Keynesian theory of income and employment may briefly be put as follows :</p> <p>(a) The level of income and of employment in a country at any given time depends upon the volume of effective demand (b) An increase in effective demand will lead to an increase in production, in</p>

<ul style="list-style-type: none"> ● Criticisms of Keynesion theory of employment 	<p>Income and a rise in the level of employment. (c) A decrease in effective demand will result in a contraction of production, of income and fall in the level of employment.</p> <p>(1) Full employment is not attainable (2) Not Comprehensive treatment of unemployment (3) Based on the assumption of perfect competition (4) Wrong assumption (5) Concentrates only on inducement to invest (6) Ignores the long period (7) Theory is based on the assumption of 'Closed Economy'. (8) Limited application (9) Static model (10) Ignores Micro analysis.</p>
<p>UNIT- III</p> <ul style="list-style-type: none"> ● Value of Money ● Quantity Theory of Money ● Assumptions of Quantity Theory of Money ● Equation of Quantity ● Criticisms of the Quantity Theory of Money 	<p>Purchasing power of money of one unit for goods and services is called value of money.</p> <p>According to this theory, if there is increase in the supply of money, its value diminishes, and the price of commodities increases. Thus any change in the supply of value has an opposite effect on the value of money.</p> <p>(1) Demand for money and trade, (2) No barter system (3) No change in credit money, (4) No change in velocity of circulation of money, (5) Fixed ratio of currency and credit money.</p> $P = \frac{MV + M' V'}{T}$ <p>(1) Assumptions are untrue and unpractical, (2) Difficult to measure velocity of circulation of money, (3) No mention of the causes of changes of velocity of circulation, (4) No correct measurement of purchasing power, (5) Ignorance of effects of trade cycles, (6) Stagnant economy, is imaginary.</p>

■ **UNIT- IV**

● **Factors affecting economic development and growth**

- (I) **Economic Factors-** (1) Natural Resources (2) Man-Power (3) Capital Formation (4) Technical Know-how (5) Entrepreneurship and Promotion Efficiency (6) State Economic policy
- (II) **Non-Economic Factors-** (1) Social environment (2) Political Stability (4) Religion (4) International Environment.

● **Rostow stages of growth**

- (1) Stage of Traditional Society (2) Stage of Pre-condition to Take off (3) Take off stage (4) Stage of Drive to Maturity (5) Stage of High Mass Consumption

■ **UNIT- V**

● **Meaning of Inflation**

Inflation is a state of affairs when prices rise and value of money falls.

● **Meaning of Deflation**

Deflation is opposite of inflation. When the supply of money is less than its demand it is called deflation. Deflation exists in

● **Causes of Inflation**

- (1) Deficit Financing (2) Increasing Demand of Money (3) Credit Flow (4) Fall in Production (5) War and Emergency (6) State Trade Policy.

● **Effect of Inflation**

- (1) Increase in Production (2) Employment Opportunities (3) More Public Expenditure (4) A rise in Standard of living (5) Fast Economic Development (6) Development of Banking and Insurance.