

CA Foundation (New Syllabus)

Business Economics Abhyaas Notes

By CA Mohnish Vora (MVSIR)

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Summary of Important Points

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Business Economics

Abhyaas Notes

Chapter 1

Nature & Scope of Business Economics

By CA Mohnish Vora (MVSIR)

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Summary of Important Points

Economics Chapter 1 – Nature & Scope of Business Economics

UNIT 1 – INTRODUCTION

❖ Basics

- Two fundamental facts of Economics
 - 1) _____ Wants (aka ends) (which are graded prioritised)
 - 2) Resources (aka means) are _____ (Problem of Scarcity)
and have _____ uses
- We cannot have everything we want with resources we have, we are _____ forced to make _____.
- Therefore, we choose to satisfy only _____ of our wants leaving many other wants unsatisfied.
- Problem of scarcity is faced by _____ in this world
- Thus Economics is “कहानी घर घर की”
- 'Economics' is derived from _____ word '_____'. Its meaning is '_____'.
 - ❖ Economics is the study of processes by which _____ scarce resources are allocated to satisfy competing _____ wants of human beings in a society.
 - ❖ Till 19th century, Economics was known as '_____'
 - ❖ Father of Economics - _____. He wrote a book 'An Inquiry into the Nature and Causes of the _____' (1776)

Economists	Important Definitions of Economics
	Wealth Definition Limitation : neglect of immaterial services
	Economics is a “ Science which deals with wealth ”
	Welfare Definition
	Scarcity Definition Economics is neutral between ends.
	Growth Definition

- ❖ The **study of economics** helps us in-
 - **Developing an _____ approach**
 - Choosing _____ **course of action** from among different alternative courses
- ❖ Most economic problems are of _____ **nature** & are **affected by _____ forces**
- ❖ The study of Economics _____ **ensure that all problems will be appropriately tackled**; but, it enable student to **examine a problem in its _____**

❖ **Decision making** refers to process of

- **selecting an** _____ that will provide the
- **most efficient means of attaining a desired end,**
- from _____ alternative courses of action.

❖ **Business Economics**

- It may be defined as the **use of** _____ **to make** _____ involving the **best use of an organization's scarce resources.**
- _____ defined "Business Economics" as use of economic analysis in formulation of business policies.
- Business Economics is aka. _____ **Economics** or _____ **Economics**

❖

Subject matter of Economic	
Micro Economics	Macro Economics
Study of behaviour of _____ or _____ rather than all the units combined It examines how individual units make decisions as to how to efficiently _____	Study of economy _____. It analyzes the _____ economic environment. Aka – _____ Economics
Few areas under Micro- Economics are: (i) Product pricing; (ii) Consumer behaviour; (iii) _____ ; (iv) The economic conditions of _____ ; (v) Behaviour of firms; and (vi) Location of industry.	Few areas under Macro- Economics are: (i) National Income & National Output; (ii) _____ & interest rates; (iii) Balance of trade & balance of payments; (iv) External value of currency; (v) The overall level of _____ ; and (vi) The level of _____ and rate of economic growth.

❖ **Nature of Business Economics**

1) **Business Economics is a Science**

- ❑ Economics is a branch of _____ of how people in a society focused on production, distribution & consumption of goods/services.

2) **Based largely on Micro Economics**

3) **Incorporates elements of Macro Analysis**

4) **Business Economics is an art**

5) Use of Theory of Markets and Private Enterprises

6) Pragmatic in Approach

- ❑ Micro-Economics → _____ & purely _____ (due to unrealistic assumptions)
- ❑ Business Economics → pragmatic (tackles _____ problems)

7) Interdisciplinary in nature

- ❑ Incorporates tools from other disciplines (subjects)

8) Normative in Nature

- ❑ Positive Economics – _____, “_____” current situation, analyses cause & effect relationship between variables in objective & scientific manner
- ❑ Normative Economics – _____, “_____” done for _____, involves value judgements

Scope of Business Economics

Operational / Internal Issues (solved using Micro-Economics)	Environmental / External Factors (solved using Macro-Economics)
Those issues that arise _____ organisation and are _____ of management .	These are _____ control of management ; thus organization should fine-tune its policies to minimise their adverse effects

❖ Other Important Points

- 1) Taxation involves which aspects of normative economics: _____
- 2) In a two-good economy, the _____ reflects the maximum amount of one good that can be produced when a given amount of the other good is produced
- 3) A wise individual or a society likes to provide for its growth of productive capacity.” This requires some resources should be used for production of _____

❖ ECONOMICS Vs. BUSINESS ECONOMICS

Basis of Difference	Economics	Business Economics
Meaning	_____ of economic principles to solve economic problems	_____ of economic principles to solve business problems.
Character	Micro & _____ economic	_____ economic
Main Task	Fulfilment of needs of individuals & also entities.	Proper decision making in a particular business entity
Nature	Positive as well as normative	_____
Scope	Wider Scope	_____ scope
Branches	It has business economics as its applied branch.	It is an applied branch of economics
Concerned with	Theories relating to production, distribution & consumption	Only _____ theory ignoring other theories

Basis of Difference	Economics	Business Economics
Analysis Involved	Analysis of macro level issues like growth, inflation & emp.	Analysis of _____ level issues like demand, supply & profit
Concentration	only on economic aspects	Both economic as well as non-economic aspects of any business problem
Validity of Assumptions	Based on certain assumptions	Some assumptions become _____ when applied.

UNIT 2 – BASIC PROBLEMS OF AN ECONOMY & ROLE OF PRICE MECHANISM

❖ **Every economic system** has to deal with **central problem of scarcity of resources** relative to the wants for them. This is generally called 'the central economic problem'.

- 1) **What to produce?** → What (more of capital or consumer goods) & how much to produce (quantity)
- 2) **How to produce?** → Capital or Labour Intensive technique (Depends on availability & relative prices)
- 3) **For whom to produce?** → How G/S distributed
- 4) **What provisions are to be made for economic growth?** → Decide how much saving and investment should be made for future progress.

❖ An _____ refers to the sum total of arrangements for the production and distribution of goods and services in a society.

❖ 3 Types of Economies-

- 1) **Capitalist** - All resources are owned and controlled by **private individuals for** _____
- 2) **Socialist** - Material resources are owned by _____ (aka Govt. or Central Planning Authority)
- 3) **Mixed** - It depends on **both** _____ **and** _____ for allocation of resources

CAPITALIST ECONOMY

- Aka **free** _____ **economy** or _____ **economy** or **market economy**
- **All means** of production are **owned and controlled by private individuals for** _____. In short, _____ **is the mainstay** of capitalism and _____ **is its driving force.**
- **Eg- USA, UK, Hong Kong etc.**

❖ Characteristics of Capitalist Economy

- _____ is driving force.
- Right to **private property**
- Freedom of **enterprise & economic choice**
- **Consumer Sovereignty**
- **Competition** (The regulatory mechanism of the market system is _____)

- **Absence of Govt. Interference-** All economic decisions are guided by _____ and _____ operates automatically without any direction by govt. authorities.

❖ **Merits of Capitalist Economy**

- Consumers _____ – **many** _____ **quality** goods at _____ **prices** – results in **higher standard of living**
- _____ – regulating and resources allocated automatically by **price mechanism**
- Functions in a _____ **framework**
- High degree of **operative efficiency** & Cost of production is _____
- Offers **incentives** for efficient _____ **decisions, innovation and technological progress**
- **Preserves fundamental rights** such as right to freedom and right to private property
- Encourages **enterprise & risk taking**

❖ **Demerits of Capitalist Economy**

- **Vast economic** _____ and social injustice, splits society into 'haves' & 'have-nots'. _____ human welfare
- Precedence of _____ rights over _____ rights
- _____ of labour & consumers. Often strikes & lock outs. No security of employment.
- **Resource misallocation** – more production of _____ goods & less of _____ goods & merit goods.
- **Unplanned production** – economic instability – results in a lot of human misery.
- **Waste of resources** – huge amounts spent on _____
- Leads to **formation of** _____ as large firms may drive out small ones.
- **Excessive** _____ as well as conspicuous and unethical consumption lead to **environmental degradation**.

❖ **How do capitalist economies solve their central problems?**

Capitalist economy uses the impersonal forces of **market** _____ & _____ or the _____ to solve its central problems

1) Deciding 'what to produce'

- ✓ Decided by consumers who show their preferences by _____ on the goods which they want

2) Deciding 'how to produce'

- ✓ The _____ of factors of production help in deciding how to produce. If labour is relatively _____, he will use labour-intensive method

3) Deciding 'for whom to produce'

- ✓ Production is done for those who have _____. Higher the income, higher buying capacity and higher demand for goods.

4) Deciding about consumption, saving and investment

- ✓ Higher the interest rates, higher will be the savings
- ✓ The greater the **profit** expectation, greater will be the investment.

SOCIALIST ECONOMY

- Aka _____ or _____ **Economy** or _____ **Economy**
- Concept given by _____ and _____ in 'The _____' (in _____)
- Production by Govt. is aimed at **maximizing** _____ of public. Here goods & services are produced _____

❖ **Characteristics of Socialist Economy**

- 1) **Collective Ownership** (_____ ownership)
- 2) **Economic planning**: Central Planning Authority takes all economic decisions & solve central problems.
- 3) **Absence of Consumer Choice**:
 - ✓ Freedom from hunger is guaranteed, but range of choice is limited by planned production.
 - ✓ Right to work is guaranteed, but the choice of occupation gets restricted.
- 4) **Relatively Equal Income Distribution**
- 5) **Minimum role of Price Mechanism or Market forces**
 - ✓ Price mechanism has secondary role, e.g., for disposal of accumulated stocks.
 - ✓ The prices prevailing under socialism are ' _____ prices' which are set by central planning authority on the basis of socio-economic objectives.
- 6) **Absence of Competition**: Since the state is the sole entrepreneur

❖ **Merits of Socialist Economy**

- _____ **distribution of wealth** & provision of _____ **opportunities**.
- _____ **and balanced economic development** as central planning authority coordinates all resources in an efficient manner.
- _____ **utilization of resources** & ensuring maximum production. **Wastes** of all kinds are _____ through strict economic planning.
- Since **competition is absent**, there is _____ wastage on **advertisement** also.
- In a planned economy, **unemployment is** _____, **business fluctuations are** _____ and **stability** is brought about and maintained.
- Absence of profit motive helps community to develop a _____ **mentality** and _____ **class war**. This ensures _____ of the society.
- Socialism ensures **right to** _____ and _____ **standard of living**.
- Under socialism, **labourers and consumers** are _____ **from exploitation**.
- Provision of _____ **social security** which makes citizens feel secure

❖ **Demerits of Socialist Economy**

- **Bureaucracy & red tapism**, inefficiency and delays, corruption, favouritism
- **Takes away the basic right- right to** _____
- Does _____ provide necessary incentives to hard work
- _____ **monopolies** - sometimes become _____
- **No freedom of** _____ - what the state produces has to be accepted
- No importance to **efficiency & productivity** - disincentive to work.
- **Extreme form of** socialism is _____ practicable (Socialist economy is a _____)

❖ **How do socialist economies solve their central problems?**

- By using the **tool of** _____ to solve the central problems

MIXED ECONOMY

- It **includes the best features of _____ capitalism & socialism**
- Private enterprises are _____ to do any type of economic activity. However, the Govt. imposes measures to _____ and _____ private sector
- The Government itself runs **important and selected industries** and eliminate the free play of profit motive and self-interest.
- ❖ **In a mixed economy, there are three sectors of industries:**
 - 1) **Private sector**
 - 2) **Public sector**
 - 3) **Combined sector**
- ❖ **Merits of Mixed Economy**
 - Economic freedom & private property → **incentive to work & capital formation.**
 - Price mechanism & competition promotes **efficient decisions & better resource allocation.**
 - Consumers are benefitted → **consumers' sovereignty** and **freedom of choice.**
 - Appropriate **incentives** for **innovation and technological progress.**
 - **Encourages enterprise and risk taking.**
 - Advantage of **economic planning & rapid economic devp.** on basis of planning.
 - Comparatively **greater economic and social equality** and freedom from exploitation due to greater govt. participation.
 - **Disadvantages of cut-throat competition averted** through government's **legislative measures** such as environment and labour regulations.
- ❖ **Demerits of Mixed Economy**
 - **Excessive control by state** → reduced incentives & constrained growth of pvt sector.
 - **Poor implementation** of planning
 - Higher rates of **taxation**
 - Lack of **efficiency**
 - **Corruption**
 - **Wastage** of resources
 - **Undue delays** in economic decisions.
 - **Poor performance of the public sector. Difficult to maintain a proper balance** between public & pvt sector
- ❖ **How do Mixed economies solve their central problems?**
 - It uses a **mix of both _____ & _____**

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Chapter 2 **THEORY OF DEMAND &** **SUPPLY**

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Summary of **Important Points**

Chapter 2 – THEORY OF DEMAND & SUPPLY

UNIT 1 – THEORY OF DEMAND

- ❖ 'Demand' refers to **quantity** of a good or service that **buyers are willing and able to purchase** at various **prices** during a **given period of time**.
- ❖ In Economics, **demand** is **_____ the same** thing as **desire** to purchase.
- ❖ The **effective demand** for a thing depends on
 - i. _____
 - ii. _____ to purchase and
 - iii. _____ to use those means for that purchase.
- ❖ **Two things about quantity demanded-**
 - 1) Quantity demanded is **always expressed at a given _____**. At different prices different quantities are demanded.
 - 2) Quantity demanded → **_____ concept** → we must thus **express demand as 'so much per period of time'**

Determinants of Demand

Factors which influence the demand for a commodity are determinants of demand

- 1) **Price of the good**
Ceterus paribus, price increases → demand _____ & vice versa
- 2) **Price of related goods**
 - **Complementary goods** (goods _____) → Eg **Car & Petrol** → Price of Petrol increases, demand of car _____ [**_____** relation]
 - **Substitute/Supplementary/Competing goods** (goods which satisfy _____) → Eg **Tea & Coffee** → Price of tea increases, demand of coffee _____ [**_____** relation]
- 3) **Disposable Income of Consumers**
 Generally, **higher** income → _____ demand, however it **depends on nature of goods**.
- 4) **Taste & Preferences**
Modern or more fashionable goods have _____ demand. However preferences may get **affected by 4 types of effects**. (Refer next page)
- 5) **Consumers' Expectations**
 If consumer **expects** → **Increase in future price OR** Increase in future income **OR** Shortage of good in future → **Current Dem. _____ & vice versa**

Nature of Good	Meaning
Normal Goods Eg- Furniture, Automobile, Consumer Durables	Increase in income leads to _____ demand.
Essential Consumer Goods Eg- Food Grain, Cooking Oil, Fuel	Satisfies _____ of consumers. Increase in income leads to higher demand, but this incr. will be _____ proportionate to increase in income
Durable Goods Eg- TV, Car, House	As people become richer , there is decline in importance of non-durable goods & _____ in importance of durable goods.
Inferior Goods Eg- Cheap substitutes, Local goods	Demand rises only up to a certain level of income & decreases with an increase in income beyond this level. Same good may be normal for one condition & inferior in another.
Luxury / Prestige Goods Eg- Sports Car etc	Demand rises beyond a certain level of consumers' income and keep rising as income increases.

4 Types of "Effects" which influences consumers' Tastes and preferences of consumers

Demonstration Effect (Dekha-Dekhi)	<ul style="list-style-type: none"> ➤ Given by _____, ➤ Desire of people to _____ (imitate) the consumption of others. ➤ People buy things as they see that other people have them.
Bandwagon Effect (Bhed-Chaal)	<ul style="list-style-type: none"> ➤ It refers to extent to which demand is _____ due to fact that others are also consuming same commodity. (_____ Mentality) ➤ Purchase commodity in order to be fashionable or stylish or to _____ to the people they wish to be associated with.
Snob Effect (function of _____ of others)	<ul style="list-style-type: none"> ➤ It refers to extent to which demand is _____ owing to fact that others are also consuming same commodity. ➤ Desire of people to be _____; to be different; to _____ themselves from the "common herd."
Veblen Effect (function of _____)	<ul style="list-style-type: none"> ➤ Given by _____. ➤ _____ priced goods are consumed by _____ seeking rich people to satisfy their need for _____ consumption. ➤ People buy these goods to _____ that they have style, class, money, and good taste.

Bandwagon Effect	Snob Effect
A psychological effect in which people do the same what others are doing. They do _____ have their own belief and thinking.	It is understood as the desire to possess a unique commodity having a prestige value. It is quite opposite to the bandwagon or demonstration effect.
It leads to _____ in demand of a particular commodity.	It leads to _____ in demand of a particular commodity.
Example: When some people start investing money in share market then many people start following the same without considering its advantages and disadvantages	Example: If Miss. X and Miss. Y are rich rivals of each other and if in any party Miss. X wears an expensive dress and on seeing it Miss. Y who also having the same dress decided to reject the use of the same dress further. Rather Miss. Y will try to use even more expensive one.

6) Other Factors

a) Size of population	_____ the size of population, higher demand
b) Age Distribution of population	More old people, then demand for spectacles, sticks → ____ If more of children , demand for toys, toffees, etc. will be ____. If there is migration from rural areas to urban areas , there decrease in demand in _____ areas.
c) The level of National Income & its Distribution	Higher the national income , _____ the demand Rich people has _____ propensity to consume (PTC) and poor have higher PTC. Uneven Distribution, then PTC _____, demand _____ Even Distribution, then PTC _____, demand _____
d) Consumer-credit facility and interest rates	_____ interest rate , _____ demand _____ credit available, then high demand
e) Government policies and regulations	Tax increase , demand _____ Subsidy increase , demand _____ Ban or restriction increase , demand _____

Law of Demand

- As per _____, Law of demand states- ceterus paribus (other things being equal), if **price** of commodity **falls**, **quantity demanded** will _____ and vice versa
- The **quantity demanded** is **amount of a good or service** that consumers are _____ **to buy** at a **given price**, holding **other factors constant**.
- The **quantity demanded can** _____ **quantity actually sold**.

Demand Schedule

A **demand schedule** is a _____ showing **quantities** of a good that **buyers** would demand at **different prices**, **per unit of time**, with **all other variables held constant**.

Demand schedule _____ **law of demand**.

Demand Curve

A **demand curve** is a _____ **presentation of the demand schedule**. It is obtained by plotting **Price on** ____-axis & **Quantity Demanded on** ____-axis.

Slope of demand curve is →

Negative sign in slope → consistent with law of demand.

Demand curve can be **linear** (straight line) or **curvilinear** (slope may vary along curve).

Market Demand Schedule

Market demand is **total quantity** that **_____ buyers** of a commodity are **willing to buy per unit of time** at a **given price, other things** remaining **constant**.

Market Demand Schedule

The market demand curve is obtained by **_____ (lateral) summation of all individual demand curves**. If we **plot the market demand schedule** on a graph, we get the market demand curve.

Demand Function

Demand function states relationship between

- ☐ _____ for a product (dependent variable) and
- ☐ its _____ (independent or explanatory variables).

A demand function may be expressed as follows:

$$D_x = f(\text{Price of Good X, Income, Price of Related Goods})$$

Demand Equation

The straight-line demand curve where we hold everything else constant other than price, can be described by a linear demand function.

$$Q =$$

Where 'a' is the vertical intercept and 'b' is the slope.

Rationale of the law of demand**1) Utility maximising behaviour of Consumers**

According to Marshall, consumer has **diminishing utility for each additional unit** of a commodity and thus, he will be **willing to pay only _____ for each additional unit**.

2) Arrival of new consumers

When **price falls**, some consumers **who could _____ afford to buy earlier** may **now be able to buy it**, & thus increase the qty demanded.

3) Different Uses

Goods having multiple uses → **Price decrease** → used for **varied purposes** & **demand _____**
Eg- Milk, Electricity etc.

4) Price effect

The **_____ in quantity demanded** due to an **increase in price** is termed as **Price effect**.

The price effect is sum of its **two components** namely: (as explained by _____)

- i) **substitution** effect
- ii) **income** effect.

i) Substitution effect:

When the **price** of a commodity **falls**, it **becomes relatively** _____ **than other commodities**, & it **induces** consumers to _____ **demand of commodity whose price has fallen**.

When **price falls**, substitution effect is **always** _____

The substitution effect will be _____ when:

- the **goods** are _____ **substitutes**
- there is _____ **of switching** to the substitute good
- there is _____ **while switching** to the substitute good

ii) Income effect

➤ **Increase in demand** on account of an **increase in real income** is known as **income effect**.

➤ When **price falls**, consumer can

- ☐ **buy** _____ **quantity with** _____ **money or**
- ☐ he can **buy** _____ **of same commodity with** _____ **amount**.

➤ In case of **inferior goods**,

- ☐ income effect **works in** _____ **direction** to substitution effect.
- ☐ **expansion in demand** due to a **price fall** will take place **only if** _____
- ☐ Here, **violation of law of demand** takes place when _____

Exceptions to the law of demand**1. Conspicuous goods**

- Aka. Prestige goods, Snob goods, Veblen goods.
- Some **consumers measure utility** of a commodity **by its** _____ i.e., if commodity is **expensive** they think that it has **got** _____ **utility. Higher the price → higher the demand**
- The price of a piece of jewellery rises, the demand for it may also rise as consumers attach a _____ to owning & displaying expensive items.

2. Giffen Goods

- **Sir** _____ **Giffen** - found that as **price of bread increased**, the British workers **purchased more bread**.
- Generally those goods which are
 - ☐ _____,
 - ☐ with _____ **close substitutes** easily available and
 - ☐ which **occupy a** _____ **place in consumer's budget**
 are called '**Giffen goods**'.
- Giffen goods exhibit
 - ☐ _____ **price-demand relationship** (_____ **sloping demand** curve)
 - ☐ _____ **income-demand** relationship (_____ **sloping engel** curve)
- All Giffen Goods are inferior Goods, but all inferior goods are _____ Giffen Goods

3. Conspicuous necessities

- Demand for certain goods is affected by _____ effect of **consumption pattern of their social group**. These goods, due to _____, become necessities of life.
- For example, despite increase in prices of **TV, refrigerators**, → **demand does not fall**.

4. Future expectations about prices

- When **prices are rising**, households **expecting** that **prices in future will be still _____**, tend to **buy _____ quantities currently** & vice versa.

5. Irrational Consumer

- A person may demand **larger quantity even at a higher price** because he may be _____ of ruling price
- **Irrational people** make _____ purchases **without any rational calculations**

6. Demand for necessities

- **Irrespective of price changes**, people have to consume _____ quantities of necessities.
Eg- Food, power, water, gas etc.

7. Speculative goods

- In stock market, **more** is **demanded** when **prices are _____** and less will be demanded when prices decline.

Changes in demand

Demand		Quantity Demanded	
Demand refers to entire relationship between price & quantity demanded .		Quantity demanded is the quantity which is demanded at a specific price .	
It is represented by _____ demand schedule & demand curve .		Represented by a _____ on demand curve .	
“Changes in Demand” occur due to changes in factors _____ price of the good .		“Changes in Quantity Demanded” occur due to changes in _____ of goods concerned .	
Favourable change in any factor other than price Increase in Demand → _____ shift in demand curve Eg- Increase in Income (normal goods) Increase in price of substitutes etc.	Unfavourable change in any factor other than price Decrease in Demand → _____ shift in demand curve Eg- Decrease in Income (normal goods) Increase in price of complements etc.	Increase in price of goods concerned Contraction of Demand → _____ movement along the same demand curve	Decrease in price of goods concerned Expansion or Extension of Demand → _____ movement along the same demand curve

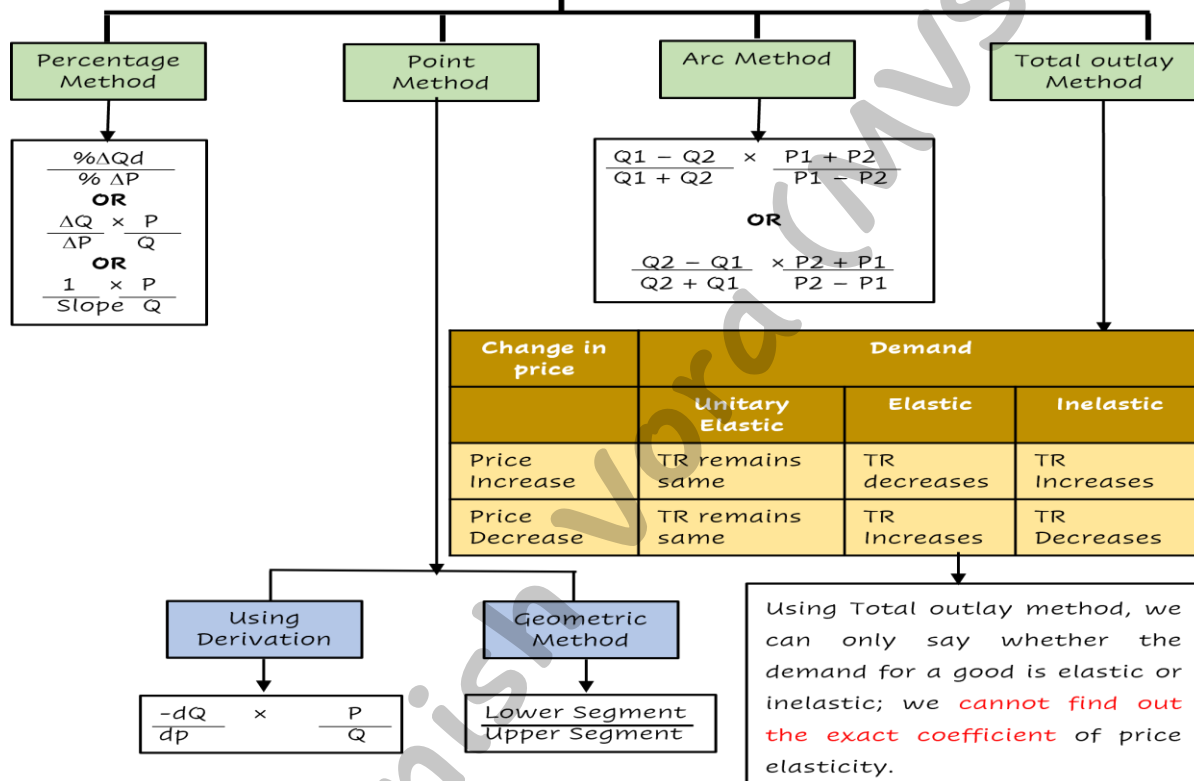
- **Objective of advertisement** by any firm is to-
 - **shift demand curve to _____**, &
 - _____ **elasticity** of demand.

Elasticity of Demand

Elasticity of demand → _____ of quantity demanded to a change in one of _____ of demand

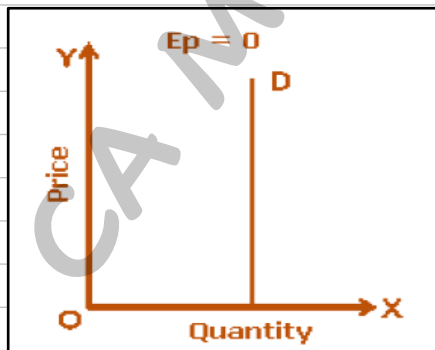
I) Price Elasticity of Demand (Ep)

Responsiveness of quantity demanded to a change in price of the good.

Methods of calculating price Elasticity of Demand**Interpretation of Values of Price Elasticity of Demand**

Value of **price elasticity of demand** varies from _____ to approach _____,

However while **interpreting** its value we _____ -ve sign (to draw conclusions)

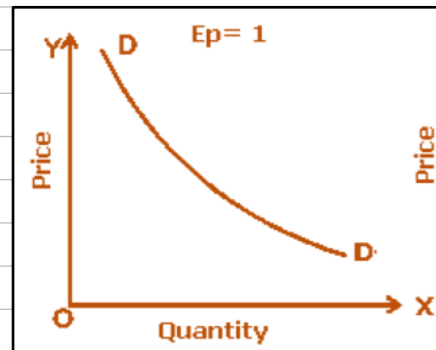


☐ Perfectly inelastic demand ($E_p = 0$)

☐ _____ Demand Curve

☐ Parallel to _____ axis or _____ axis

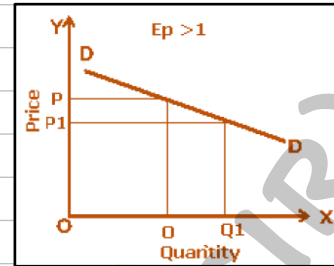
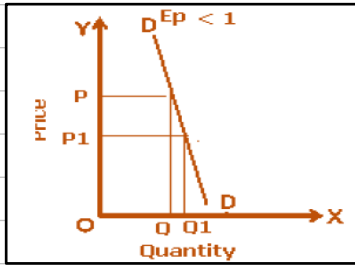
☐ When price changes $\rightarrow \% \Delta Q =$



☐ Unitary Elastic demand ($E_p = 1$)

☐ Demand Curve Shape \rightarrow

☐ $\% \Delta Q$ $\% \Delta P$



□ Relatively inelastic demand ($E_p < 1$)

□ _____ Demand Curve

□ $\% \Delta Q < \% \Delta P$

□ When price falls → buyers are unwilling to significantly contract demand.

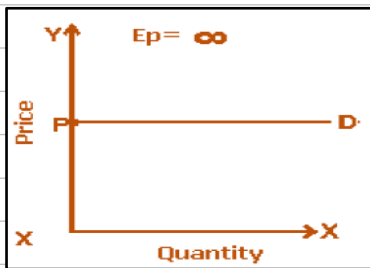
□ Qty dem. here is relatively _____ to price changes.

□ Relatively elastic demand ($E_p > 1$)

□ _____ Demand Curve

□ $\% \Delta Q > \% \Delta P$

□ Qty dem. is relatively _____ to price changes



□ Perfectly elastic demand

□ $E_p = \infty$ (Infinite)

□ _____ Demand Curve

□ Parallel to _____ axis or _____ axis

□ Small price reduction raises demand from 0 to ∞

□ Small price increase, $Q_d = 0$

□ Found in _____ competition market

Additional Notes – Total Outlay Method

Generally, when **price increases**, there are **two effects** which **act in opposite directions** on revenue.

Price effect

After a **price increase**, each unit sold sells at a higher price, which leads to _____ **revenue**.

Quantity effect

After a **price increase**, fewer units are sold, which leads to _____ **revenue**.

What will be the net effect on total revenue?

When price increase, & demand is	PE vs QE		Net effect on TR
Inelastic Demand ($E_p < 1$)	$QE < PE$	Decr in TR < Incr in TR	TR will _____
Elastic Demand ($E_p > 1$)	$QE > PE$	Decr in TR > Incr in TR	TR will _____
Unit Elastic Demand ($E_p = 1$)	$QE = PE$	Decr in TR = Incr in TR	TR will _____

Determinants of Price Elasticity of Demand

1	Availability of Substitutes	<ul style="list-style-type: none"> ➤ Goods having substitutes → _____ Demand ➤ No substitutes → _____ Demand ➤ Goods as a group (generic) → _____ Demand (eg- petrol) ➤ If we consider brands → _____ Demand (eg- IOCL Petrol, Reliance Petrol etc)
2	Position of a commodity in a consumer's budget	<ul style="list-style-type: none"> ➤ _____ proportion of income spent on a commodity → _____ elasticity of demand & vice-versa. ➤ Salt, matches, buttons → _____ dem ➤ Rental apartments, clothing → _____ dem
3	Nature of the need that a commodity satisfies	<ul style="list-style-type: none"> ➤ Luxury goods (possible to _____ consumption) → _____ demand ➤ Necessities (_____ be postponed) → _____ dem.
4	No. of uses of which a commodity	➤ _____ the possible uses of a commodity, _____ its elasticity of demand
5	Time period	<ul style="list-style-type: none"> ➤ Long time period to adjust to price change → _____ ➤ Short time period → _____ demand
6	Consumer habits	Consumer is habitual of a good → _____ demand
7	Tied demand	Tied demand → _____ (Eg pen & refill)
8	Price Range	<ul style="list-style-type: none"> ➤ Very high price or very low-price range → _____ ➤ Middle range → _____ demand.
9	Minor complement items	Cheap & complementary items to be used with a costlier product → _____ demand.

III) Income Elasticity of Demand (Ey)

Responsiveness of quantity demanded to a change in income of the consumer

Proportionate Method (Ey)

Percentage Method (Ey)

Arc Method (Ey)

Proportionate Method (Ey)

If after an increase in income, the proportion of income spent on a good	Type of Income Elasticity
	Income Elasticity = 1
	Income Elasticity > 1
	Income Elasticity < 1

Percentage Method (Ey)

$$E_y = \frac{\% \Delta \text{Qty Demanded}}{\% \Delta \text{Income}}$$

OR

$$E_y = \frac{\Delta Q}{\Delta Y} \times \frac{Y}{Q}$$

Arc Method (E_y)

$$E_y = \left[\frac{Q_2 - Q_1}{Q_2 + Q_1} \times \frac{P_2 + P_1}{P_2 - P_1} \right] \quad \text{OR} \quad E_y = \left[\frac{Q_1 - Q_2}{Q_1 + Q_2} \times \frac{P_1 + P_2}{P_1 - P_2} \right]$$

IV) Cross Elasticity of Demand (E_c)

Responsiveness of quantity demanded of Good X to a change in price of related good Y. Where Goods X & Y can be-

Substitute Goods

Two goods which _____ the _____.
Eg- Pepsi & Coke

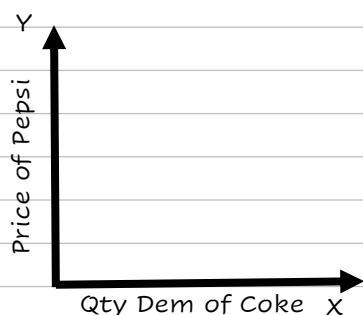
Complementary Goods

Two goods which are to be _____.
Eg- Pen & Ink

Unrelated Goods

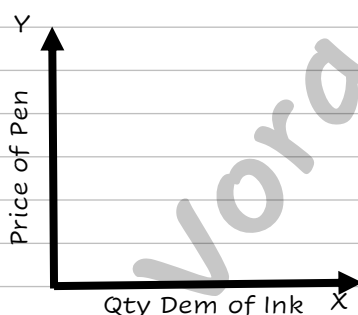
Two goods having _____ relation between them
Eg- Laptop & Burger

No relation between Price of Laptop & Qd of Burger.



Direct or Positive relation between Price of Pepsi & Qd of Coke.

_____ sloping cross demand curve



Negative or Inverse relation between Price of Pen & Qd of Ink.

_____ sloping cross demand curve

Cross Elasticity of Demand (E_c)Percentage Method (E_c)

$$E_c = \frac{\% \Delta \text{Qty Dem of X}}{\% \Delta \text{Price of Y}}$$

OR

$$E_c = \frac{\Delta Q_x}{\Delta P_y} \times \frac{P_y}{Q_x}$$

Arc Method (E_c)

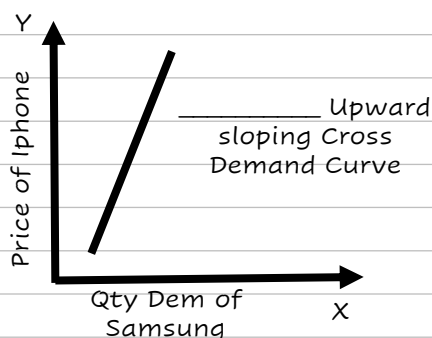
$$E_c = \left[\frac{Q_2 - Q_1}{Q_2 + Q_1} \times \frac{P_2 + P_1}{P_2 - P_1} \right] \quad \text{OR} \quad \left[\frac{Q_1 - Q_2}{Q_1 + Q_2} \times \frac{P_1 + P_2}{P_1 - P_2} \right]$$

Value of E_c	Type of Good	
$E_c = 0$	Unrelated Goods	
E_c is Positive $\rightarrow E_c > 0$	E_c is Positive & Low	_____ Substitutes
	E_c is Positive & High	_____ Substitutes
	E_c is Positive & Infinite	Perfect Substitutes
E_c is Negative $\rightarrow E_c < 0$	E_c is slightly below zero	_____ Complements
	E_c is Negative & High	_____ Complements
	E_c is Negative & Infinite	Perfect Complements

Remote Substitutes

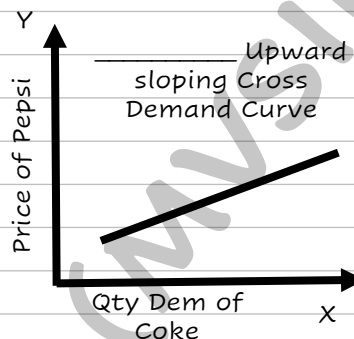
2 Goods are substitutes but have _____ similarity. [E_c is +ve & low]

Eg- Iphone & Samsung Mobile

**Close Substitutes**

2 Goods are substitutes & are _____ similar. [E_c is +ve & high]

Eg- Pepsi & Coke etc.



Chapter 2 - THEORY OF DEMAND & SUPPLY

UNIT 2 – THEORY OF CONSUMER BEHAVIOUR

Introduction

- All **desires, tastes and motives** of human beings are called wants in Economics. Since **resources are limited**, we must **choose** between urgent wants and not so urgent wants.
- **Nature of Human Wants**
 - _____ → never completely satisfied.
 - **Differ in** _____ → Some are **urgent**, others are **less intensely felt**
 - _____ (capable of being satisfied)
 - _____ → resources are scarce in relation to wants.
 - _____ → Some wants satisfied only by using multiple goods together.
 - A particular want may be satisfied in _____ ways
 - Wants are _____ (vary person to person) and _____ (vary with **time & place**)
 - Some wants _____ (non-durable goods) whereas others **do** _____ **occur again** and again (durable goods)
 - Wants may become _____ and _____
 - Wants are affected by **income, taste, fashion, advertisements** and **social norms** and **customs**
 - Wants **arise from** _____ such as **physical** and **psychological** instincts, **social obligations** and individual's **economic and social status**

Classification of Wants

Necessaries	Necessaries for life or existence	Necessary to meet minimum _____ needs → food, clothing & shelter.
	Necessaries for efficiency	Necessities required to maintain _____ energy and efficiency of work. Eg- nourishing food, adequate clothing, clean water etc
	Conventional necessities	Not necessities in reality but arise either due to pressure of _____ or due to compelling _____ & _____.
Comforts	While necessities make life possible comforts make life comfortable and satisfying . Comforts are _____ urgent than necessities. Eg- Tasty and wholesome food, good house, clothes that suit different occasions, audio-visual and labour saving equipments etc.	
Luxuries	Wants which are _____ and expensive . _____ essential for living . Eg- expensive clothing, exclusive motor cars, classy furniture, etc.	

What is Utility ?

- **Utility** to "that **property** in any object, whereby it tends to **produce benefit, advantage, pleasure, good, or happiness**".
- **Utility** → _____ / _____ **satisfaction**
- Commodity **has utility even when it is** _____ **consumed**.
- It is subjective & **varies** with person, time & place. Utility is _____ same thing as **usefulness**.
- From the economic standpoint, **even harmful things** like liquor, may be said to **have utility** because people want them. Concept of utility is **ethically** _____.
- People know utility of goods by means of _____

Utility

Utility hypothesis forms **basis** of **theory of consumer behaviour**

Cardinal Utility Approach	Ordinal Utility Approach
Cardinal Utility is the utility wherein the satisfaction derived by the consumers from the consumption of good or service can be measured _____.	Ordinal Utility states that the satisfaction which a consumer derives _____ be measured numerically . Here utility measured in terms of _____ of preferences of a commodity when compared to each other
Marginal Utility Analysis propounded by _____	Indifference Curve Analysis propounded by _____

Marginal Utility Analysis

- The law of diminishing marginal utility states that → "The _____ **benefit which a person derives from a given increase in the stock of a thing** _____ **with every increase in the stock that he already has.**"
- Since each want is satiable, as a consumer **consumes more and more units** of a good, the **intensity of his want** for the good goes on _____ and a **point** is reached where the consumer **no longer wants it**.

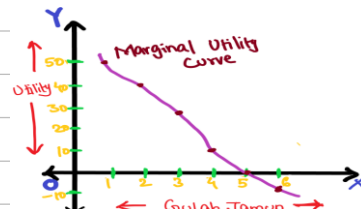
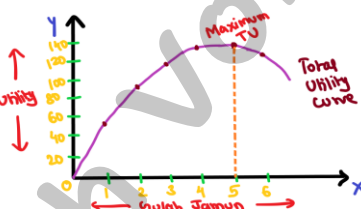
Gulab Jamun	Marginal Utility (MU) (in Utils)	Total Utility (TU) (in Utils)
1 st Piece	50	50
2 nd Piece	40	90
3 rd Piece	28	118
4 th Piece	10	128
5 th Piece	0	128
6 th Piece	-5	123

Observations from above table

- 1) MU can be _____, _____ or _____.
- 2) MU _____ throughout.
- 3) TU rises as long as MU is positive, but at a diminishing rate because MU is diminishing.
- 4) When MU = 0, TU is _____. It is a **satiation point** or **saturation point**. Once this point is reached, consumer would **refuse any extra unit** even if it were free
- 5) When MU is _____, TU is diminishing.
- 6) _____ = Slope of TU.

Total Utility (TU)

- TU is _____ of marginal utilities
- $TU = MU_1 + MU_2 + \dots + MU_n$



Marginal Utility (MU)

- MU is **addition made to TU by consumption of 1 additional (marginal) unit** of a commodity.
- $MU_n = TU_n - TU_{n-1}$

Assumptions of Marginal Utility Analysis

Rationality	Consumer is rational & attempts to attain _____ from his limited money income.
Cardinal Measurability of Utility	Utility is a cardinal concept → _____ & _____ → in utils. Compare different commodities & express which commodity gives him greater utility & by _____
Money is the measuring rod of utility	The _____ of money which a person is _____ for a unit of a good is a measure of utility which he derives.
Other factors 'constant'	Price of commodity, tastes & preferences, income, habits, etc are assumed constant.
Continuity in consumption	_____ or interval between consumption of different units.
Homogenous Units	All units consumed should be _____ in nature. If successive units show variation or are of superior quality , diminishing utility may _____ occur.

Standard Units	Eg- spoonfuls of juice are _____ units & in such cases we could consider the normal units as a glass of juice. Also, the commodity should be _____ in nature.
Constancy of the Marginal Utility of Money	If MU of money changes as income changes , the measuring-rod of utility becomes _____ & thus would be _____ for measurement.
The Hypothesis of Independent Utility	Total utility which a person gets from whole collection of goods is simply the sum total of separate utilities of the goods. The theory _____ complementarity between goods.

Assumptions of Marginal Utility Analysis

Unrealistic assumptions	Assumptions like cardinal measurability of utility , constancy of marginal utility of money , continuous consumption & consumer rationality are unrealistic.
Case of related goods	Utility is _____ independent. Shape of utility curve may be affected by presence or absence of substitutes or complements .
Law is not universal	Exceptions to this law- <ul style="list-style-type: none"> ➤ _____ goods → gold, cash, diamond etc ➤ _____, rare collections etc ➤ People who seek greater _____ & information will be more satisfied with every additional information secured by them. ➤ Creative _____, painting, music, poetry etc ➤ _____ forming commodities → alcohol, cigarettes, & computer games etc. ➤ People with _____ behaviour → as accumulation of every additional unit of money → gives more satisfaction.

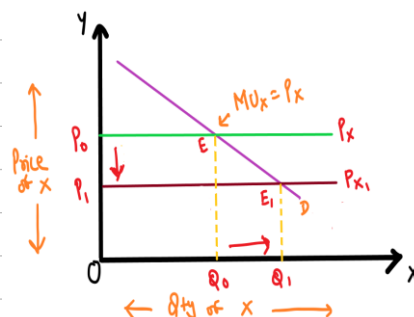
(Not in syllabus, but ICAI asked MCQ on below topic)

Marshallian theory of consumer's behavior is based on- Hypothesis of _____ **utilities** & Hypothesis of _____ **utilities**.

Consumer Equilibrium in Single Commodity Case (Cardinal Approach)

- A consumer will be in **equilibrium** (will be **deriving maximum satisfaction**) in respect of the quantity of **one good** when _____.
- A consumer will **go on** _____ a good **till MU = Price**
- At equilibrium **marginal utility of money spent on X** →

$$MU_m = \frac{MU_x}{P_x} = 1$$
- **When price falls** → **Buy** _____ of good
- **When price rises** → **Buy** _____
 so as to equate the marginal utility to price.
- Thus, we can say that **downward sloping demand curve** is **directly derived** from _____ **curve**.



Law of Equi-Marginal Utility

➤ When **consumer spends** his income on _____ **good** → then consumer equilibrium is explained with **Law of Equi-Marginal utility**.

➤ Consumer will be in **equilibrium** → **spending** money in **such a way** that **MU of each good** is **proportional to its price** & **last rupee spent on each commodity yields him equal MU**.

$$(MU_x / P_x) = (MU_y / P_y) = MU_m$$

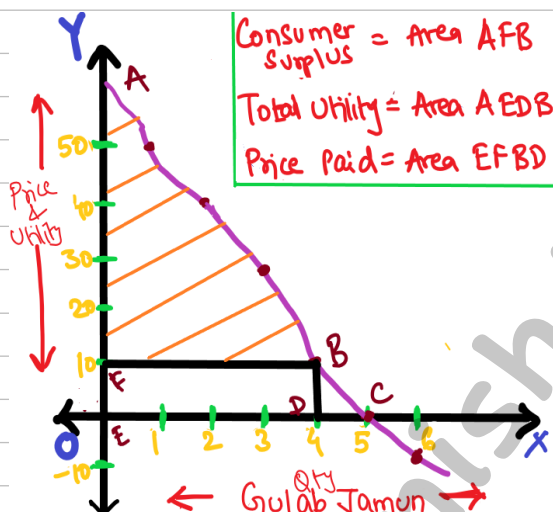
or

$$(MU_x / MU_y) = (P_x / P_y)$$

Consumer Surplus (CS)

Alfred Marshall gave concept of CS.

CS = what consumer is _____ - what he _____ OR CS = _____ - _____



Gulab Jamun	Marginal Utility (MU) (in Utils)	Total Utility (TU) (in Utils)	Price	Consumer Surplus
1st Piece	50	50	10	40
2nd Piece	40	90	10	30
3rd Piece	28	118	10	18
4th Piece	10	128	10	0
5th Piece	0	128	10	-
6th Piece	-5	123	10	-

➤ The concept of consumer's surplus is **derived from the _____**.

➤ _____ of demand curve measures **buyers willingness to pay**.

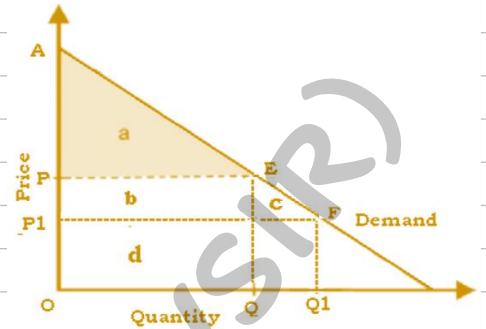
➤ Difference between his willingness to pay and price that he actually pays is _____ **to consumer** called the _____ **consumer surplus**.

➤ _____ **consumer surplus** in a market is **sum of _____ individual consumer surpluses** in market & is equal to **area _____ market demand curve but _____ price**.

Consumer Surplus – New Point

A **fall in price** from P to $P_1 \rightarrow$ increases consumer surplus from APE to AP_1F . **Increase in CS has _____ components-**

- ✓ Increase in CS of _____ **buyers** (rectangle marked by "**b**")
- ✓ CS now available to _____ **buyers** who now started buying due to lower prices (the triangle **c**)



- **Imp Limitation of CS-** In case of **necessaries** \rightarrow CS is always _____

Ordinal Approach

- As per ordinal approach, **Human satisfaction** \rightarrow **psychological phenomenon** & _____ **be measured in monetary terms.**
- It is easier & more sound to _____ **preferences than to measure them** in money terms.

Assumptions of Indifference Curve Analysis

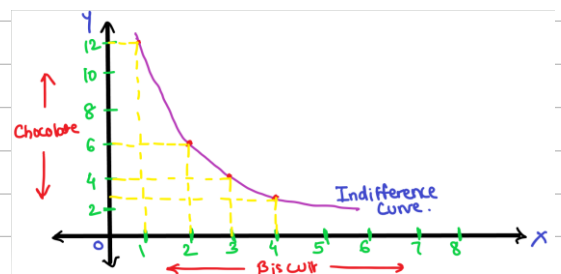
- 1) Consumer _____ **his own tastes & preferences** and **possesses full information**
- 2) Consumer is _____ \rightarrow result in a more preferred consumption bundle over a less preferred bundle.
- 3) Utility is _____ expressible. The consumer is capable of **ranking all conceivable combinations** (But he **cannot tell quantitatively**)
- 4) _____ **choices** \rightarrow If consumer **prefers combi. A to B**, & **B to C**, then he must prefer **A to C**
- 5) If combination **A** has **more commodities** than B, then _____ **must be preferred** to _____.

❖ **(Not in syllabus, but ICAI asked MCQ on below topic)**

- A consumer's preferences are _____, **if & only if** between any two bundles, the consumer prefers the bundle which has-
 - ✓ **More of** _____ of the goods, &
 - ✓ _____ **of the** _____ good
 as compared to the other bundles

Indifference Curve

Combination	Biscuit	Chocolate	MRS
A	1	12	-
B	2	6	6
C	3	4	2
D	4	3	1



- An indifference curve is a curve which represents all those combinations of goods which give _____ satisfaction to consumer.
- If a consumer **equally prefers two product bundles**, then consumer is **indifferent** between the two bundles. An Indifference curve is also called _____ -utility curve or utility curve.

Marginal Rate Of Substitution (MRS)

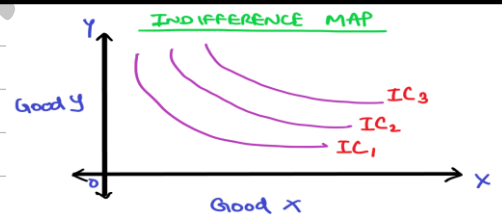
- **MRS of X for Y** → **amount of _____ whose _____ can just be compensated by a unit _____ of _____ in such a manner that the level of satisfaction remains same.**
- MRS is absolute value of _____ of IC
- **$MRS = \Delta Y / \Delta X$** OR **$MRS = MU_x / MU_y$**

❖ Why MRS keeps falling ?

- Wants are _____ → when consumer has more of a good, his **intensity to want more** of it _____.
- Most goods are _____ substitutes of one another.

Indifference Map

- Indifference map → _____ of _____ **indifference curves** where **each curve represents certain level of satisfaction**. (set of ICs)
- It **depicts _____ of consumer's tastes & preferences**.



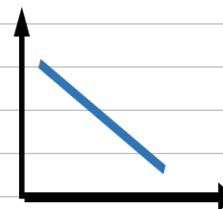
Properties of IC

- 1) Indifference curves **slope _____ to the right**
- 2) Indifference curves are **always _____ to the origin** (since _____ which is slope is _____)
- 3) Indifference curves **can _____ intersect each other** (_____ necessary that they are **parallel** to each other)
- 4) **Higher IC** represents _____ satisfaction
- 5) Indifference curve will _____ touch either axes

Indifference Curve in case of

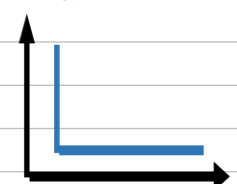
Substitute Goods

- Downward Sloping
- Straight Line
- MRS is constant



Complementary Goods

- L-shaped
- Convex to origin
- 2 straight lines with right angle bent

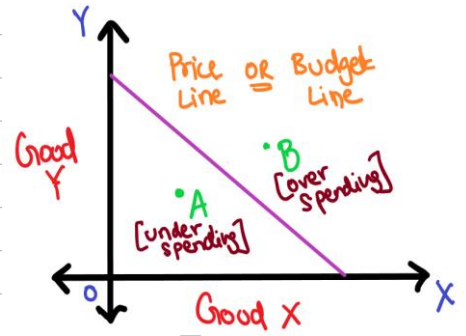


Budget Constraint

- A consumer → **to maximise satisfaction** → try to reach _____ IC.
- But, in his pursuit of **maximizing satisfaction**, he **has to work under _____ constraints**:
 - 1) _____ for goods &
 - 2) Has a _____ money _____
 Thus, a consumer's _____ are _____ by the budget available.
- Algebraically, **budget constraint** for two goods X and Y as → **$[P_x Q_x + P_y Q_y] = B$**

Budget Line (aka. Price Line)

- Budget constraint → explained by budget line
- A **budget line** shows all those **combinations of two goods** which **consumer can buy** spending his **money income** on the two goods at their given prices.
 - ❑ Any point **on BL** → **spends** ____ his money income
 - ❑ Any point **above BL** (pt. B) → ____-spending (**beyond reach**)
 - ❑ Point **within** (below) BL (pt. A) → ____ spending

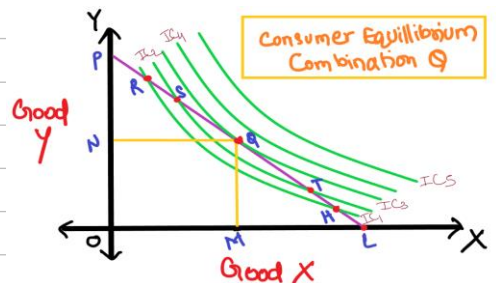


- **Slope of budget line** = ' _____ ' = P_x / P_y
- The budget line will **shift** when there is:
 - ❑ A **change in** _____ of one or both goods, or
 - ❑ A **change in level of** _____ or
 - ❑ A **change in** _____ **income** and **relative prices**

Consumer's Equilibrium (Ordinal Approach)

- Consumer is in **equilibrium** → deriving _____ **satisfaction** & thus is in no position to rearrange his purchases of goods.
- A consumer's optimal choice should satisfy **two criteria** → Equi. point should
 - ✓ Be a **point on his** _____ ; &
 - ✓ Lie on _____ **IC possible**
- Consumer is in equilibrium at '**Combination** _____', where **budget line** PL is _____ to **indifference curve** IC3
- At equilibrium point,

Slope of IC = Slope of BL OR $[MU_x / MU_y] = [P_x / P_y]$

**IC Analysis Vs Utility Analysis**

- ❖ **IC analysis** is **superior** to **utility** analysis:
 - 1) **No assumption** of _____ of **utility**
 - 2) Studies _____ **commodity** at a time
 - 3) Does **not assume** _____ of MU of money
 - 4) _____ **income effect** from **substitution** effect.

Chapter 2 – THEORY OF DEMAND & SUPPLY

Unit 3 – THEORY OF SUPPLY

Introduction

- Demand → Consumer point of view
- Supply → _____ point of view (Sellers can be **individuals, firms & governments**)
- 'Supply' refers to amount of G/S that producers are
 - ✓ _____ and
 - ✓ _____ **to offer** to the market
 - ✓ at various **prices**
 - ✓ during a _____.
- **Three** important things about supply
 - 1) Supply → what a **firm** _____ → not necessarily to what they succeed in selling.
 - 2) Supply is a _____ **concept** → '**so much**' **per unit of time**
 - 3) Supply requires → **willingness & ability** to supply.

Determinants of Supply

- 1) **Price of the good**
Ceterus paribus, price increases → **supply** _____ (since profit increase) & vice versa
- 2) **Price of related goods**
 If a farmer produces & sells wheat and soya. If **price of wheat rises, farmer** may **shift his land to** _____ **production** away from soya (decreasing supply of soya)
- 3) **Prices of factors of production**
Rise in price of factors of prod. → increase in cost of prod. → profit decreases → **supply** _____
- 4) **State of technology**
 Use of **advanced tech** → low cost → **supply** _____
- 5) **Government Policy**
 - **Increase in Taxes** → cost rises → supply _____
 - **Increase in Subsidy** → cost falls → supply _____
 - **Restrictions** → **import quota** or **rationing** on inputs → production **fall** → supply _____
- 6) **Number of sellers, Nature of competition and size of industry**
No. of sellers rise → **Competition** increase → _____ **supply** and vice versa.
- 8) **Expectations**
 An **increase in anticipated future price** → _____ **its supply today**
- 9) **Other Factors**
 - government **policies**,
 - **goals** of firm,
 - infrastructural **facilities**,
 - **natural factors** → weather, floods, earthquake
 - **man-made factors** → war, labour strikes, communal riots etc.

Law of Supply

- Other things remaining constant, **quantity supply** will **increase as price rises** and vice versa.
- The **behavior of supply** is affected by the **time taken** into consideration-
 - ❑ In **short run** → **easy to increase supply**,
 - ❑ In **long run** → can be **adjusted** in response to changes in price.
- Law of supply → explained through **supply schedule** & **supply curve**.

Supply Schedule

_____ presentation of law of supply

	Price (Rs)	Qty Supplied (in units)
A	2	10
B	4	20
C	6	35
D	8	60
E	10	80

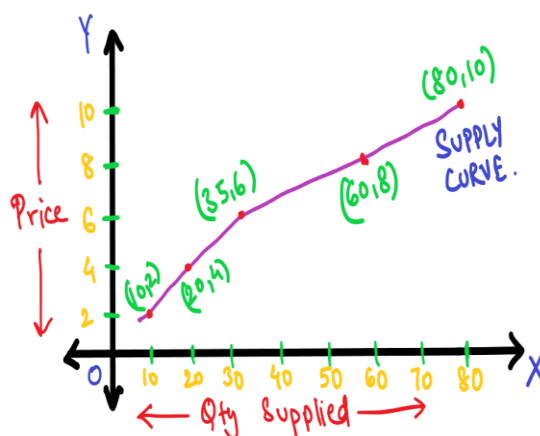
Supply Curve

A supply curve is the _____ **presentation of supply schedule**. Here **price** is plotted on the **Y-axis** & **quantity supplied** on the **X-axis**.

- Supply curve depicts _____ **relation** between **price & qty supplied** → thus it is _____ **sloping**.

- Supply curve shows simultaneously:

- ❑ _____ **quantity willingly supplied** by the suppliers at each price &
- ❑ _____ **price which will induce suppliers** to offer the various quantities for sale



- **Market supply** → sum of supplies of a commodity made by all sellers in a market
- **Market supply curve** → Obtained by adding horizontally the supply curves of various firms.

Changes in Supply vs Quantity Supplied

Supply

Supply refers to **entire relationship** between **price** & **quantity supplied**.

Represented by _____ **supply schedule & curve**.

"Changes in Supply" occur due to **changes in factors** _____ **of good**.

Favourable change in any factor other than price

Increase in Supply → _____ **shift** in supply curve

Eg- Decrease in price of related good, Advance tech, fall in tax etc.

Unfavourable change in any factor other than price

Decrease in Supply → _____ **shift** in supply curve

Eg- Increase in price of related good, Govt restriction, fall in tax etc.

Quantity Supplied

Quantity supplied is the quantity which is supplied at a specific price.

It is represented by a _____ **on the supply curve**.

"Changes in Quantity Supplied" occur due to **changes in** _____ **of goods concerned**.

Increase in price of goods concerned

Expansion or Extension of Supply → _____ **movement** along the same supply curve

Decrease in price of goods concerned

Contraction of Supply → _____ **movement** along the same supply curve

Elasticity of Supply

Elasticity of supply → **Responsiveness of quantity supplied** of a good **to a change in its price**.

Percentage Method

$$\frac{\% \Delta Q_s}{\% \Delta P}$$

OR

$$\frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

OR

$$\frac{1}{\text{Slope}} \times \frac{P}{Q}$$

Point Method

$$\frac{dQ}{dP} \times \frac{P}{Q}$$

Where, dQ/dP = Derivative of qty with respect to a point on supply curve

Arc Method

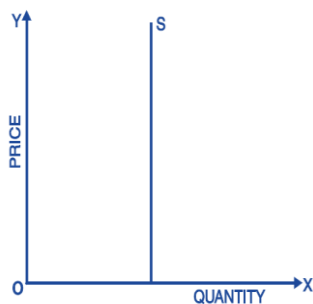
$$\frac{Q_2 - Q_1}{Q_2 + Q_1} \times \frac{P_2 + P_1}{P_2 - P_1}$$

OR

$$\frac{Q_1 - Q_2}{Q_1 + Q_2} \times \frac{P_1 + P_2}{P_1 - P_2}$$

- Value of price elasticity of supply is always _____, since price & qty supplied have direct (positive) relation
- When no method is specified in question → use percentage method.
- Use _____ method
 - When price change is infinitesimal small,
 - When data of Qty supplied is given as an _____
- When price elasticity is to be calculated between two points → use _____ method.

Interpretation of Values of Elasticity of Supply



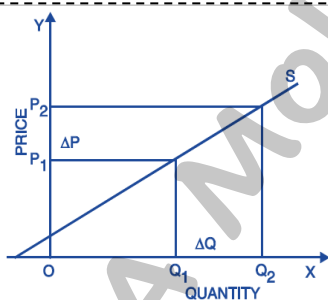
☐ **Perfectly inelastic supply**

☐ $E_s = 0$

☐ _____ Supply Curve

☐ Parallel to _____-axis or Price axis

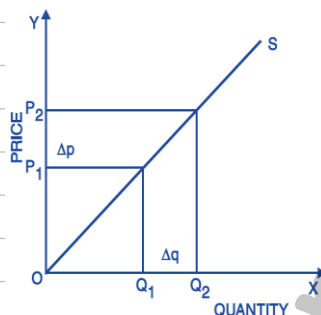
☐ When price changes → $\% \Delta Q = 0$



☐ **Relatively elastic supply ($E_s > 1$)**

☐ _____ Supply Curve

☐ $\% \Delta Q_s > \% \Delta P$

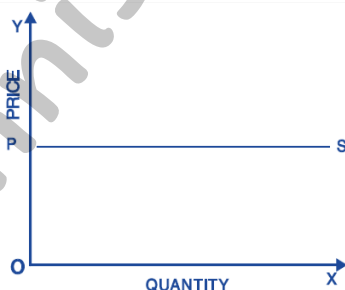


☐ **Unitary Elastic Supply**

☐ $E_p = 1$

☐ Supply Curve → passes through _____ (irrespective of degree with X axis)

☐ $\% \Delta Q = \% \Delta P$



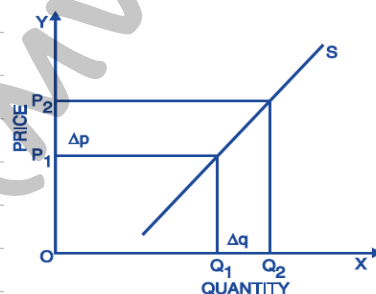
☐ **Perfectly elastic supply**

☐ $E_s = \infty$ (Infinite)

☐ _____ Supply Curve

☐ Parallel to _____-axis or qty axis

☐ **Small increase in price causes supply to rise from zero to an infinitely**

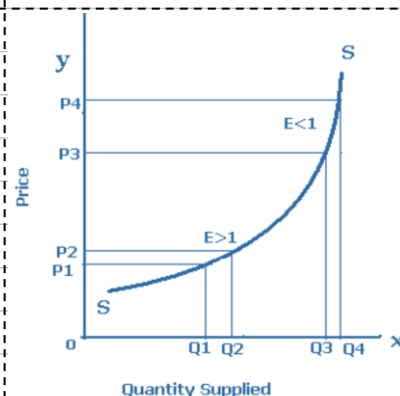


☐ **Relatively inelastic supply**

☐ $E_s < 1$

☐ _____ Supply Curve

☐ $\% \Delta Q_s < \% \Delta P$



If firms have-

☐ **Idle capacity** → _____ supply

☐ Reached their **full capacity** → _____ demand

How to improve price elasticity of supply ?

A business organization generally tries to keep their price elasticity of supply _____ as they want to **earn more profit when prices rise**, or shorten their production when price fall.

To **improve** price elasticity of supply an organisation can-

- ☐ Improve **the** _____ used, such as upgrading equipment
- ☐ Improve _____ **capacity**
- ☐ expanding _____ for stock while making sure that products can last long while stored.

Determinants of Elasticity of Supply

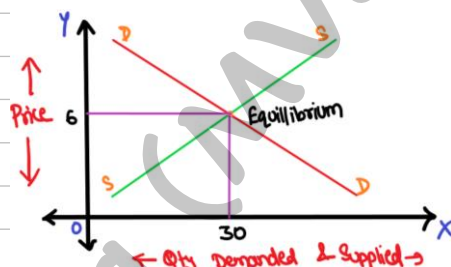
1.	Increase in Production → substantial cost increase → Profit decrease	
	Increase in Production → negligible rise in cost or constant cost	
	Complex production process → require long time to produce (Eg- aircraft, cruise ship)	
2.	If after increase in price → short time period	
	If after increase in price → long time period → build new plants or new firms	
3.	More no. of sellers → More competition → Fewer barriers to entry	
4.	Not working on full capacity → more spare capacity	
5.	Key raw material → easily & cheaply available	
	Procuring resources is difficult or costly	
6.	Raw material & finished goods → easily & cheaply stored → have adequate stock	
7.	Sellers expect → rise in future price	
8.	Inputs → Short in supply → require longer delivery period → highly specialized nature	
9.	Labour → highly skilled → scarce → require longer training period	
10.	Capital & labour → occupationally mobile	
	Products continuously produced	
	Products infrequently produced	

Equilibrium Price

- **Market Equilibrium** is a market situation where,

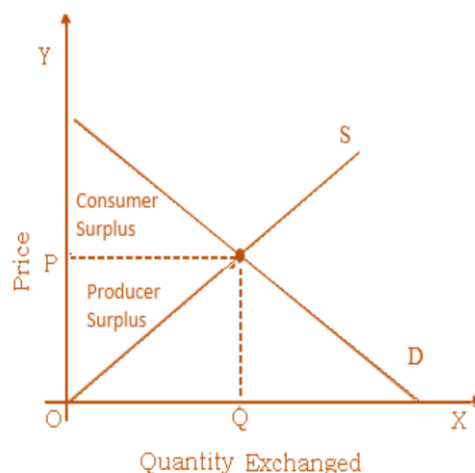
Qty dem Qty supplied
- **Intersection** of **demand & supply** determines **equilibrium price** (aka. **market clearing price**)
- **Determination of market price** is **central theme** of micro economic analysis. Thus, micro-economic theory → aka. _____ theory.

P	Qd	Qs	Impact on Price
8	15	52	
6	30	30	
3	40	18	



Social Efficiency

- **Social efficiency** represents **net gains to society** from **all exchanges** that are made in a particular market. It **is achieved** when both **producers & consumers** enjoying **maximum possible surplus**.
- **Consumer surplus** → measure of **consumer welfare**.
 [MU – Price]
 - ❑ It is represented by **area _____ demand curve & _____ price line**
- **Producer surplus** → **benefit derived by producers** from the **sale of a unit above & beyond their cost of producing that unit**. [SP – Cost]
 - ❑ It is represented by **area _____ supply curve & _____ price line**.



CA Foundation
(New Syllabus)

Business Economics **Abhyaas Notes**

Chapter 3 **Theory of Production & Cost**

By CA Mohnish Vora (MVSIR)

Complete these notes by watching classes of MVSIR

Summary of **Important Points**

Chapter 3 – Theory of Production & Cost

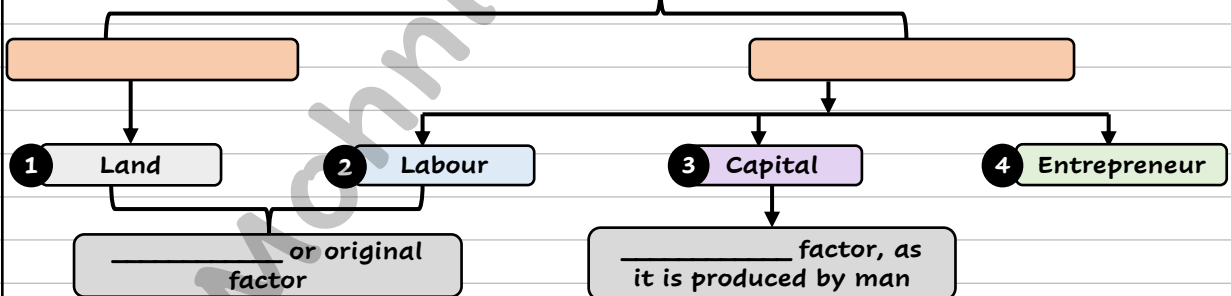
UNIT 1 – THEORY OF PRODUCTION

Basics

- **Production** is a **process** → **man utilises resources** to **transform** them into **goods & services** to **satisfy human wants**. (similar definition given by **James Bates** and **J.R. Parkinson**)
- **Man** _____ **create matter**, but can add utility to resources existing in nature.
- **Production** can also be defined as **creation or addition of** _____.
- **During production we can confer 4 types of utility-**
 - 1) **Form Utility-** **Changing** _____ of things to add utility to it. Eg- Wood to chair.
 - 2) **Place Utility-** **Changing place** of resources **from a place** where they are of _____ to **another place where they are of greater use**. Eg- extraction of minerals from earth, apple from Kashmir to Mumbai etc.
 - 3) **Time Utility-** **Making available** materials **at times** when they are _____. Eg- Canning of seasonal fruits
 - 4) **Personal Utility-** Making use of _____ in form of **services**, e.g., those of organisers, merchants, transport workers etc
- Production **does** _____ **include** **work done within a household** by anyone out of **love and affection, voluntary services** and goods produced for **self consumption**. Eg- Food made by mother in home is NOT production

Factors of Production (Inputs)

An input is a good or service which a **firm buys** for use in its production process.



Land

It refers to soil or earth's surface and to **all** _____ **gifts of** _____ like **natural resources, soil, water, air, light**, etc.

Characteristics of Land

- 1) Land is a **free gift of nature** (____ **human effort** in making it, **no supply price**)
- 2) **Supply** of land is _____
Supply of land is **perfectly inelastic** from view of _____; &
Relatively elastic from the point of view of a _____
- 3) Land is _____ and has **indestructible** powers
- 4) Land is a _____ **factor**
- 5) Land is _____
- 6) Land has _____ **uses**
- 7) Land is _____

Labour

- ❑ All human _____ of mind or body undergone to secure an income apart from pleasure derived directly from work & directed to produce g/s.
- ❑ Human efforts which require use of physical exertion, skill & intellect.
- ❑ Labour must be done with motive of _____ reward. If done out of love & affection or pleasure or love, is _____ labour

Characteristics of Labour

- Labour is _____, requires human effort, _____ factor, _____ from labourer, _____, all labour may not be productive
- Labour power _____ from labourer to labourer
- Labour has _____ bargaining power
- Supply of labour _____ be increased or decreased instantly
- Supply curve of labour- _____ shape

Capital

- **Capital** is '_____ means of production' or 'man-made instruments of production'. It refers to all man made goods (assets) that are a _____ of wealth (total assets) and are used for further production of wealth.
- Eg- Machine tools and instruments, factories, etc.
- **Capital** → _____ concept which yields a periodical income → _____ concept
- Whereas, **wealth** refers to _____ those goods & human qualities, useful in production & which can be passed on for value, only a _____ of wealth can be characterised as **capital** because if these resources are lying idle they will constitute wealth but not capital.

Types of Capital

- 1) **Fixed capital** - _____ nature & renders services over a period of time
- 2) **Circulating capital** - For _____ use and is _____ available for further use. Eg, seeds, fuel, raw materials etc
- 3) **Real (Tangible) capital** - **Physical goods** (can be perceived by senses)
- 4) **Intangible Capital** - Which _____ be perceived by senses. Eg- patents, goodwill etc.
- 5) **Human capital** - **Human skill and ability**
- 6) **Individual capital** - **Personal property**
- 7) **Social capital** - **Belongs to** _____ as a whole in form of roads, bridges, etc.

Capital Formation (aka Investment)

- Capital formation means a **sustained increase in stock of** _____ capital in a country.
- It involves **production of more** _____ like, machines, factories, etc. which are used for further production of other goods.
- To accumulate capital goods → **current consumption has to be sacrificed**.
- _____ consumption → _____ savings & investment (devoted to new capital formation)
- **Higher rate** of capital formation will
 - ✓ enhance production and **productive capacity**,
 - ✓ increase the efficacy of **production efforts**,
 - ✓ accelerate **economic growth** and
 - ✓ add to opportunities for **employment**.

Stages of Capital Formation

- 1)
- 2)
- 3)

Entrepreneur

Entrepreneur is a factor which

- **mobilises other factors** of production,
- **combines them** in right proportion,
- **initiates process of production** and **bears risks** involved in it.

Functions of Entrepreneur

1) _____ **business** enterprise and resource co-ordination

2) **Risk bearing or uncertainty bearing**

- ✓ **Financial** risks & **Technological** risks, **Profit** is **reward**,
- ✓ **Need not bear** the **foreseeable risks** like fire, theft, burglary etc. as these **can be insured** against. But, **uncertainties cannot be insured** against- like change in taste, competition,
- ✓ **Risk bearing** _____ be **delegated**

3) _____ – **Most Important Function**

Enterprise Objectives

1) **Organic objectives**

Basic minimum objective- survival, growth & expansion.

2) **Economic objective**

Profit & sales maximization. As per _____, **four functional goals** in addition to profit goal are-

- i. _____ goal,
- ii. _____ goal,
- iii. _____ goal
- iv. _____ goal

3) **Social objectives**

- Maintain **continuous & sufficient supply of unadulterated goods** & of **standard quality**.
- **Avoid** _____ & **anti-social** practices.
- **Create opportunities** for _____.
- Ensure that output does not cause _____ – **air, water or noise**.

4) **Human objectives**

- Provide _____ **to employees** at different levels
- **Develop new skills & abilities** & provide good **work climate**.
- Provide employees **opportunity** to **participate in decisions** → in matters affecting them.
- Make **job contents interesting** & challenging.
- Secure **loyalty & support**.

5) **National objective**

- **Remove** _____ **of opportunities** & provide fair opportunity to all to work.
- To **produce** according to **national priorities**.
- To help country become **self-reliant** and **avoid dependence** on other nations.
- To **train young men** as apprentices & **contribute in skill formation**.

Enterprise Problems

- | | |
|---|---------------------------|
| 1) Objectives | 5) Organisation structure |
| 2) Location & size of the plant | 6) Marketing |
| 3) Selecting & organising physical facilities | 7) Legal formalities |
| 4) Finance | 8) Industrial Relations |

Production Function

Production function is a mathematical statement of **relationship** between _____ variable (**output**) and _____ variable (**inputs**). [similar definition given by Samuelson]

$$Q = f(\text{Labour, Capital}) = f(L, K)$$

Assumptions of Production Function

- Relationship between inputs and outputs exists for a **specific** _____
- Production **technology** remains _____
- Output** resulting from use of inputs is **at the** _____ **level** (no wastage)

Short Run Production Function

Short-run production function shows **maximum amount** of a good or service that can be produced by set of inputs, **assuming** that amount of _____ of inputs used remains _____.

In short run, **Capital is** _____ and **Labour is** _____.

It is the subject matter of the **law of** _____

Long Run Production Function

A long run production function shows **maximum quantity** of a good or service that can be produced by set of inputs, **assuming** that _____ are _____

It is the subject matter of the **law of** _____

Law of Variable Proportions

Aka. **Law of returns to a** _____ OR **Law of** _____

Law states that as we **increase quantity of one input** (_____) which is combined with other fixed inputs, **marginal product (MP)** of the _____ input must eventually _____.

Assumptions of Law of Variable Proportions

- Production **technology** remains _____
- Must be _____ inputs which are _____ (Short Run)
- Law **does** _____ apply where **factors must be used in** _____ proportions to yield output
- Consider **only** _____ inputs and outputs (unit terms) and not in monetary terms

TP vs AP vs MP

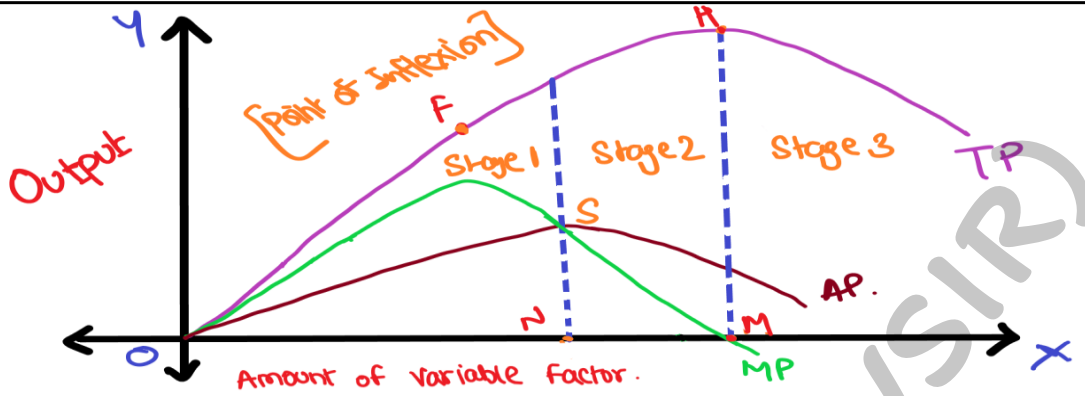
Total Product (TP) : Total output resulting from **efforts of all factors of production combined** together at any time

Average Product (AP) : Total product per unit of the _____

$$AP = TP / \text{No. of Units of Variable Factor}$$

Marginal Product (MP) : Change in TP per unit change in quantity of _____

$$MP = \Delta TP / \Delta Q$$



Stages	TP	MP	AP
1 Increasing Returns	TP increases at _____ rate till POI. After POI, TP increases with _____ rate.	MP rises & is maximum corresponding to POI, and then falls. MP > AP, throughout.	AP is rising. Stage ends= AP is _____ & AP < MP
2 Diminishing Returns	TP increases with decreasing rate. Stage ends= TP is max.	MP is decreasing but positive. Stage ends= MP is _____ MP < AP, throughout.	AP is decreasing but positive.
3 Negative Returns	TP is _____	MP is decreasing & _____.	AP is decreasing but positive.

Relationship between AP & MP

- When AP _____ → MP > AP
- When AP is _____ → MP = AP
- When AP _____ → MP < AP

Stage of Operation

- Never produce in Stage 1 & 3 are → 'economic _____' or 'economic _____'
- Rational producer → Produce in stage _____

Returns to Scale

Occurs in _____ RUN

A **change in scale** means that _____ factors of production are increased or decreased in _____ proportion.

The study of **changes in output** as a consequence of **changes in scale** forms subject matter of **returns to scale**.

Eg- When ALL inputs are increased by 40%

➤ Constant Returns to Scale (CRS)

% Increase in Output = % Increase in Input
Eg; If output increases by 40%, then it is CRS

CRS is also referred to as "_____ Homogeneous Production Function"

➤ Increasing Returns to Scale (IRS)

% Increase in Output > % Increase in Input
Eg; If output increases by 70%, then it is IRS

➤ Decreasing Returns to Scale (DRS)

% Increase in Output < % Increase in Input
Eg; If output increases by 35%, then it is DRS

Cobb-Douglas Production Function

This function **applies** _____ to an individual firm but to _____ of manufacturing _____. **Labour contributed about 3/4th & capital about 1/4th of increase in production**
 Earlier formula..... $Q = K \cdot L^a \cdot C^{(1-a)}$

Later updated the formula..... $Q = K \cdot L^a \cdot C^b$

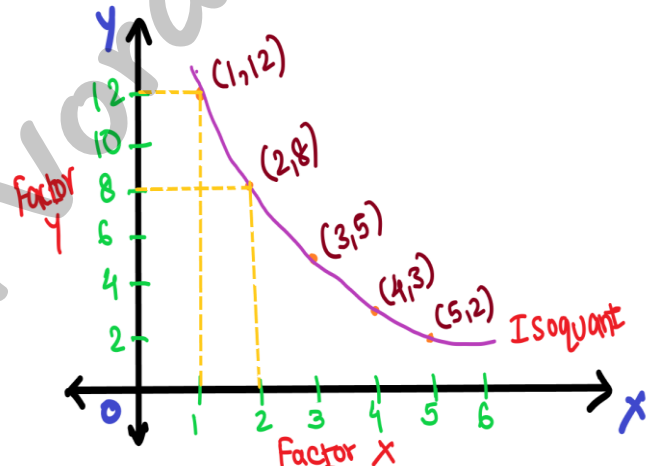
Where 'Q' is output, 'L' the quantity of labour and 'C' the quantity of capital, 'K' and 'a' and 'b' are positive constants.

- $a + b > 1$, _____ returns to scale
- $a + b = 1$, _____ returns to scale
- $a + b < 1$, _____ returns to scale

Isoquants

An isoquant represents **all those combinations** of _____ which can **produce** _____ of **output**. Isoquants are aka : **equal-product curves, production indifference curves** or **iso-product curves**.

Factor combination	Factor X	Factor Y	MRTS
A	1	12	-
B	2	8	4
C	3	5	3
D	4	3	2
E	5	2	1

**Properties of Isoquants-**

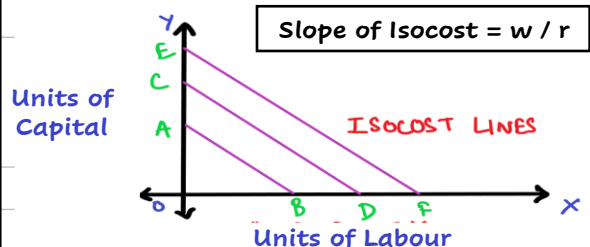
- _____ **sloped**, (Slope of Isoquant = MRTS)
- _____ **to the origin** due to diminishing MRTS
- **Curve on right** → _____ output,
- _____ **intersecting**.

However, one **difference** between isoquant (chp 3) & indifference curve (chp 2) is that in an

- Isoquant → **level of production** is **easily** _____ whereas,
- Indifference curve → _____ **possible to quantify level of** _____

Isocost

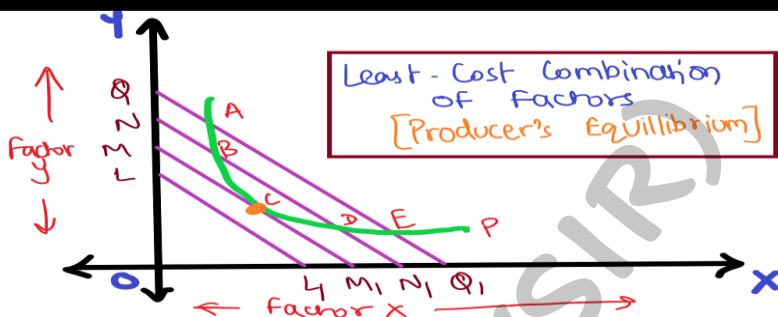
- **Isocost line**, aka. **Equal-Cost Line** or **budget line** or **budget constraint line**,
- It shows various alternative **combinations of two factors** which the **firm can buy with** _____.
- **Whatever be the combination** of factors the firm chooses on isocost line, the **total** _____ to firm remains the _____.



Producer Equilibrium

A producer can produce the desired output at _____ possible cost at equilibrium.

Producer equilibrium will be achieved where **isocost line** is _____ to **isoquant** (at point C)



Chapter 3 – Theory of Production & Cost

UNIT 2 – THEORY OF COST

Cost Analysis

Cost analysis is concerned with the _____ of production relations as against physical aspects which were considered in production analysis.

Cost Concepts**1) Accounting Costs & Economic Costs**

Accounting (Explicit or Outlay) costs → exp. which will **have to be incurred** by firm & **recorded in financial statements**.

$$\text{Economic Cost} = \text{Cost (+)} \quad \text{Cost}$$

Implicit Cost is **cost of using** _____ **factors**.

2) Outlay costs & Opportunity costs

Outlay costs involve **actual expenditure**

Opportunity cost is the **cost of** _____ **alternative opportunity which was foregone** to pursue certain action. It is **cost of the** _____ **opportunity**

3) Traceable (Direct) costs & Non-Traceable (Indirect) costs

Direct costs → **readily** _____ & **traceable** to a **particular product**

Indirect costs → _____ **easily & definitely identifiable**. Eg- Electricity exp, common exp etc.

4) Incremental costs & Sunk costs

Incremental cost → _____ **cost** incurred by a firm **as result of a business decision**

Sunk Costs → costs _____ **incurred once & for all** & _____ **be recovered**. Based on past commitments and _____ **be revised or reversed**. Eg- advertising, R&D etc

5) Historical costs & Replacement costs

Historical cost → **cost incurred in past** on _____ of a **productive asset**

Replacement cost → exp. to **be incurred for replacing an old asset**

6) **Private costs & Social costs**

Private costs → **costs actually incurred** by firms and are either explicit or implicit

Social cost → total **cost borne by _____ on account of a business activity**

$$\text{Social Cost} = \text{Cost (+) Cost}$$

7) **Fixed Costs & Variable costs**

➤ **Fixed or constant** or _____ costs → **do _____ vary with output upto a certain level of activity.**

❑ **Fixed cost (FC)** is a function of _____

❑ If the **firm closes down for some time** in short run → F.C. _____ **be avoided (inescapable)**

❑ _____ → costs which will **continue even after operations are suspended.**

Eg- for **storing of old machines** which cannot be sold in market.

➤ **Variable Costs (VC)** → costs which **vary with the level of output (function of _____)**

❑ If a **firm shuts down** for a short period, then VC _____ avoided

❑ Eg- **wages of labour, prices of raw material, fuel, transportation** cost etc

8) **Semi – Variable Cost**

Costs which are **neither variable nor completely fixed.**

Eg: **Electricity exp, Postpaid Phone Bill** etc

9) **Stair-Step Variable Cost**

Costs which may **increase in a stair-step fashion** → **remain _____ over _____ of output**; but **suddenly _____** to new higher level when output goes beyond a given limit.

Short Run Total Costs

❑ $TC = TFC + TVC$

❑ **Total Fixed Cost curve (TFC)**

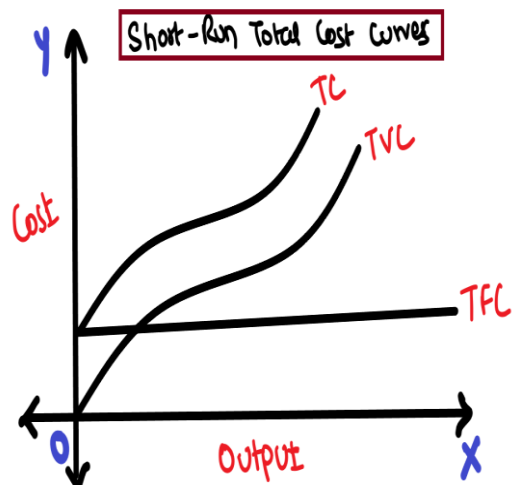
- _____ straight line parallel to X-axis
- Starts from a point on the _____

❑ **Total Variable Cost (TVC)**

- Initially increases at a _____ rate & then at _____ rate. (Inverted-S shaped)

❑ **Total Cost Curve (TC)**

- Obtained by adding vertically the _____ curve & _____ curve.
- Slopes of TC & TVC are _____ (Inverted-S shaped)
- At each point the TC & TVC curves have vertical distance equal to _____.



Short Run Average Costs

Average Fixed Cost curve (AFC)

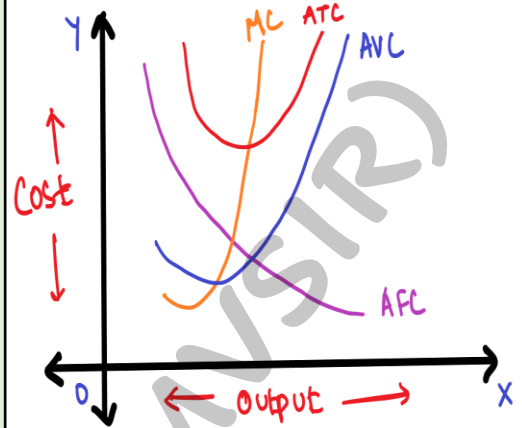
- $AFC = TFC / Q$
- AFC is **fixed cost per unit of output**.
- AFC decreases as **output increases**.
- AFC curve will **slope downwards** throughout its length but will never touch the X-axis as **AFC cannot be zero**. (shape- rectangular hyperbola)

Average Variable Cost (AVC)

- $AVC = TVC / Q$
- AVC curve will **first** fall, then reach a minimum and then rise (U-shaped)

Average Total Cost (ATC or AC)

- $ATC = TC / Q$ or $ATC = AFC + AVC$
- ATC curve will **first fall**, then reach a **minimum** and then **rise** (U-shaped)

**Marginal Cost Curve (MC)**

Marginal cost is **addition made to total cost** by **production of an additional unit** of output.

$$MC = \Delta \text{ in } TC / \Delta \text{ in Output}$$

Or

$$MC = \Delta \text{ in } TVC / \Delta \text{ in Output}$$

- MC is **independent of** output.
- The value of MC comes **due to** the **changes in** total cost.
- MC curve becomes vertical corresponding to **point of inflection** on total cost curve
- MC curve **declines first**, reaches its **minimum** and **then rises** (U shaped)
- MC Curve **intersects AC & AVC** curve at their respective minimum points.

MC & AC

AC falls → $MC < AC$

AC rises → $MC > AC$

AC min. → $MC = AC$

MC & AVC

AVC falls → $MC < AVC$

AVC rises → $MC > AVC$

AVC min. → $MC = AVC$

Long Run Average Cost Curve

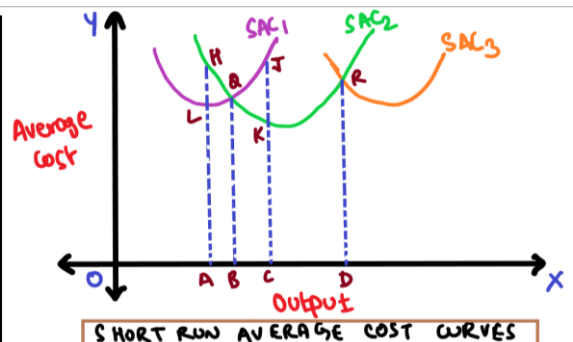
- **Long run** → where **firm can vary all inputs**.
- In long run, firm can **build** any size or scale of plant & thus, can move from one **plant to another**. Long run is infinite horizon.
- A firm **plans for the** long run and **operates in** short run.
- Long run cost of production → **least possible cost** → when all inputs are variable.
- Long run cost curve → **relationship** between **output** & **long run cost of prod.**

How to select a Short Run Average Cost Curve (SAC Curve) in the long run?

SAC Curve is aka. Short Run Average Cost Curve

As per above figure,

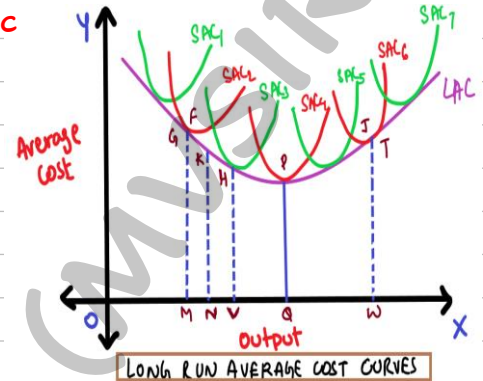
- For making output **upto OB** – use SAC 1
- For output **more than OB**, but **less than OD** – use SAC 2
- For output **more than OD** – use SAC 3



- LAC Curve is aka. _____ Curve or _____ Curve or _____ Curve
- LAC Curve is drawn so as to be _____ to each of the SAC curves
- However, LAC curve is _____ tangent to minimum points of SAC curves

- When LAC curve is declining → tangent to _____ portions of SAC
- When its rising → tangent to _____ portions of SAC

- "OQ" is _____ output → as its produced at minimum point of LAC.
- Production of OQ is done at _____ capacity.
- If producing output less than "OQ", → _____ than its full capacity,
- If outputs larger than OQ → _____ its optimum capacity.



- The falling portion (negatively sloped) region of LAC curve is due- _____ Returns to Scale and _____ of Scale
- The rising portion (positively sloped) region of LAC curve is due- _____ Returns to Scale and _____ of Scale

SCALE OF PRODUCTION

Economies of scale are **cost advantages** that enterprises obtain **due to their** _____, with **cost per unit** of output _____ which causes scale increasing.

Internal Economies

Internal economies accrue to firm when it **expands** _____ output, so that **cost of production** would **come down**.

Internal economies arise purely due to **endogenous** (_____) factors

Internal Economies and Diseconomies

- 1) Technical
- 2) Managerial
- 3) Commercial
- 4) Financial
- 5) Risk bearing

External Economies

External economies are **benefits** accruing **to each member firm** of the industry as a result of _____ of the _____.

They are _____ dependent on the output level of **individual firms**.

External Economies and Diseconomies

- 1) Cheaper raw materials & equipment
- 2) Technological external economies
- 3) Development of skilled labour
- 4) Growth of ancillary industries
- 5) Better transportation & marketing
- 6) Economies of Information

- **External diseconomies** are **disadvantages** that **originate** _____ firm, like in input markets. Eg- **Rise in various factor prices**.
- Moreover, **too many firms in industry** → result in _____ **transportation cost, marketing cost & high pollution control cost**.
- Government's **location policy** can **restrict expansion** of an industry.

- ❖ **Economies of** _____ refers to the **decrease in average total cost** that can occur when a firm produces _____ product. (Asked in ICAI MTP)

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Business Economics **Abhyaas Notes**

Chapter 4 **Price Determination in** **Different Markets**

By CA Mohnish Vora (MVSIR)

Complete these notes by watching classes of MVSIR

Summary of **Important Points**

Economics Chapter 4 – Price Determination in Different Markets

UNIT 1 – MEANING AND TYPES OF MARKETS❖ **From where does the concept of price arises ?**

- _____ - These goods are free or **have zero prices**. They are **_____ in supply** thus **do not have scarcity**. Example: air, sunlight etc
- _____ - They are **scarce** in relation to their demand and have an **opportunity cost**. They are **exchangeable in the market** and command a **price** Eg clothes, mobile phone etc
- _____ signifies the **quantity of money necessary to acquire a good** or service. It is **money-value** → purchasing power expressed in terms of money.
- **Value in exchange** or **exchange value**, according to **Ricardo**, means **command over commodities** or **power in exchange** over purchasable goods in general.

❖ **'Value in Use' and 'Value in Exchange'**

- **Value in use** refers to **usefulness or utility** i.e, attribute which a thing has to satisfy human needs
- **Value in exchange** or **economic value** is **amount of goods** and services which we may obtained in market **in exchange** of a particular thing.
- In Economics, we are **only concerned with _____**. Considerations such as **sentimental value** is **not considered**, as it is subjective.

❖ **Meaning of Market**

- Exchange value is determined in the **market** where exchange of goods and services takes place
- A market is a **collection of _____ and _____** with the **potential to trade**.
- A market **need _____ be formal** or held in a particular place. Eg- 2nd hand goods are often sold through listing it in an online websites. (OLX, Quikr etc)
- **Elements of Markets**
 - 1) _____ and _____;
 - 2) A **product** or service;
 - 3) _____ for a price;
 - 4) **Knowledge** about market conditions; (rational buyers & sellers) and
 - 5) _____ for a product/service at a given time.

❖ **Classification of Markets**➤ **I) General Classification**

- a) _____ - Market in which **firms buy the resources (inputs)** to **produce G/S**. They **allocate productive resources to _____**. Prices in factor markets – **factor prices**.
- b) _____ - Markets in which **households buy G/S they want from firms**. They **allocate goods to _____**.

➤ **II) Geographical Area Classification**

- a) _____ - Here buyers & sellers are **limited to a local area or region**, **Highly _____ goods & _____ articles**, (transport of over long distance is uneconomical) are sold here. Also it is **limited to a particular _____**. Eg- locally supplied services - **hair dressers & retailers**.

❖ Classification of Markets➤ II) Geographical Area Classification

- b) _____ Market – They cover a _____ area such as a few _____ cities, parts of states etc.
Eg- **Mekhela Chador** (Assamese Saree), Yewle Tea etc.
- c) _____ Market – When demand is limited to _____ of a country. The _____ of government may restrict trading of a commodity to within country.
Eg- **Hindi books** – national markets in India.
- d) _____ Market – _____ value & _____ bulk commodities are demanded and traded internationally.
Eg- **Gold** and **Silver**.

Above classification has become _____ as in modern days even perishable goods have international market.

➤ III) Regulation

- a) _____ Market – Here transactions are _____ regulated, to put an end to unfair practices. Eg. Stock exchange
- b) _____ Market – Aka. free market – no stipulations on transactions. Eg- Weekly (Haat) Baazaars.

➤ IV) Time

_____ conceived the 'Time' element in markets

- a) **Very Short Period Market** – Aka. _____ period –here supply is _____ - cannot be increased or decreased.
Eg- **perishable goods**- vegetables,, fish, milk, etc
Since supply is _____, very short period price is dependent on _____.
- b) **Short Period Market** – Slightly longer than very short period. Here, supply can be _____ adjusted.
- c) **Long-period Market** – In long period, all factors become _____ and supply can be _____ to changes in demand by altering scale of production. The interaction between long run supply and demand determines long run equilibrium price or 'normal price'.
- d) **Very long-period Market** – Aka. _____ period

➤ V) Nature of Transaction

- a) _____ or **Cash Market**- Goods are exchanged for money payable either immediately or within short span of time
- b) _____ or **Future Market**- Transactions involve contracts with a promise to pay and deliver goods at some future date

➤ VI) Volume of Business

- a) _____ Market- Goods are sold in _____ or large quantities. Transactions between _____ (B2B)
- b) _____ Market- Goods are sold in _____ quantities. This is the market for ultimate _____ (B2C)

❖ Classification of Markets➤ VII) Competition

Assumptions	Market Types			
	Perfect Competition	Monopolistic Competition	Oligopoly	Monopoly
Number of Sellers	Very Large	Large	Small Numbers	One
Product Differentiation	None	Slight	None to substantial	
Price Elasticity of Demand of firm		Large	Small	Small
Degree of control over price	None	Some	Some	Very Considerable

❖ Concepts of TR, AR & MRI) Total Revenue (TR)

➤ **Amount** of money which a **firm realises by selling a commodity**. [$TR = \underline{\hspace{2cm}}$]

II) Average Revenue (AR)

➤ AR is **revenue earned per unit of output**.

➤ **AR = Price = $\underline{\hspace{2cm}}$**

➤ Also, **AR curve = $\underline{\hspace{2cm}}$ Curve** of firm

III) Marginal Revenue (MR)

➤ MR is **change in TR resulting from sale of an additional unit of commodity**.

➤ MR is $\underline{\hspace{2cm}}$ of TR

$$MR = \underline{\hspace{2cm}} \quad \text{or} \quad MR_n = TR_n - TR_{n-1} \quad \text{or} \quad MR = dTR / dQ$$

AR = Price → Happens in ALL types of market

AR = Price = MR → ONLY in Perfect Comp.

❖ TR, AR & MR in Imperfect Competition

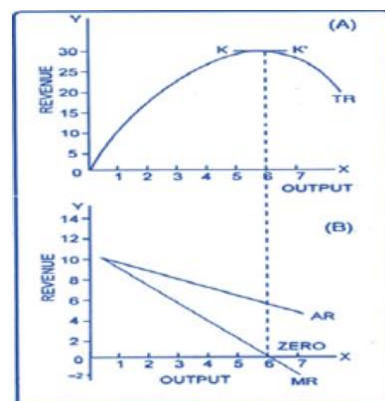
➤ AR curve slopes downwards → AR (Price) is **falling** → inverse relationship between price & qty dem

➤ **MR < AR** → MR declines $\underline{\hspace{2cm}}$ rapidly than AR → because any reduction in price **applies to $\underline{\hspace{2cm}}$ units sold**.

➤ TR $\underline{\hspace{2cm}}$ when MR is +ve & TR $\underline{\hspace{2cm}}$ when MR is -ve

➤ TR initially increases at $\underline{\hspace{2cm}}$ rate due to diminishing MR & reaches maximum & then it falls. ($\underline{\hspace{2cm}}$ shaped)

➤ When MR (Slope of TR) = $\underline{\hspace{2cm}}$, TR = maximum

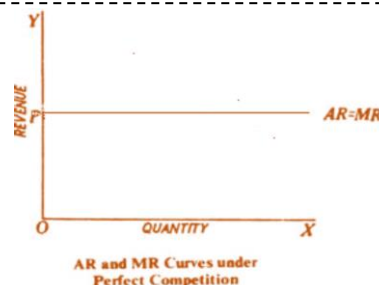
❖ TR, AR & MR in Perfect Competition

➤ **Constant average revenue** (or price) schedule

➤ AR = Price = $\underline{\hspace{2cm}}$

➤ AR Curve = $\underline{\hspace{2cm}}$ Curve = MR Curve → Horizontal straight line parallel to X axis → $\underline{\hspace{2cm}}$ demand ($E_p = \infty$)

➤ TR will be upward sloping straight line



❖ Relationship → AR, MR, TR & Price Elasticity of Demand

MR = AR x _____ OR **MR = AR x _____**

Portion of Demand Curve	Value of e	MR	TR
Mid Point	$e = 1$		
Upper	$e > 1$		
Lower	$e < 1$		

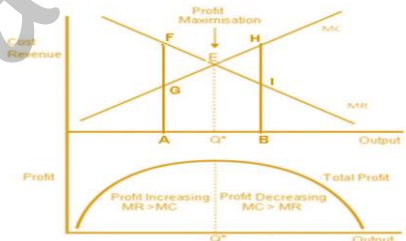
❖ Behavioural Principles

Principle 1

- A firm should **_____ produce** at all if its **total _____ costs** are **not met** ($TR \leq TVC$)
- **When AR = _____ → Shutdown point**
- Shutting down is _____ & does _____ mean going out of business.
- **At shut down point :**
 - ☐ Price is equal to _____
 - ☐ TR = _____
 - ☐ Total loss = _____

Principle 2

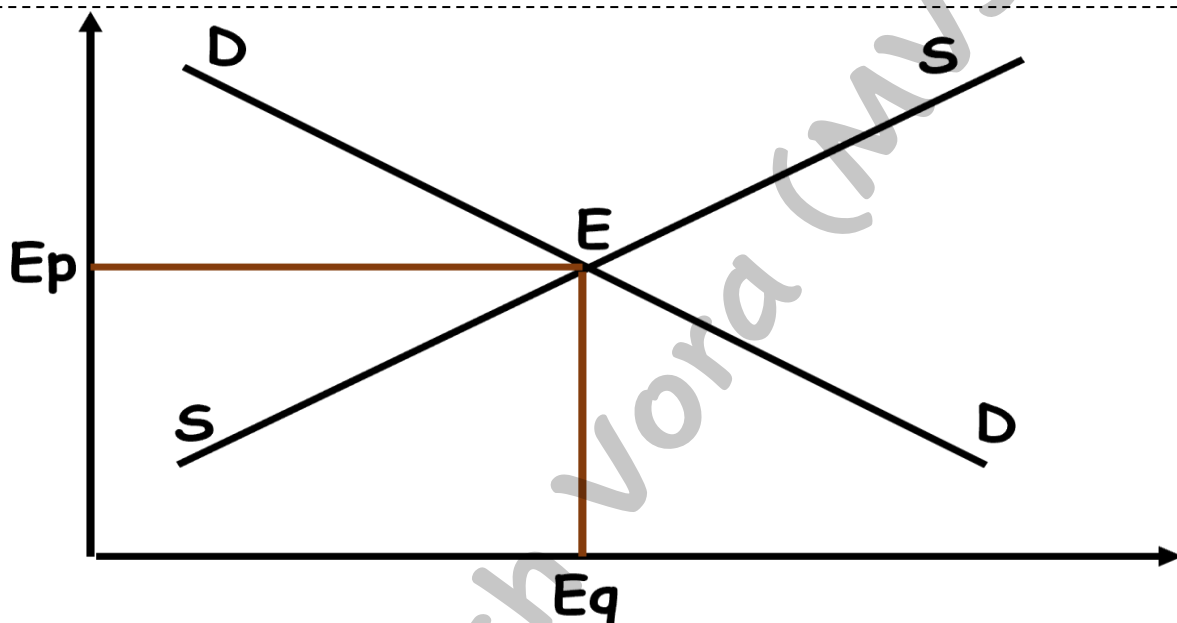
A firm will **maximum profits** (or minimize losses) at _____



UNIT 2 – MEANING AND TYPES OF MARKETS

S. No	Situation	Effect	Diagram
1.	Mkt Price > Equi Price i.e., $Q_s > Q_d$ (Surplus)	Pressure on Price Qty Supplied _____creases & Qty Demanded _____creases Upto Equilibrium	
2.	Mkt Price < Equi Price i.e., $Q_s < Q_d$ (Shortage)	Pressure on Price Qty Supplied _____creases & Qty Demanded _____creases Upto Equilibrium	

S. No.	Situation	Effect	
		Equi Price	Equi Qty
3.	Increase in Demand	Increase	
4.	Decrease in Demand	Decrease	
5.	Increase in Supply		Increase
6.	Decrease in Supply	Increase	

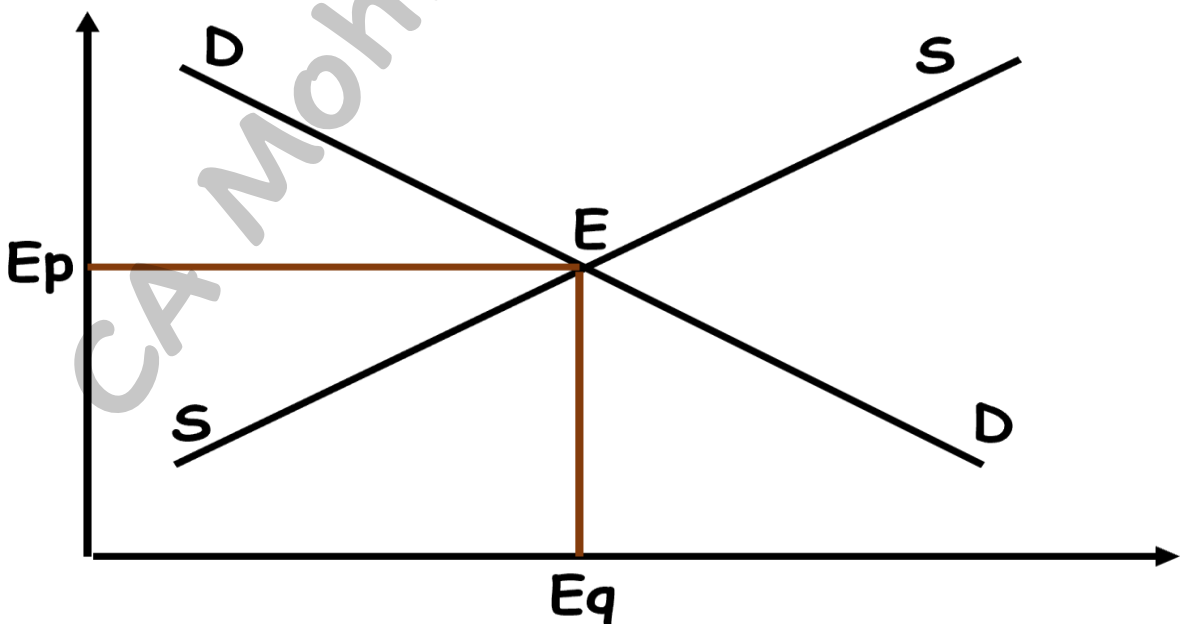


S. No.	Situation	Effect	
		Equi Price	Equi Qty
7.	Increase in Demand is equal to Increase in Supply		Increase
8.	Increase in Demand is greater than Increase in Supply		Increase
9.	Increase in Demand is less than Increase in Supply		Increase
10.	Decrease in Demand is equal to Decrease in Supply		Decrease
11.	Decrease in Demand is greater than Decrease in Supply		Decrease
12.	Decrease in Demand is less than Decrease in Supply		Decrease

- When **both demand & supply increase**, but no other data given → then **EQ _____**, but effect on EP cannot be determined
- Similarly, when **both demand & supply decrease**, but no other data given → then **EQ _____**, but effect on EP cannot be determined

S. No.	Situation	Effect	
		Equi Price	Equi Qty
13.	Increase in Demand is equal to Decrease in Supply	Increases	
14.	Increase in Demand is greater than Decrease in Supply	Increases	
15.	Increase in Demand is less than Decrease in Supply	Increases	
16.	Decrease in Demand is equal to Increase in Supply	Decreases	
17.	Decrease in Demand is less than Increase in Supply	Decreases	
18.	Decrease in Demand is greater than Increase in Supply	Decreases	

- When **demand incr & supply decr** → **EP _____** but effect on EQ cannot be determined
- When **demand decr & supply incr** → **EP _____** but effect on EQ cannot be determined



UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

❖ **Market structure** → the way sellers & buyers interact to determine equilibrium price and quantity. It determines a firm's power to fix the price of its product. [Bargaining Power]

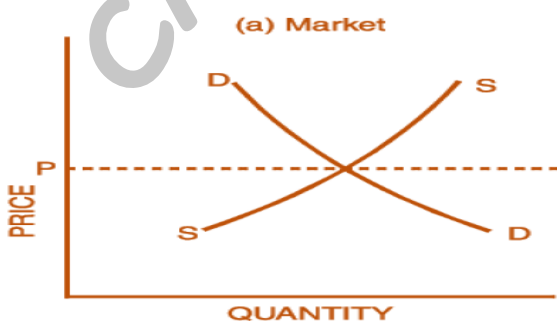
❖ **1) Perfect Competition**

Features / Characteristics of Perfect Competition		
1	Large number of buyers and sellers	➤ Share of each seller & buyer in market → is too small → _____ to influence price, demand or supply
2	Homogenous or Identical Products	➤ _____ substitutes ➤ Buyers have _____ preference between different sellers and different units of goods
3	Free Entry & Exit	➤ _____ legal or market related barriers to entry & no special costs to enter an industry.
Above 3 characteristics are conditions for _____ competition		
4	Perfect knowledge of market condition	➤ Both buyers and sellers have all information relevant to their decision to buy or sell
5	Very low transaction costs	➤ Buyers and sellers do not have to spend much time and money finding each other ➤ _____ advertisement required.
6	All firms individually are price takers	➤ Firms _____ price determined by market forces ➤ Price taking applies to consumers as well ➤ There is perfect knowledge and perfect mobility , if any seller raises his price , he would lose his customers .

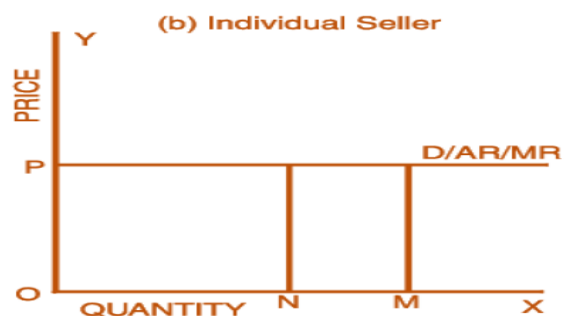
➤ Perfect comp is a _____. Eg- **agricultural products**, financial instruments (**stock**, bonds, **foreign exchange**), precious metals (gold, silver, platinum)
the above examples **approach the condition of perfect competition**

Equilibrium of PC Industry in Short Run

- **Industry** → large number of independent firms in similar business
- When **total output (Mkt supply) of industry** is equal to **total demand (Mkt Demand)** → industry is in **equilibrium** in short run

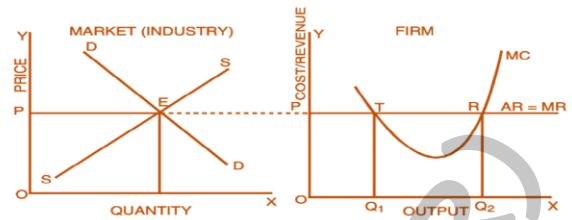
**Equilibrium of PC Firm**

- Firm is in equilibrium → **maximizes its profit**.
- **Output which gives maximum profit** to the firm is called **equilibrium output**. In the equilibrium state, the firm has **no incentive** either to **increase or decrease its output**.
- PC Firms are _____. They _____ **price determined by market forces**.
- Demand curve of each PC firm is _____
- In PC firm, **MC curve above AVC** has identical shape of firm's _____ curve.



Conditions for Equilibrium of PC Firm in Short Run

- 1st order condition → _____
- 2nd order condition → **MC curve** should **cut MR curve from _____** (MC → _____ slope)

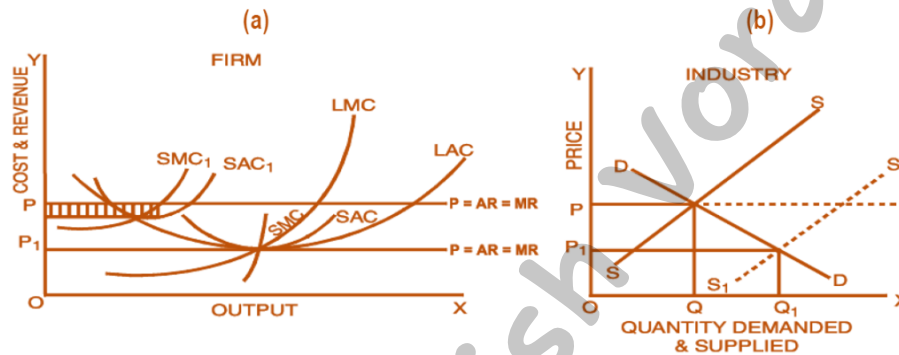


❖ A PC firm can in short run-

- ❑ **Normal Profit** → _____ or
- ❑ **Super Normal Profit** → _____ or
- ❑ **Losses** → _____

Equilibrium of PC Firm in Long Run

- In long run → firms can alter scale of operation & freely enter/exit PC industry.
- PC firms are in **long run equilibrium** → when they have **adjusted their plant to produce at _____ of their LAC curve**, which is **tangent to the demand curve** defined by the market price.
- In **long run**, all PC firms → **earn just _____ profits**, which are included in the ATC.



- The **condition** for **long run equilibrium of PC firm** is that **MC = Price (AR)** and **MC = LAC**

- At equilibrium, **SMC = LMC = SAC = LAC = P = MR**

Equilibrium of PC Industry in Long Run

❖ **Three conditions:**

- 1) _____ **firms** in industry are in _____ (**maximizing profit**)
- 2) **No firm** has **incentive** either to _____ → **all firms are earn normal profit**
- 3) **Price** is such that **mkt supply = mkt demand**

❖ A firm producing output at optimum cost (min pt of LAC) → **optimum firm**. In long run, **all PC firms** are _____ **firms** having _____ **size**

❖ Thus, under PC, in long run → market mechanism leads to **optimal allocation of resources** which is shown by-

- (a) Output is produced at _____ **feasible cost**.
- (b) Consumers pay minimum possible price → _____
- (c) Plants used at full capacity → no wastage of resources i.e. _____
- (d) Firms earn **only normal profits** i.e. _____
- (e) Firms **maximize profits** (i.e. _____), but level of profits → normal.
- (f) There is **optimum number of firms** in the industry.

❖ In other words, in the long run,

$$\text{LAR} = \text{LMR} = P = \text{LMC} = \text{LAC} \rightarrow \text{optimum allocation of resources.}$$

❖ **II) Monopoly**

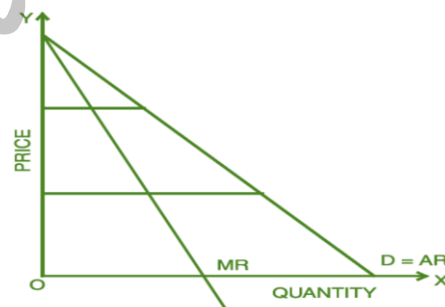
- 'Monopoly' = "_____ to sell" → **single seller** of product which has _____ **close substitute**.
- **Pure monopoly** is _____ found in practice. However, in _____ such as **transport, water & electricity**, we may find monopoly market.

❖ **Features of Monopoly**

1	Single seller of product	<ul style="list-style-type: none"> Only one firm producing or supplying a product. _____ distinction between firm and industry (absence of competition)
2	Barriers to Entry	<ul style="list-style-type: none"> _____ barriers to entry which could be economic, institutional, legal or artificial.
3	Market power	<ul style="list-style-type: none"> Monopoly firm has ability to charge a price _____ MC and earn a positive profit ($AR > MC$)
4	No close substitutes	<ul style="list-style-type: none"> Monopoly firm has control over market _____ (price _____) Sells a product which has _____ close substitutes. Cross elasticity of demand = _____. Price elasticity of demand is _____ 1. _____ downward sloping demand curve.

❖ **Monopolist's Revenue Curves**

- AR & MR **both** are _____ sloping curves.
- Slope of _____ = 2 x Slope of _____
- **MR curve lies half-way** between **AR curve & Y axis**. i.e. it **cuts** horizontal line between Y axis & AR into _____ **parts**
- **AR** _____ **be zero**, but **MR** can be **zero or even negative**.

❖ **Monopolies are mainly of two types****1) Simple monopoly**

Here the monopolist charges _____ **price** from all buyers

For eg, Indian Railways charging same fare from all AC 3Tier passengers

2) Discriminating monopoly

Monopolist **charges** _____ **prices** from **different buyers** of same good/service

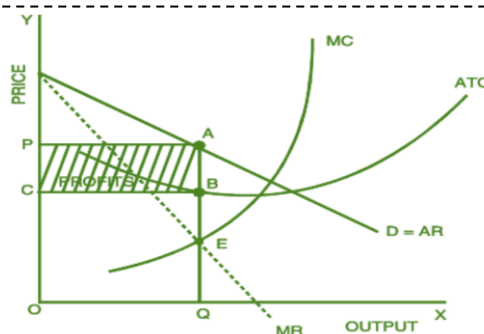
For eg. Dynamic fare charged by Indian Railways in specific trains.

❖ **Conditions for Equilibrium of Monopoly in Short Run**

- 2 conditions → _____ and MC should cut MR from _____
- Can a monopolist incur losses in short run? YES, if _____
 - ☐ **Should firm shutdown in such case ?**
 - ☐ It depends, If _____, then shutdown or else continue

❖ **Equilibrium of Monopoly in Long Run**

- In **absence of competition**, monopolist _____ produce at **optimal level**. He can **produce at a sub-optimal scale** also.
- He _____ reach minimum of LAC curve; he **can stop at any point** on the LAC where his profits are maximum.
- **Monopolist will** _____ **continue** if → **losses in long run**.
- He will **continue** to make _____ profits even in **long run** as **entry of outside firms** is _____.



❖ **Price Discrimination**

- Price discrimination occurs when **producer sells** specific G/S to **different buyers** at **two or more _____ prices** for **reasons _____ associated with difference in cost**.
- Adopted by a **monopolist** → **to earn _____ profits**.
- Price discrimination **cannot persist under _____** as they have no influence over price.

❖ **Conditions for Price Discrimination**

- 1) **Seller** should have **some _____** of his product (**price-setting power**)
- 2) Seller should be **able to divide his market** into **_____ sub-markets**.
- 3) **Price-elasticity** of product should be **_____ in different sub-markets**.
Charge **_____ price** → for buyers having **inelastic demand**
Charges **_____ price** → for buyers having **elastic demand**
- 4) **Not be possible** for **buyers of _____-priced market** to **resell** to **buyers of _____-priced market (no market arbitrage)**

❖ **Degrees for Price Discrimination by _____**

_____ Degree (Customer Wise)	Separating market into each individual consumer & charge them different prices (extract _____ consumer surplus) Eg- Doctors, lawyers, consultants etc., charging different fees, prices decided, auctions
_____ Degree (Quantity wise)	There are two possibilities here: 1) Larger quantities available at _____ unit price . Eg- family pack of soaps or biscuits tends to cost less per kg than smaller packs . 2) Each consumer pays different price for consecutive purchases . Eg- mobile sim service → charge higher internet prices when consumption exceeds a particular limit.
_____ Degree (Attribute wise)	Price varies by attributes → location or customer segment . Divide consumers into separate sub-markets & charge _____ prices in different sub-markets . Eg- Dumping , charging different prices for domestic and commercial uses, lower prices in railways for senior citizens , etc.

❖ **III) Monopolistic Competition**

- **Large no. of sellers** selling **_____ (similar but _____ identical)** products → to **attract customers** on some basis **other than price**.
- Eg of monopolistic market- **soaps, detergent, toothpaste** etc

Features of Monopolistic Competition		
1	Large no. of sellers	Large number of sellers → small share in mkt
2	Product differentiation	Products → differentiated on basis of _____ → _____ substitutes → demand is _____ . Firms use size, design, colour, shape, performance, features, packaging & promotional techniques to make their products different. (may be true or fancied)
3	Freedom of entry/ exit	Firms are _____ to enter or exit the market
4	Non-price competition	They indulge in aggressive advertising, product development, efficient after-sales service etc. _____ price wars → throw few firms out of market or reduce profit

❖ In Monopolistic Competition

➤ Since **product is differentiated** → each firm makes **independent decisions** about **price & output**.

➤ Each firm → **price** _____ → some control on price due to prod diff.

Less differentiation → More Similar to other products → More Substitutability → More Elastic Demand → Flatter Demand Curve

❖ Conditions for Equilibrium of Monopolistic Competition in Short Run

➤ 2 conditions → _____ and MC should cut MR from _____

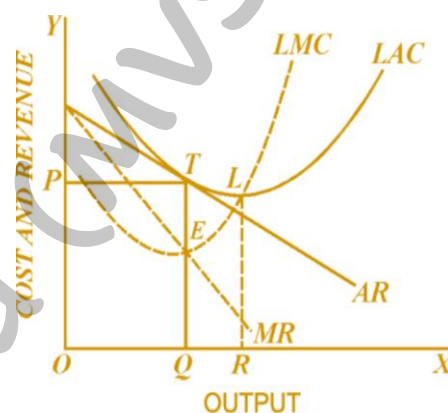
❖ Equilibrium of Monopolistic Competition in Long Run

➤ In long run → **all monopolistic comp. firms** → earn only _____

➤ At equi. → _____ produce at min point of LAC → **do not fully realize economies of large scale** prod → **not used to optimum capacity**.

➤ Any **attempt to produce more** → _____
→ fall in AR fall in AC

➤ Long run equilibrium → produce at _____
portion of LAC curve → producing _____
quantity than its full capacity level → leading to _____
capacity.

❖ IV) Oligopoly

➤ Oligopoly → '**competition among** _____' (2 to 10 firms)

➤ Prof. _____ defines oligopoly → "situation in which **a firm bases its market policy**, in part, **on expected behaviour of a few close rivals**".

➤ Eg of Oligopoly- _____, **automobile, Airlines, petroleum refining, power generation**, _____ & **Internet service providers** etc.

Features of Oligopoly

Strategic Interdependence	Each seller is big enough to influence market . A firm must _____ to its rivals' actions , and simultaneously rivals also respond to the firm's actions .
Importance of advertising and selling costs	Firms use aggressive & defensive marketing weapons to gain greater market share . Firms avoid price cutting & _____ compete on non-price basis
Group Behaviour	No generally accepted theory of group behaviour. Firms may agree to pull together as a group in promotion of their common interest. May or may not have a leader.

Types of Oligopoly

1	Pure oligopoly or perfect oligopoly occurs when the product is _____ in nature, e.g. Aluminium industry. It tends to process _____ (intermediate goods) that are used as _____ by other industries . Eg- are petroleum, steel, and aluminium
	Differentiated or imperfect oligopoly occurs when goods sold is based on product differentiation , e.g. _____ powder.
2	_____ oligopoly → new firms can enter market & compete with existing firms.
	In _____ oligopoly entry is restricted .

Types of Oligopoly

3	When few firms of oligopoly market come to common understanding or act in collusion → _____ price or output or both , it is collusive oligopoly .
	When there is _____ of such an understanding among the firms and they compete with each other, it is called competitive oligopoly .
4	Oligopoly is partial when industry is dominated by _____ large firm → looked upon as _____ of group. Dominating firm will be _____
	Full oligopoly → _____ of price leadership.
5	_____ oligopoly → Firms _____ their products through a centralized syndicate .
	_____ oligopoly → Firms organize themselves into a _____ for fixing prices, output, quotas , etc.

❖ Price & output Decision in Oligopoly

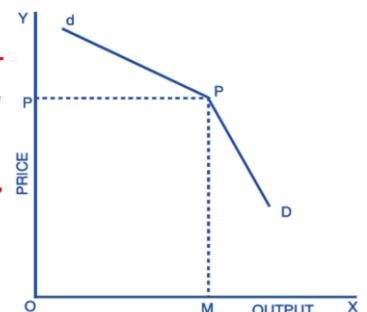
- An oligopoly firm _____ have **sure & determinate demand curve**, since **demand curve keeps** _____ as **rivals change their price in reaction** to price change made by a firm.
- Now, what **price & output** to be fixed **cannot be ascertained**.
- However, economist have given some **price-output models**
 - 1) **Ignore** firm's **inter dependence**
 - 2) **a) _____ model** → firms' **control variable** is **output**. They do **not collude**.
 - 2) **b) _____ model** → **leader commits** to an output → rest of firms are **followers**
 - 3) **c) _____ model** → **price** is **control variable**
 - 4) **Enter into agreement** and **pursue common interests**. Eg- OPEC

❖ Price Leadership

- _____ → A group of firms that explicitly **agree (collude) to coordinate their activities** → leads to **high market power & earn monopoly profits**
- But it is possible that there is a dominant firm **surrounded by many small firms (fringe firms)**. These firms are too **unreliable** → **large firm** then **decides how to set its price**
- 1) **Live and let live philosophy** → **Dominant firm accepts presence of fringe firms** and **sets price to maximize its profit** (price-leadership by dominant firm) – [TTMM]
- 2) **Price leadership by low cost firm** → **Price leader sets price** in a manner that it **allows some profits to followers also**.
- 3) **Barometric price leadership** → An **old or most respected firm acts as a leader** and **assesses market conditions** about demand, cost, competition etc. and **makes changes in price** which are **best from view point of all firms**.

❖ Kinked Demand Curve

- As per _____, prices in oligopoly **remain** _____ or **inflexible**.
- _____ under oligopoly is explained by **kinked demand curve hypothesis** (_____ 's Model)
- Kinked demand curve → '**kink**' at level of _____ price.
- ❑ **segment** of demand curve **above prevailing price** is **highly** _____ (when firm raises price, competitors do not follow)
- ❑ **segment** of demand curve **below prevailing price** is _____ (when firm decreases price, competitors will follow)



❖ **Other Market Forms**

	A subset of oligopoly where there are only two firms in market.
	Market where there is single buyer of G/S & is applicable to factor markets in which a single firm is the only buyer of a factor.
	Market where there is a small number of large buyers & is relevant to factor markets .
	Market structure where there is only a single buyer and a single seller i.e. it is combination of _____ market & a _____ market

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Business Economics **Abhyaas Notes**

Chapter 5 **Business Cycles**

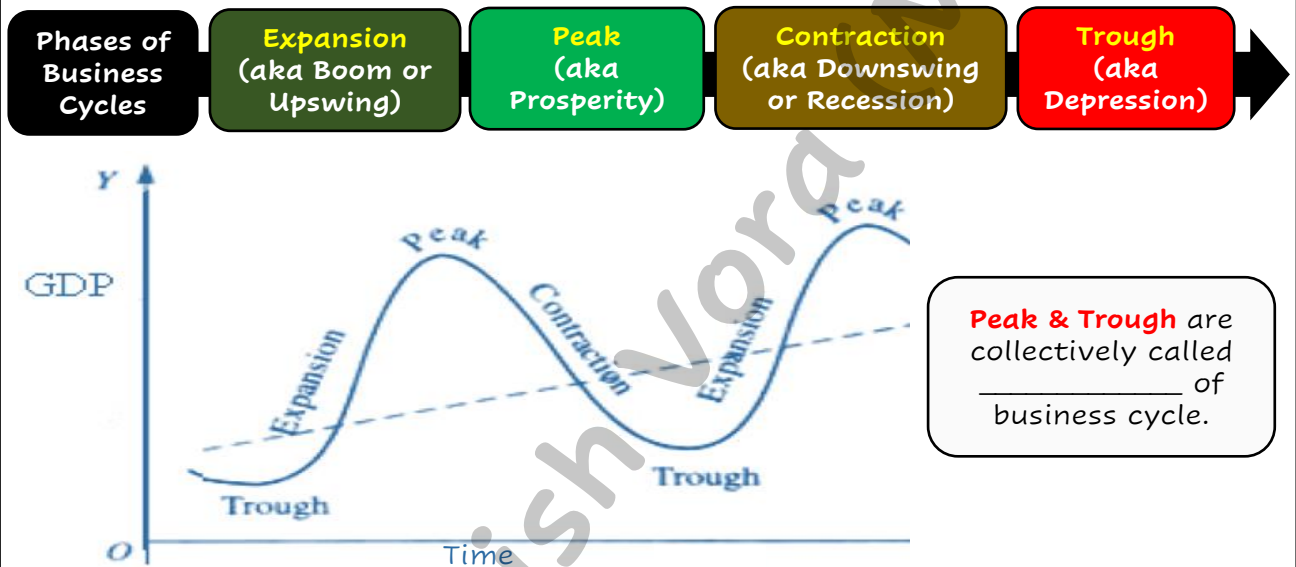
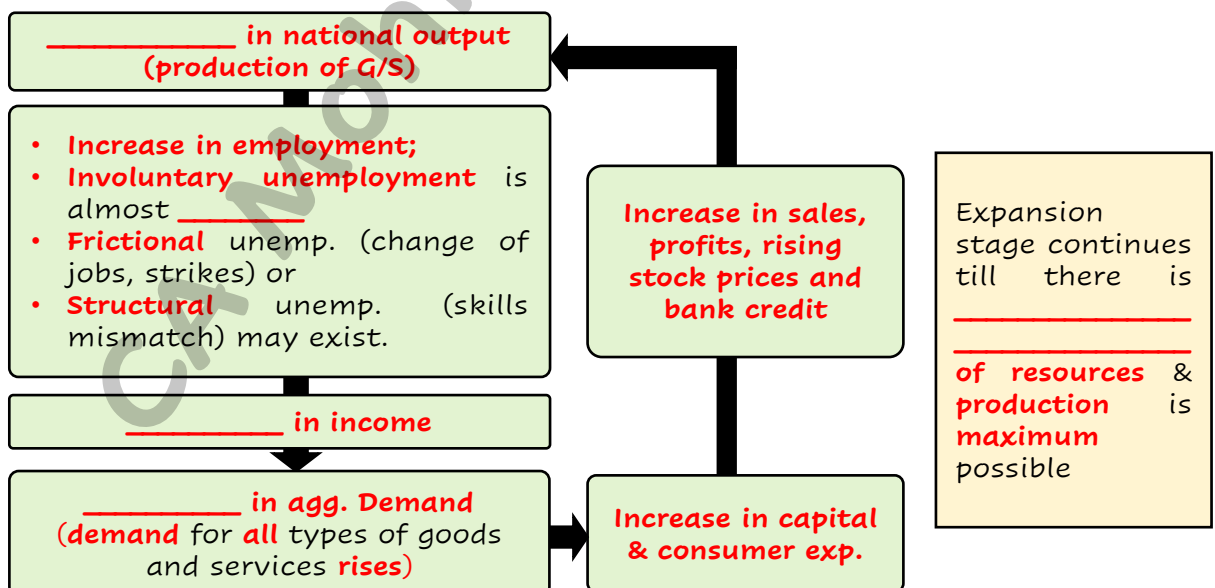
By CA Mohnish Vora (MVSIR)

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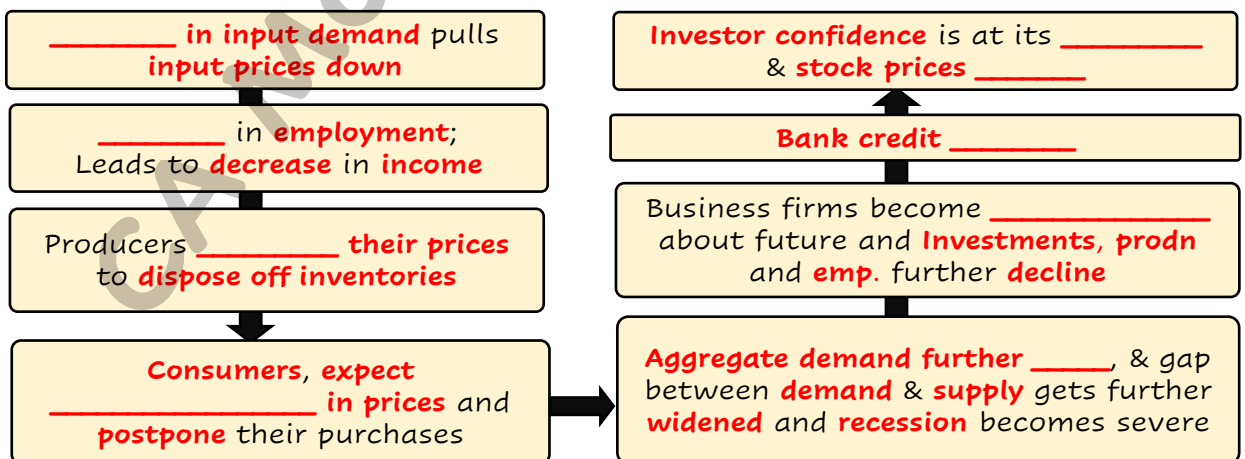
Summary of **Important Points**

Economics Chapter 5 – Business Cycles

- ❖ **Rhythmic fluctuations** in _____ that economy experiences **over a period of time** → **business cycles** or **trade cycles**.
- ❖ A trade cycle is composed of-
 - Periods of _____ characterised by **rising prices** and **low unemployment** percentage, (Expansion)
 - Periods of _____ characterised by **falling prices** and **high unemployment** percentages. (Contraction)
- ❖ Business cycles is that they **occur again & again** but _____ always at regular **intervals**, **nor** are they of **same length**.

❖ **Expansion (aka Boom or Upswing)**

- ❖ In later stages of _____,
 - **inputs are difficult to find** as they are **short of their demand** and therefore **input prices _____**.
 - **Output prices also _____** rapidly leading to **increased cost of living** and **greater strain on fixed income earners**.
 - Consumers begin to _____ on housing, durable goods etc.
- ❖ **Peak (aka Prosperity)**
 - Growth rate in expansion stage **eventually slows down** and reaches its **peak**.
 - Peak = **top** or _____ **point** of business cycle.
 - Actual **demand _____**.
 - **It is end of expansion** and it occurs when **economic growth** has reached point where it will **stabilize** and then **move in reverse direction, starting contraction stage**
- ❖ **Contraction (aka Downswing or Recession)**
 - **Producers _____** **instantaneously recognize pulse** of economy (that contraction is coming) & **keep anticipating high level of demand** (because earlier expansion was going on), and **maintain** their **investments**.
 - Consequence is **mismatch** between **demand & supply**. **Supply _____ demand**. Gradually it spreads to all sectors.
 - **Producers**, now being **aware of above**, respond by
 - ❑ **holding back future _____** plans,
 - ❑ _____ of **orders for equipments & inputs** incl. **labour**.
 - This in turn generates a _____ of **reactions** in **input markets** and **producers** of **capital goods and raw materials** in turn respond by **cancelling and curtailing their orders**. This is **beginning of _____**.
 - Decline of aggregate economic activity **over _____** is **RECESSION** (when contraction stage lasts for _____ quarters continuously, then it is called recession)



❖ **Trough (aka Depression)**

- _____ **contraction** pushes economy into phase of **depression**.
- **Growth rate becomes _____** → **national income & exp. declines** rapidly.
- Agg. demand decreases, **prices are lowest** - forcing some firms to _____. It leads to **mounting _____** which leaves consumers with **little income**.
- A typical feature of depression is _____ **in interest rate**. With low interest, people's **demand for holding liquid money** (i.e. in cash) _____.
- Despite lower interest rates, **demand for credit _____** because **investors' confidence has _____**. It may lead to **possible banking or financial crisis**.
- Industries, especially _____ and consumer _____ goods industry, **suffer** from **excess capacity**. Large number of **bankruptcies** and **liquidation**.

❖ **Recovery**

- Economy cannot continue to contract endlessly. **Trough** lasts for some time & **marks end of pessimism** and **beginning of optimism**. This reverses process.
- Process of **reversal** is **initially felt in _____ market**. _____ unemployment **forces workers to accept lower wages**.
- The producers **anticipate _____ costs** and **better business** environment. Slowly **business confidence takes off**, & firms **start to invest again** and to build stocks
- **Technological advancements** require **fresh investments**; thus **bank credit increases**. **employment incr**, **agg. demand picks up** and **prices gradually rise**.
- _____ acts as a self-correcting process in free market economy.
- _____ of investment causes **recovery** of economy. This acts as a **turning point** from **depression to expansion**.

❖ **Features Of Business Cycles**

- 1) Business cycles occur periodically, but _____ **exhibit the same regularity**. The **duration & intensity** of fluctuations **varies**.
- 2) The phases _____ **display smoothness and regularity**.
- 3) Generally originate in _____ **economies**. Get **transmitted to all sectors**.
- 4) _____ goods & _____ consumer goods industries are **disproportionately (more) affected**. _____ **sector is more prone** compared to agri. sector
- 5) **Complex** phenomena; they do _____ have uniform characteristics and causes.
- 6) **Repercussions** of get _____ felt on nearly **all economic variables**
- 7) **Contagious** and are **international** in character.
- 8) Have **serious consequences** on **well-being** of society.

❖ **Indicators**

- Economists use **changes in a variety of activities** to **measure** business cycle and to **predict** where economy is headed towards. These are called **indicators**

_____ Indicators	_____ Indicators	_____ Indicators
Indicator that changes _____ (prior to) economy starts to follow a particular pattern .	Reflect economy's historical performance & changes in these indicators are observable only _____ an economic trend already occurred.	They coincide or occur simultaneously with business-cycle movements. They describe _____ state of business cycle .
Eg- Changes in Stock Price , value of new orders for goods, building permits for private houses, delayed deliveries	Eg- unemployment , corporate profits, labour cost per unit, interest rates, consumer price index , commercial lending	Eg- GDP , industrial production, inflation, personal income, retail sales

❖ Causes Of Business Cycles**Internal or Endogenous Causes**

Fluctuations in Effective Demand

Fluctuations in Investment

Variations in government spending

Macroeconomic policies

Money Supply

Psychological factors

External or Exogenous Causes

Wars

Post War Reconstruction

Technology shocks

Natural Factors

Population growth

❖ Macroeconomic policies (**monetary & fiscal policies**) also cause business cycle

- ❑ **Expansionary policies** – Policies resulting in _____ **agg. demand** (Results in booms)
 - Exp. Fiscal Policy- _____ **government spending** and **tax** _____,
 - Exp. Monetary Policy- _____ **(decr) interest rates**.
- ❑ **Anti-inflationary measures** – Policies resulting in _____ **agg. demand** (Controlling inflation)
 - Cont. Fiscal Policy- _____ **govt spending** & _____ **tax**,
 - Cont. Monetary Policy- _____ **interest rates**.

	Business Cycles are caused due to fluctuations in aggregate effective demand
	Business Cycles are caused due to anticipations of business firms & are affected by waves of optimism or pessimism
	Business Cycles are caused due to innovation theory.
	Business Cycles are caused due to cobweb theory - present prices substantially influence production at some future date .
	Business cycle is purely monetary phenomenon. Unplanned changes in supply of money may cause business fluctuation.

❖ Other Important Points

- Businesses whose **fortunes** are closely **linked to the rate of economic growth** are referred to as _____
- These include **fashion retailers, electrical goods, _____, house-builders, restaurants**, advertising, overseas tour operators, construction and other infrastructure firms.
- During a _____, such businesses see a **strong demand** for their products but during a _____, they usually **suffer a sharp drop in demand**.

❖ Examples of Business Cycles

- 1) Great Depression of _____
- 2) Information Technology bubble burst of _____ → Aka. **Dot.Com bubble** (1997-2000)
- 3) Global Economic Crisis (20____-____) → sub-prime crisis

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Business Economics

Abhyaas Notes

Chapter 6

National Income

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Summary of Important Points

Chp 6: Determination of National Income

Unit 1: Macro Economic Aggregates and Measurement of National Income

- The **performance of an economy** depends on _____ of goods and services produced by it, which is measured by National Income.
- In order to calculate National Income, first we need to understand the concept of GDP.
- **Gross domestic product (GDP)** is a measure of-
 - ✓ _____ value of
 - ✓ all _____
 - ✓ _____ goods and services,
 - ✓ _____ of depreciation,
 - ✓ produced _____ the domestic territory of a country
 - ✓ during a _____.

- **National Income** is defined as the -
 - ✓ _____ value of
 - ✓ all economic goods and services
 - ✓ produced
 - ✓ within the domestic territory of a country
 - ✓ in an accounting year
 - ✓ _____ the net factor income from abroad.

Also, according to the **Central Statistical Organisation (CSO)** 'National income is the **sum total** of _____ generated by the _____ of a country in the form of **wages, rent, interest and profit** in an **accounting year**'.

EXCLUSIONS FROM GDP & NATIONAL INCOME

- 1) _____ Payments (Govt. **making a payment, without goods** or services **received in return**)
- 2) _____ transactions (**Stocks & bonds transactions** - do **not** involve current production)
But, **value of services accompanying sale** (e.g. fees to agents/broker) **is included**.
- 3) Sale of _____ goods
- 4) _____ output - **illegal transactions**. Eg - narcotics and gambling

NOMINAL GDP vs REAL GDP

- '**Nominal GDP**' or '**GDP at** _____' changes due to 2 reasons-
 - 1) _____ **changes**, and/or
 - 2) When _____ **change**.
 Changes in GDP due to changes in _____ - _____ **to explain performance of economy**

- **Real GDP** or **GDP at constant prices** is an **inflation adjusted** measure of GDP

- ✓ _____ **affected** by changes in **prices**;
- ✓ **Changes only when** there is change in _____.

Thus, Real GDP is a _____ **measure** of **economic** _____.

GDP Deflator

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

$$\text{Inflation rate in Yr 2} = \frac{\text{GDP deflator in Yr 2} - \text{GDP deflator in Yr 1}}{\text{GDP Deflator in Yr 1}} \times 100$$

DOMESTIC VS NATIONAL

- 'National' → normal residents of a country who may be within or outside domestic territory of a country & is a _____ concept compared to the term 'domestic'.
- The term 'domestic' refers to production done by people _____ the domestic territory

IMPORTANT FORMULAS➤ **Net Factor income from abroad (NFIA)**

= Factor income earned by _____ Factor income earned by factors of _____
 _____ factors of production (-) production of _____
 employed in _____ employed in _____ territory

- **Operating Surplus** = _____ent + _____nterest + _____rofit(also add Loyalty if given in Question)

➤ **3 Golden Rules of NI**

- 1) Gross – Depreciation = Net
- 2) $MP = FC + IDT - \text{Subsidy} \dots \text{or} \dots MP = FC + NIT$
- 3) Domestic + NFIA = National

Total 8 Aggregates

- | | |
|--------------|--------------|
| 1) GDP at MP | 5) GNP at MP |
| 2) GDP at FC | 6) GNP at FC |
| 3) NDP at MP | 7) NNP at MP |
| 4) NDP at FC | 8) NNP at FC |

➤ **Net Domestic Product at Factor Cost (NDP FC)**

(aka. - Domestic Income or Factor Income earned in Domestic Territory)

=

➤ **National Income (NNPFC) = NDP_{fc} +**➤ **GDP Per Capita**

- ✓ Measure of country's economic output per person. Indicator of standard of living of country
- ✓ **GDP Per Capita =**

➤ **Indirect Taxes and Subsidies**1) **Production Taxes & Production Subsidies**

These are _____ of volume of actual production

2) **Product Taxes & Product Subsidies**

Paid or received on _____ of product

Basic Price		Market Price	
=	Factor Price	=	Basic Price
+		+	
-		-	

Personal Income

Income _____ by household sector including _____ Institutions Serving Households from _____ sources

= National Income

+

-

Disposable Personal Income

It is a measure of amount of money in the hands of the individuals that is available for their consumption or savings.

= Personal Income

-

-

Income from domestic product accruing to private sector

= NDP_{fc}

- Income from Prop. & Ent accruing to govt admin dep

- Savings of Non dep enterprises

Private Income

It is a measure of the income (**both income & income**) which **accrues to private sector** from **sources** & **country**.

Private Income

=	Income from domestic product accruing to private sector
+	
+	
+	

Net National Disposable Income (NNDI)

The amount of G/S domestic economy has at its disposal.

=	National Income (NNP _{fc})
+	
+	

- **GNDI = NNDI + Depreciation**
- Ignore "Govt transfer pay" in calculation of GNDI / NNDI

Circular flow of income

Circular flow of income refers to the **continuous circulation of production, income generation & expenditure** involving **different sectors** of the economy. There are 3 phases-

Production phase

Firms **produce** G/S with help of factor services.

Income or Distribution phase

The **flow of factor incomes** in the form of **rent, wages, interest and profits** from firms **to the households** occurs

Exp. or Disposition phase

Income received by factors is **spent** on **consumption of G/S and investment goods**. This **exp. leads to further production of G/S & sustains circular flow**.

Method	Data Required	What is measured?
Value Added Method or Product Method or Industrial Origin or Net Output Method	The sum of net values added by all the producing enterprises of the country	Contribution of production units
Factor Income Method or Factor Payment or Distributed Share	Total factor incomes generated in the production of goods and services	Relative contribution of factor owners
Expenditure method or Income Disposal	Sum of exp. of 3 spending units- 1. government, 2. consumer households, and 3. producing enterprises (firms)	Flow of consumption and investment expenditures

VALUE ADDED METHOD

Step 1- Calculate GVA for each sector

	Value of Output
-	
=	

Step 2- Calculate QVAmp by adding GVA of all sectors

	GVA by Primary Sector
+	GVA by Secondary Sector
+	GVA by Tertiary Sector
=	

Step 3- Calculate NNP_{fc} from GDP_{mp}

	NNP _{fc} (National Inc.)
	GDP _{mp}
(-)	
(+)	
(-)	

➤ If "Value of Output" is not given separately, then

Value of Output = **Sales (+)**

(where → Change in Stock = Cl. Stock - Op. Stock)

EXPENDITURE METHOD

Step 1- Calculate GDP_{mp}

	Private Final Consumption Expenditure (PFCE) (C)
+	Gross Domestic Capital Formation (GDCF) (I)
+	Government / Public Final Consumption Exp. (GFCE) (G)
+	Net Exports (X-M)
=	

Step 2- Calculate NNP_{fc} from GDP_{mp}

	NNP _{fc} (National Inc.)
	GDP _{mp}
(-)	Depreciation
(+)	NFIA
(-)	Net Indirect Taxes
	GDCF (if not given in Q)
	= Gross Domestic Fixed Capital Formation (H/B/G)
(+)	
(+)	

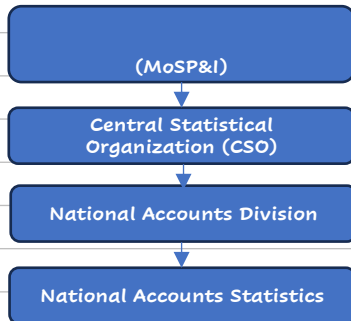
INCOME METHOD

+	
+	
=	NDP _{fc}
+	NFIA
=	NNP _{fc} (National Income)

Comp. of Emp. does **not** include "Employee's Contribution to PF"

NI as per Inc. Method does **not** include-
→ Int. paid by govt/firm
→ Capital gains, windfall profits etc

NATIONAL INCOME IN INDIA



Reliable statistical data is _____ available → not possible to estimate India's NI wholly by one method.

Therefore, a _____ of methods is used.

- _____ method → commodity producing sectors like agriculture and manufacturing.
- In _____ sector → income method, &
- In _____ sector → expenditure method.

Method used for National Income in developed economies:

_____ method → most suitable
But, sometimes expenditure method also used.

SYSTEM OF REGIONAL ACCOUNTS IN INDIA

_____ Income or Net State Domestic Product (NSDP) is a measure in monetary terms of volume of all G/S produced in state within a given period of time (generally a year) accounted without duplication.

Per Capita State Income is obtained by dividing the NSDP (State Income) by the midyear projected population of the state.

State level estimates are prepared by the _____ of respective State _____ of Economics and Statistics (DESS). CSO assists & advises in preparation

Certain activities such as railways, communications, banking and insurance and central government administration, that _____ state boundaries, and thus their economic contribution cannot be assigned to any one state directly are known as the '_____ sectors' of the economy. The estimates for these compiled for economy as a whole & allocated to states on basis of relevant indicators.

Can GDP be index of welfare?

No, since GDP measures exclude the following which are critical for the overall wellbeing of citizens.

- a) Income _____
- b) _____ improvements → technological & managerial innovations.
- c) Productions _____ from govt., → evading taxes or illegal (drugs, gambling etc.).
- d) Non-market production and Non-economic contributors → health, education levels etc.
- e) Economic '_____ ' → crime, pollution, traffic congestion etc which make us worse off.
- f) _____ work → without remuneration
- g) Leisure time, fairness, gender equality, security of community feeling etc.,

Limitations And Challenges of NI

Conceptual difficulties

- 1) lack of an agreed definition of national income,
- 2) accurate _____ between final & intermediate goods,
- 3) issue of _____ payments,
- 4) difficulty of incorporating _____ of income,
- 5) valuation of a _____ good at constant prices, and

Challenges

- 1) _____ of data and lack of reliability of available data,
- 2) absence of _____ of incomes due to illiteracy and ignorance,
- 3) lack of proper _____ classification, and
- 4) accurate estimation of consumption of fixed capital
- 5) production for self-consumption

Chp 6: Determination of National Income

Unit 2: The Keynesian Theory of Determination of National Income

INTRODUCTION

- In **previous unit**, '**ex post**' (**realized**) values were used. In this unit, _____ (**anticipated**) values are used, if we want to _____ what **equilibrium value of output or GDP** is.
- Before Keynes, **classical economists** said that **economy is** _____-**regulating** and is always **capable of** _____ **achieving equilibrium** at '**natural level**' of **real GDP**
- However, _____ in his "**General Theory of Employment Interest & Money**" → **markets** would _____ **automatically** lead to **full-employment equilibrium**, as **prices & wages are** _____ (**rigid**), especially **downward**. This **prevents economy** from **returning to natural level** of real GDP. So, **output will remain at** _____ **full employment level** **unless** there is **insufficient** _____
- Keynesian theory of income determination is presented in **3 models**:
 - 1) **Two-sector** = household + business,
 - 2) **Three-sector** = household + business + government,
 - 3) **Four-sector** = household + business + govt. + foreign

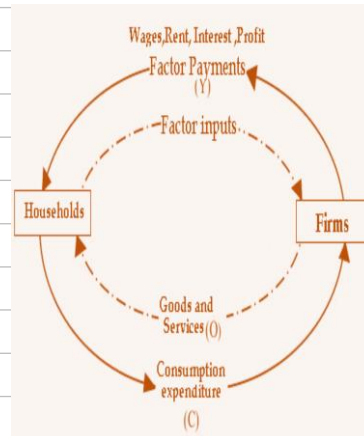
Circular Flow in a Simple Two-sector Model

- The **circular flow of income** is a process where the **national income** and **expenditure** of an economy **flow in a circular manner continuously** through time.

- Two sector economy model assumes **only two sectors** in economy viz., **households** and **firms**, with only **consumption** and **investment** outlays.

- In the figure-

- Circular **broken lines** - factor and product flows- '_____ flows'
- **Continuous line** with arrows show _____ flows



Factor Payments
 = Household Income
 = Household Expenditure
 = Value of Output
 = Total Receipts of Firms

Important Concepts

- 1) **Consumption function**- Functional **relationship between consumption spending and disposable income** → $C = f(Y) =$
- 2) **Average Propensity to Consume**- Ratio of **total consumption to total income**.
 $APC =$
 Consumption is _____ **function of income**.

3) **Marginal Propensity to Consume (MPC = "b")-** Increment in consumer expenditure per unit of increment to income. \rightarrow $MPC = \frac{\text{Increment in consumption}}{\text{Increment in } Y_d} = b$

✓ Keynes **assumes** that **consumption increases with an increase in Y_d** , but that increase in consumption < increase in Y_d

✓ Value of MPC is **between 0 & 1**.

✓ MPC is also the **slope of consumption line**

4) **Saving function-** Functional **relationship between saving & income** $\rightarrow S = f(Y) =$

5) **Marginal Propensity to Save**

✓ **Increment in saving per unit increase in disposable income.**

$$MPS = \frac{\text{Increment in saving}}{\text{Increment in } Y_d} = 1 - b \quad \& \quad MPC + MPS = 1; \quad MPS \ 0 < b < 1$$

Also, **MPS is the slope of savings line**

6) **Average Propensity to Save-** Ratio of **total saving to total income**. $\rightarrow APS =$

Saving is **a function of income**.

7) **Aggregate Supply (AS)-** Ex ante or planned AS \rightarrow **total supply of G/S** which firms plan on selling during a specific time period.

✓ $AS = \text{Agg. Production} = \text{Factor Payments} = \text{Factor Incomes}$ [National Income $\rightarrow Y$]

8) **Aggregate Demand (AD)-** Total planned **expenditure** in the economy.

9) **Equilibrium output-** **Desired amount of output demanded = amount produced**. ($AD = AS$)

Two Sector Model

- Household Sector & Business Sector only
- $AD = C + I$ (I is assumed to be constant)
- $AS = C + S$
- Equilibrium is achieved when -
 $AD = AS$ or $C + I = C + S$
or

Three Sector Model

- Household + Business + Govt Sector
- $AD = C + I + G$ (I & G are assumed to be constant)
- $AS = C + S + T$
- Equilibrium is achieved when
 $AD = AS$ or $C + I + G = C + S + T$
or

Govt sector adds following flows to 2 sector model:

- 1) **Taxes**
- 2) **Transfer payments & subsidy payments**
- 3) **Govt purchases**
- 4) **Govt borrowing to finance deficits** (when $G > T$)

Four Sector Model

- Household + Business + Govt. + Foreign Sector
- $AD = C + I + G + (X - M)$ (I, G & X are assumed to be constant)
- $AS = C + S + T$
- Equilibrium is achieved when -
 $AD = AS$ or $C + I + G + (X - M) = C + S + T$
or

Foreign sector adds following flows to circular flow of 3 sector model:

- 1) **exports,**
- 2) **imports and**
- 3) **net capital inflow** which is the difference between capital outflow and capital inflow

If $(X > M)$ is **+ve** then NI **increases**

If $(X < M)$ is **-ve** then NI **decreases**.

LEAKAGES & INJECTIONS

❑ **Leakage-** _____ of income from circular flow → part of income _____ used to purchase goods.

- 2 sector Model : Leakages =
- 3 sector Model : Leakages =
- 4 sector Model : Leakages =

❑ **Injection-** It is an inflow of income to the circular flow. Due to injection, the volume of income increases.

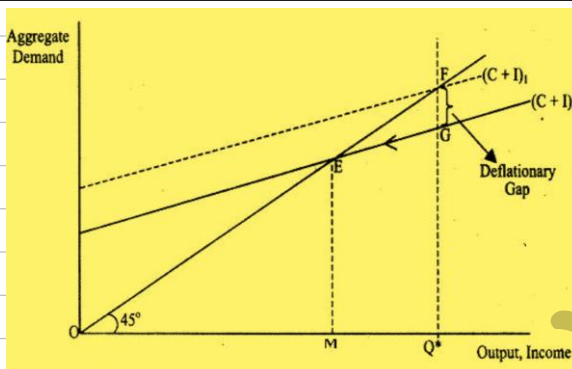
- 2 sector Model : Injection =
- 3 sector Model : Injection =
- 4 sector Model : Injection =

❑ If $AS = AD \rightarrow Leakages = Inj.$
NI will be in _____.

❑ If $AS > AD \rightarrow Leakages > Inj.$
Stock _____ or Deficient Demand → (NI will _____)

❑ If $AS < AD \rightarrow Leakages < Inj.$
Stock _____ or Excess Demand → (NI will _____)

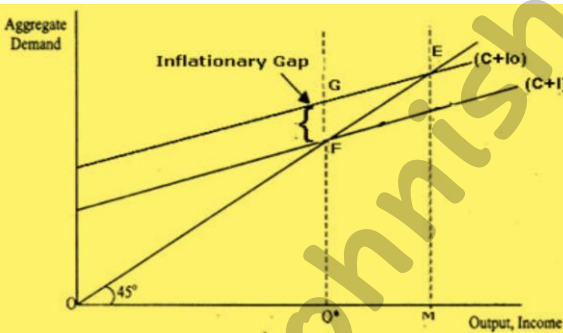
DEFLATIONARY & INFLATIONARY GAP

**Deflationary Gap**

If actual $AD < \text{full employment level of output} \rightarrow$ _____ demand.

It leads to '_____ gap' or '_____ gap'. Occurs when economy is in contraction.

Firms will experience unplanned _____ of inventories → _____ in output & income in future until _____-employment equilibrium is reached at E.

**Inflationary Gap**

If actual $AD > \text{full employment level of output} \rightarrow$ _____ demand.

It leads to 'inflationary gap'. Occurs during expansion & causes _____ inflation.

Real output will be constant, but rise in prices will cause increase in nominal output until new equilibrium is reached at point E.

INVESTMENT MULTIPLIER

Investment Multiplier (k) → how many times _____ increases as result of increase in autonomous _____

More the leakages → _____ the multiplier

$$K = \frac{\Delta Y}{\Delta I} \text{ or } \frac{1}{1 - MPC} \text{ or } \frac{1}{MPS}$$

IMPORT

Import function is: $M =$

Marginal propensity to import → $m =$

is assumed to be constant.

Summary of Multiplier

How to solve Numerical MCQs of National Income?

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Business Economics

Abhyaas Notes

Chapter 7

Public Finance

By CA Mohnish Vora (MVSIR)

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Summary of Important Points

Chapter 7 – Public Finance

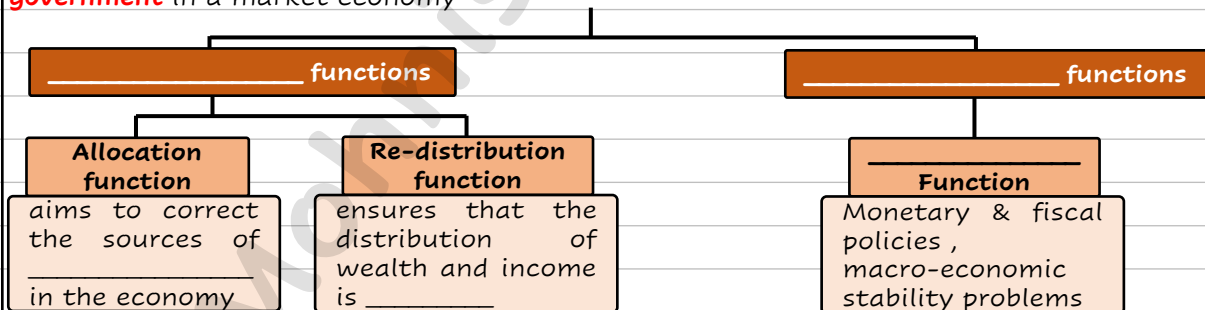
Unit 1 – Fiscal Functions: An Overview, Centre And State Finance

INTRODUCTION

- **Macroeconomics** → study of economy as a _____
- **3 main macroeconomic goals** for any nation.
 - 1) **Economic** _____ → Growth of Real GDP > population → leads to higher standard of living.
 - 2) **High levels of** _____.
 - 3) _____ **price levels**
- ✓ **Inflation** _____ real incomes and purchasing power
- ✓ **Deflation** signals a _____ → which cause recession & unemployment.
- The objective of economic system & role of govt → **improve** _____ of people.
- **Adam Smith** was a **bold advocate of** _____ **markets** & _____ **governmental activity**.
As per Smith, important resource allocation roles of govt.-
 - a) **national defense**,
 - b) **establishing a system of justice** to provide internal law & order
 - c) **establishment & maintenance of public institutions** & public works - roads, bridges, etc

RICHARD MUSGRAVE – 3 Roles of Government

- **Richard Musgrave**, in his book '**The Theory of Public Finance**' (1959), introduced **3 roles of government** in a market economy



ALLOCATION FUNCTION

- **Resource allocation** → way in which **available resources** are **allocated** among various uses. It determines _____ of G/S will actually be produced in an economy.
- **Economic efficiency** → resources allocated in best way → _____ waste & inefficiency.
- **Resource allocation** aims to **correct sources of inefficiency** in the economic system.
- If a **market** is **left to itself** → leads to _____ & _____ of **scarce resources**. Thus, market failures provide rationale for government's allocative function
- **Absence of govt. intervention** lead to- **Under-Production** or **Over-Production** of goods

□ Allocation instruments which govt. can use to influence resource allocation

- 1) Government may _____ **produce** an economic good
- 2) Government may _____ **private allocation** through-
 - ✓ Incentives :
 - ✓ Disincentives :
- 3) Government may influence allocation through its _____ **policies**. Eg- Competition Act 2002
- 4) Governments' _____ **activities** such as licensing, minimum wages etc.
- 5) Government sets **legal and administrative frameworks**
- 6) any **mixture** of above methods

REDISTRIBUTION FUNCTION

- If **left to market, distribution of income** is likely to be _____ & thus govt. has to **intervene** to **ensure more socially** _____ & _____ **distribution**.
- It is related to question → _____ **should an economy produce G/S**.

□ Redistributive Function in Govt Budgeting

- **Expenditure side of budget**- Govt. may provide _____ **education, healthcare**, housing, food etc to deserving people
- **Revenue side of budget**- Redistribution is done through _____ **taxation**
- An **optimal budgetary policy** towards any distributional change should **reconcile** the **conflicting goals** of **efficiency & equity** by exercising an **appropriate trade-off (balance)**

□ Aim of Redistribution Function

- 1) Achieve **equitable distribution of societal** _____ among households
- 2) **Advancing** _____ of those members of society who suffer from **deprivations**
- 3) Providing _____ in income, wealth & opportunities
- 4) Providing _____ (fulfilment of basic needs) for people who have hardships
- 5) Ensuring everyone enjoys a _____ **standard of living**

□ Examples of Redistribution function OR Market intervention for socio-economic reasons

- 1) _____ **taxation** of rich & **subsidy to poor**
- 2) **Proceeds from progressive taxes** used for **financing** _____
- 3) **Employment** _____ to protect certain segments
- 4) **Unemployment benefits & transfer payments** to deprived sector
- 5) Families **below poverty line** → _____ **aid** & **aid in** _____
- 6) **Regulation** of **mfg. & sale** of certain products to ensure well-being
- 7) _____ for **backward regions** & for vulnerable sections

STABILISATION FUNCTION❑ **Macroeconomic stability is said to exist when:**

- 1) economy's output = production capacity,
- 2) economy's total spending = total output
- 3) economy's labour resources are fully employed, and
- 4) Inflation is low and stable.

Stabilisation function ensures achievement of-

- **M**acroeconomic _____,
- maintenance of _____ levels of employment &
- _____ stability.

❑ **Rationale of Stabilisation Function**

- In absence of govt intervention, the **instabilities** in form of **recessions**, **inflation** etc. may be _____ for longer periods causing enormous **hardships** to **poor people**.
- Also situation of _____ (inflation + unemployment) is possible.
- Stabilization issue becomes more complex due to '**contagion effect**'.

Stabilization function is concerned with performance of aggregate economy in terms of:

- 1) Labour employment and capital utilisation
- 2) Overall output and income
- 3) General price levels
- 4) Balance of international payments
- 5) Rate of economic growth

Govt's stabilization intervention may be through

Monetary policy - **Controlling size of** _____ and _____, which would affect consumption, invt. & prices.

Fiscal policy - It relates to

- _____ decisions &
 - _____ decisions of govt
- Which can stimulate economic activities

Expansionary fiscal policy is adopted to alleviate recession

During **recession**, government-

- _____ its **expenditure** or _____ **taxes**

Contractionary fiscal policy is resorted to for controlling high inflation

During high inflation, government-

- _____ its **expenditure** or _____ **taxes**

Deficit budgets (Exp > Rev)

are expected to _____ economic activity

Surplus budgets (Rev > Exp)

tend to _____ economic activity.

➤ **Notes:**

CENTRE AND STATE FINANCE

- _____ (term by **Richard Musgrave**) → division of **govt. functions & financial relations** among different levels of govt.
- As per Musgrave, responsibility of-
 - ✓ central (union/federal) govt → **economic _____ & income _____**, &
 - ✓ state govt → _____
- India → **___ states & ___ union territories**.
- **Federalism** is an institutional arrangement to accommodate **two sets of government-**
 - ✓ one at **national level** and
 - ✓ other at **regional level**.
- An **independent _____** → **resolve disputes** between CQ & SQ on **division of power**.
- **Article _____** of Constitution of India → powers of union & states-
 - 1) **Union list- union parliament**
 - 2) **State list- state legislative assemblies**
 - 3) **Concurrent list- both** union & state can legislate.

In event of **conflicting legislation** in concurrent → law passed by _____ prevails.
- **Union (Central) govt. can levy taxes** like- _____ **tax** (on _____ agricultural income), **customs duties**, excise duties, **corporation tax**, tax on capital value of assets, security transaction tax, central GST, taxes other than stamp duties etc
- **State governments can levy taxes** on _____ **income**, lands & buildings, mineral rights, **electricity, vehicles**, tolls, professions, land revenue and impose excise duties on certain items.
- The **property of the union** is **exempt** from **state taxation**.
- Similarly, the **property and income of the states** are **not liable** to be taxed by the **centre**.
- **Articles ___ to ___** of constitution → distribution of finances among states by central gov

FINANCE COMMISSION

- **Article _____** → "**Finance Commission**". It is responsible for-
 - 1) evaluating the _____ of union & state govt,
 - 2) **recommending the _____ of taxes** between them and
 - 3) **laying down _____ determining _____** of these taxes among states.

- While recommending transfers, the Finance Commission considers issues-
 - ✓ **equity** (deciding about the share of states in revenue collected by centre) &
 - ✓ **equity** (allocation states their share of central revenue).

➤ The **15th Finance Commission was constituted on 27, Nov 2017**

- Share of states in central taxes (vertical equity) for 2021-26 to be
- This was **less than 42% share recommended by 14th Finance Commission** 2015-20.
- The **adjustment of 1% → and**

GOODS & SERVICE TAX (GST)

- GST rolled out on → made India's indirect tax regime **unitary** in nature.
- For any particular goods & service, SGST & CGST rates are .
- **GST (IGST)** is applied on -state movement of G/S & on **imports/exports**.
 - ✓ IGST is simply a of **SGST & CGST**
 - ✓ administered & collected by **government**,
 - ✓ kept in a **account**,
 - ✓ & **distributed** between the &
- GST → **35%** of gross tax revenue of **union** & **44%** of own tax revenue of **states**.
- As per **supreme court verdict** in , Union & state legislatures have " , **simultaneous and unique powers**" to on **GST** & the **recommendations of GST Council are not binding** on them.
- GST system **replaced old production-based** taxation system with a **based** one.

Manufacturing states → provided by levying a **cess** on **goods** & **goods** → proceeds are **credited to the** .
- **Top five GST compensation** receiving states were aharashtra, arnataka, ujarat, unjab & amil Nadu.

EXPENDITURE DECENTRALIZATION

- Central govt → **nationally important areas** like , **foreign affairs**, foreign trade, money & banking, etc
- State govts → **agriculture & industry**, **services** like health & education, **police protection**, **state infra**.
- Local self governments - municipalities & panchayats → **services** such as **water supply** & **sanitation**, **local roads**, **electricity**.

BORROWING BY GOVERNMENT

- Borrowing by Govt of India & borrowing by states → **Article &**.
- The **centre** may **borrow** within limits fixed by **parliament** upon **security of Consolidated Fund of India**.
 - The **state** governments may **borrow within territory of India** upon **security of Consolidated Fund of State**
 - The **centre** may **give loans to the states** within limits fixed under article
 - **States need to obtain centre's in order to borrow** in case **state is indebted** to centre.

Chapter 7 – Public Finance
Unit 2 – Market Failure / Government Intervention To Correct Market Failure

MARKET FAILURE

It is a situation in which the **free market** leads to _____ of **society's scarce resources** in the sense that there is either-

- _____ or
- _____

of particular G/S leading to a _____ **optimal outcome**.

If in all markets perfect competition exist, it leads to market efficiently, most often the **prerequisites of competition** are **unlikely to be present** in an economy

TWO TYPES OF MARKET FAILURE

- 1) _____ market failure. This is a case of "**missing markets**" and occurs when the market **does** _____ **supply products at all** despite the fact that such products and services are wanted by people. E.g. Pure public goods.
- 2) _____ market failure occurs when the **market does actually function**, but it **produces** either-
 - **wrong** _____ of product or
 - at the **wrong** _____.

This results in **loss of** _____.

WHY DO MARKETS FAIL ? OR REASONS FOR MARKET FAILURE



I) MARKET POWER

Market power or monopoly power is **ability of a firm** to **profitably** _____ of a G/S **over its** _____, thereby earning _____ economic profits.

Market power → cause markets to be **inefficient** because-

- producers _____ **output**, &
- keep **price** _____ **than Perfect Comp**

Thus, market fails to produce right quantity of G/S at the right price. Leading to _____ **-production** and thus **market failure**.

II) EXTERNALITIES

Sometimes, the actions of either consumers or producers result in **costs or benefits** that **do** _____ **reflect as part of the market price.**

Such costs or benefits which are **not accounted for by** _____ are called **externalities** because they are “_____” to the market.

Externalities are also referred to as

‘_____ effects’, OR ‘_____ effects’

‘_____ effects’ OR ‘_____’,

as the _____ of the externality **imposes costs or benefits on others** who are _____ **responsible for initiating** the effect.

➤ Since it occurs outside price mechanism, it has not been compensated for, or it is _____ or cost (benefit) of it is not borne (paid) by the parties.

➤ **Externalities can be-**

➤ **Negative externalities** → action of one party **imposes** _____ on another party.

➤ **Positive externalities** → action of one party **confers** _____ on another party.

❑ NEGATIVE PRODUCTION EXTERNALITY

➤ A negative externality

✓ **initiated in** _____

✓ which **imposes an** _____ on others

✓ may be **received** by another in _____ or _____

➤ **NPE received in** _____

Eg- **Factory discharges waste into river** → **affects fish output**

➤ **NPE received in** _____

Eg- Factory **discharges waste into river** → **health hazards for people** → **drinking & bathing**

❑ NEGATIVE CONSUMPTION EXTERNALITY

➤ A Negative Externality

✓ **initiated in** _____

✓ which **imposes an** _____ on others

✓ may be **received** by another in _____ or _____

➤ **NCE Received In** _____

Eg- **Undisciplined Students Creating Disturbance** → Preventing Teachers from teaching

➤ **NCE Received In** _____

Eg- **Smoking Cigarettes In Public Place** → **Passive Smoking By Others**

☐ POSITIVE PRODUCTION EXTERNALITY

➤ A positive externality

✓ initiated in _____

✓ that confers _____ on others

✓ may be **received** in _____ or in _____.

➤ Compared to NPE, **PPE** are _____.

➤ **PPE received in** _____

✓ Eg- **Firm offers training** to employees → **positive benefits for other firms** when they hire such workers as they change their jobs.

➤ **PPE received in** _____

✓ Eg- An **individual raises an attractive garden** → **persons walking by enjoy** the garden

☐ POSITIVE CONSUMPTION EXTERNALITY

➤ A positive externality

✓ initiated in _____

✓ that confers _____ on others

✓ may be **received** in _____ or in _____.

➤ **PCE received in** _____

✓ Eg- Consumption of **services of health club by employees** → **benefit to firm** → **increased efficiency** & productivity

➤ **PCE received in** _____

✓ Eg- If people **get immunized against contagious diseases** → **social benefit to others** as well by **preventing others from getting infected**

How Externalities Cause Inefficiency And Market Failure ?

➤ **Private cost** is money cost of production incurred by _____ i.e. wages, raw materials, etc, which _____ **for production**, & would _____ **in firm's accounts**.

➤ **Supply curve** here corresponds to only _____.

➤ **Social costs** → **total costs to** _____ on account of **production or consumption** activity.

➤ **Social Cost =**

➤ External costs are _____ included in firms' costs or consumers' decisions.

➤ Firms do not have to pay for damage from pollution which they generate. As a result, each **firm's cost**, considers **only** _____ **cost** & would **not incorporate** _____

- Such prices send _____ signals to producers & consumers → cause either over-production or under-production.
- Thus, here a **competitive market will produce a level of output** which is **not socially optimal**, leading to **market failure**.

III) PUBLIC GOODS

- _____ gave the concept of '**collective consumption good**' in his paper '**The Pure Theory of Public Expenditure**'
- A **public good** (aka. collective consumption good or social good) is defined as one which-
 - ✓ _____ **enjoy in** _____
 - ✓ **each individual's consumption** of such a good leads to _____ from any **other individuals' consumption of that good**.

□ CHARACTERISTICS OF PUBLIC GOODS

- 1) Consumption is _____ in nature.
 - 2) _____ : It means that **consumption** of a public good **by one** individual **does _____ reduce the quality or quantity available for all other**.
 - 3) _____ : If the good is provided, one individual _____ **deny other individuals' consumption, even if they have _____ for it**.
 - 4) _____ : Each individual may **consume all** of good i.e. **total amount consumed is same for each** individual.
 - 5) Once provided, **additional resource cost of another person** consuming it is '_____'
 - 6) _____ **direct payment** by the consumer is involved
 - 7) _____ **vulnerable** to issues → **externalities, inadequate property rights, & free rider** problem. No incentive for people to pay for it, as they can consume it without paying.
- If **left to the market**, public goods will **not be produced** at all or will be **grossly _____-produced**. Thus, leading to **market failure**

- **Private goods** are _____ & anyone who wants it, must _____ them at a _____.
- They do _____ face **free-rider problem**.
- They are '_____ ' i.e. it is **possible** to **exclude** consumers who have **not paid**.
- Consumption is '_____ ' that is consumption by one, prevents another individual from consuming it.
- Normally, markets _____ **allocate resources** for the production of private goods.
- Eg- food items, clothing, movie ticket, television, cars, etc

IV) INCOMPLETE INFORMATION

- **Perfect information** → both **buyers & sellers have complete information** about anything that may influence their decision making.

However, above **assumption is not fully satisfied in real markets** because of

- **_____ of G/S** (e.g. cardiac surgery, mutual funds etc.),
- **difficulty of getting _____ information**, and
- **deliberate _____ by interested parties** (e.g. persuasive advertisements).

- Information failure leads to –

- asymmetric information,**
- adverse selection** and
- moral hazard**

Which **affects ability of markets to efficiently allocate resources** and therefore lead to **market failure** because **party with better information** has a **competitive advantage**.

A) Asymmetric Information

- Asymmetric Information which means **imbalance in information**, i.e when **seller knows more than buyer or vice versa**. This can **distort choices** and lead to market failure.
- For eg,
 - ✓ the **landlords know more about their properties** than the tenants,
 - ✓ a **borrower knows more about their ability** to repay a loan than the lender etc.

B) Adverse Selection

- Asymmetric information **generates adverse selection**.
- When **one party** to a contract, say X, **possesses information** relevant to the contract that **other party Y does _____ have** → **expected value of transaction is known more accurately to _____** due to asymmetry of information. Then, X (having more information) may **_____ Y's ignorance & this could put the ignorant party _____ at a _____**
- Thus, asymmetric information leads **party _____ relevant knowledge to make _____ - _____ decisions** and suffer **adverse effects**.
- For eg, **insurers** know less about health conditions of buyers → thus **unable to differentiate** between **high-risk & low-risk** persons. This **forces the price of insurance to _____**, so that **more healthy people**, aware of their low risks, **choose _____ to be insured**. It also further **increases proportion of _____ people** among insured, thus **raising price up more**.

❑ **Lemons Problem** (given by _____)

- **Sellers know** _____ **about car quality** than buyers, often _____ **defects**.
- **Buyers offer** _____ **prices** to offset the risk of getting a 'lemon'.
- _____ **car owners** then _____ **selling**, leaving mostly _____ in the market.
- The result is **market distortion** with lower prices and lower average quality of cars.
- Thus, asymmetric information leads to _____ **of high-quality goods from market**.
- Economic agents end up either-
 - ✓ **selecting a** _____ **product (lemon)**, or
 - ✓ _____ **the market altogether**.

C) Moral Hazards

- It is about **informed person's taking advantage** of a _____ **person** through an _____.
- It occurs when **one party** to an agreement **knows that he need** _____ **bear the consequences of his** _____ & that consequence, if any, would be borne by the _____ party. Therefore, he **engages in** _____ **behaviour** or **fails to act in** _____.
- For eg, A **driver** who has **comprehensive insurance** → had **greater taste for risk-taking** & hence **his interests contradict with insurer**. This causes **insurance premiums to rise for everyone**, driving many potential customers out of market.

GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

I) Minimize Market Power

- Market power leads to _____ → as it _____ **output** which results in _____ **prices** thus leading to _____.
- **Governments intervene by establishing rules** & regulations designed to _____ **competition** & _____ actions that may restrain competition.
- These **legislations differ from country to country**.
- India- **Competition Act, 2002** ;
- USA- Antitrust Laws

□ **Other measures include:**

- 1) **Market** _____ → introducing competition in previously monopolistic sectors
- 2) **Controls on** _____ → if possible market domination.
- 3) _____ to consumer associations
- 4) Tough **investigations into** _____ & unfair practices → collusion & predatory pricing
- 5) **Reduction in** _____
- 6) _____
- 7) **Price** _____ and **price** _____
- 8) **Restrictions on monopsony power** of firms
- 9) **Profit or rate of return regulation** - Govt's regulatory agency determines an _____ price → to ensure a _____ rate of return → called rate-of return regulation.

II) a) Government intervention to correct Negative Externalities

□ **Direct Controls**

- Direct controls, (aka _____), _____ **activities that create negative externalities** or require that negative externality be _____ to a certain level.
- For example,
- _____ **amt of pollutants released** or make it mandatory to **use pollution control devices**.
- **Licensing, production quotas & mandates** regarding acceptable production processes.
- Production, use & sale of some commodities can be _____. Eg- Smoking at public places
- _____ to alleviate effects of neg. externalities. Eg- Environment (Protection) Act, 1986
- **Fix** _____ → legal limit on how much pollutant a firm can emit. If firm exceeds limit → _____.
- The firms have to **install pollution-abatement mechanisms** → **rise in firm's** _____.
- **Charge an** _____ which is levied on each unit of a firm's emissions.
- **Form** _____ / boards → **Ministry of Environ. & Forest, Pollution Control Board of India**

❑ Market Based Policies

- Market-based policies **provide economic** _____ so that _____ of market participants would **achieve the socially optimal solution**.
- It focus on generation of a market price for pollution, achieved by-
 - ✓ **Setting price directly**- by _____
 - The key to _____ **an externality** (both external costs and benefits) is to ensure that **those who** the externalities _____ **them while making decisions**.
 - ✓ **Setting price indirectly**- by _____
 - Second approach to **establishing prices indirectly** is ' _____ ' (carbon credits)

❑ POLLUTION TAX

- The size of pollution tax **depends on the** _____ a firm produces.
- Aka. _____ **taxes** after A.C. Pigou
- These taxes, by '**making the polluter pay**', seek to _____ the external costs **into the price** of a product or activity.
- Tax **increases** _____ & _____ **output** of good which creates -ve externality.
- **Proceeds from tax** → used for **projects** that _____ **environment**.

❑ Problems in administering an efficient pollution tax

- 1) Difficult to _____ & _____ → **complex & costly administrative procedures**
- 2) If **demand for good** is _____, such tax will an _____ **effect in reducing demand**.
In such case, producers will easily _____ in form of higher prices.
- 3) **Negative consequences** on **employment** & **investments** → high pollution taxes may encourage producers to _____ their factories to those countries with _____ taxes.

❑ TRADABLE EMISSION PERMITS

- The use of **tradable permits to limit emissions** is often called ' _____ '
- Tradable permit → license that allows a company to release a unit of pollution over some time. **By issuing a** _____ **number of permits**, the **government determines total level of pollution** that can be _____ **emitted** during each period (the 'cap').
- A firm that generates emissions above allowed limit is _____ with substantial fines.
- Firms can also _____ their permits to other firms → permits are _____ (the firm can sell for a price), a polluting firm faces an opportunity cost → for each unit of pollution → it must either _____, or _____ it could earn by selling permit
- Firm producing **less pollution** → _____ **permits** & _____ **money**.
- **High polluters** have to _____ **permits** → increasing their costs, and makes them less competitive and less profitable. Thus, firms will have incentive not to pollute.

- In 1994, USA began a **cap & trade system** for _____ emissions that cause **acid rain** by issuing permits to power plants.
- In India, _____ (**PAT**) **scheme**, carbon tax in the form of a cess on coal, lignite and peat.
- In _____, **coal cess was abolished and replaced by the GST compensation cess.**
- _____ (Amendment) Bill, 2022 empowers the central government to specify a **carbon credit trading scheme** and to **stipulate energy consumption** standards.

II) b) Government intervention to correct Positive Externalities

- Positive externality is **associated with external benefits** → still **market failure** as, left to market, there will be _____ **optimal output**.
- Since they **promote welfare**, govt implement policies → _____ positive externalities.
- Govt may intervene to correct Positive Externalities by–
- ✓ **corrective subsidies to** _____ → for increasing supply. (Eg- **fertilizer subsidy**)
- ✓ **corrective subsidies to** _____ → increasing demand (Eg- Subsidy on education fee → consumption subsidy)
- A corrective _____ **involves government paying part of cost to firms** to _____ production of goods having positive externalities. This is in fact a _____ policy as **subsidies to producers would** _____ **cost of production**.
- In case of goods whose externalities are vastly positive, _____ **enters market directly** as entrepreneur to **produce & provide** them. Eg- **Public education, health care etc**
- Governments also engage in direct production of _____.
Eg- **afforestation, reforestation, protection of water bodies, treatment of sewage etc.**

III) a) Government intervention in case of merit goods

- **Merit goods** → goods having **substantial positive externalities** & are **socially desirable**.
- They are **under-**_____ & **under-**_____ through the market mechanism so that **social welfare will** _____ **be maximized**.
- **Eg-** education, health care, welfare services, waste management, public libraries, museum
- Govt responses → regulation, subsidies, direct government provision & combination of govt provision & market provision.
- 1) **Regulation** → how private activity may be conducted. Eg, way in which **education is imparted** is government regulated.
- 2) Govt can _____ some type of activities, set standards and issue mandates. Eg, govt may make it **compulsory to avail insurance protection**, compulsory vaccination etc
- 3) Govt could also use **legislation to enforce consumption of a good which generates positive externalities**. E.g. **use of helmets**, seat belts etc.

- 4) Govt can _____ **individuals** to consume good generating external benefit. The **Right of Children to Free & Compulsory Education Act, 2009** which mandates free & compulsory education for every child of the age of 6 to 14 years.
- 5) The **ultimate encouragement** → **make good completely** _____. Eg- **freely available hospital treatment** for various diseases.

III) b) Government intervention in case of demerit goods

- Demerit goods are **socially undesirable**. Eg- cigarettes, alcohol, intoxicating drugs etc. The **consumption** of which **imposes negative externalities**.
- **Production & consumption** of demerit goods → _____ **optimal** under free markets.
- _____ that consumers pay for cigarettes is market determined and **does** _____ **account for the social costs** that arise due to externalities.
- However, **all goods with negative externalities** are _____ **demerit goods**; e.g. Production of **steel** causes pollution, but steel is _____ a socially undesirable good.

□ How do governments correct market failure resulting from demerit goods ?

- 1) Enforce **complete** _____ on a demerit good. e.g. Intoxicating drugs
- 2) Effect of total ban is _____ realized in form of _____ of demerit good; conversely such goods are **secretly driven** _____ & traded in _____ **market**
- 3) Imposing **unusually** _____ **taxes**
 - But, **demand** for demerit goods is **highly** _____, so any increase in price due to additional tax causes a less proportionate decrease in demand. Also, sellers can _____ **taxes to consumers by** _____ without losing customers.
- 4) Government can **fix a** _____ **price** _____ **which the demerit good should not be exchanged**. (Price _____)
- 5) Through _____, achieved by _____ **advertising campaigns** which emphasize dangers with consumption of demerit goods Eg- Mukesh- iss shehar ko ye hua kya hai
- 6) Through **legislations** _____ of demerit goods Eg- Alcohol ads- music cds
- 7) Strict regulations- to _____ to good → by vulnerable groups – children.
- 8) _____ **restrictions** e.g. smoking in public places, sale of tobacco to be away from schools

IV) Government intervention in case of Public goods

- _____ of public good by government → overcome **free-rider problem**.
- Important public goods- Eg- **defence, establishment & maintenance of legal system, disease prevention** etc are provided by the government.
- _____ **public goods** can be provided by govt & same can be **financed through** _____.
- **Grant** _____ **to private firms** to build a public good facility → goods will be provided to public on paying entry fee. Govt _____ **level of entry fee** & keeps **strict** _____ **on functioning of licensee** to guarantee equitable distribution of welfare.

- Some public goods are provided by _____ **contributions** and private donations by corporate entities and NGOs.
- Certain goods are produced and **consumed as public goods** and services **despite the fact** that they **can be produced or consumed as** _____ **goods**. As, left to the markets and profit motives, these may prove _____ to society. Eg-
 - 1) scientific **approval of drugs**,
 - 2) production of **strategic products** such as atomic energy,
 - 3) provision of **security at airports** etc

V) Price Intervention: Non-Market Pricing

- Price intervention → form of price controls which are _____ **on price**.
- Price controls may take the form of either-
 - ❑ **Price Floor** (a _____ price buyers are required to pay) or
 - ✓ Eg- **Minimum Support Price (MSP)**, to guarantee steady and assured incomes to farmers.
 - ❑ **Price Ceiling** (a _____ price sellers are allowed to charge)
 - ✓ Eg- **Fixing of** _____ & _____
 - ✓ When **prices of certain essential commodities rise excessively**, government resort to **price ceilings** for making commodity available to all at reasonable prices. Eg- **maximum prices of food grains** and essential items are set by government during times of _____

VI) Correcting Information Failure

- 1) Make it mandatory → **accurate** _____ & _____ **disclosures** by producers.
Eg. Labelling on cigarette packets, _____ in food packages.
- 2) **Mandatory disclosure** of information Eg: **SEBI** requires accurate information be provided to prospective buyers of new stocks. (prospectus)
- 3) **Public** _____ **of information** to improve knowledge
- 4) **Regulation of** _____ and setting of advertising _____ to make advertising more responsible, informative and less persuasive.

VII) Equitable Distribution

Redistribute incomes so that there is **equity and fairness in the society**.

Some common policy interventions include

- 1) _____ income tax,
- 2) _____ **budgetary allocations**
- 3) _____ compensation
- 4) _____ **payments, subsidies**, social security schemes, job _____, etc.

Government Failure

- When govt intervention in economy to correct market failure _____ inefficiency & leads to misallocation.
- Government failure occurs when:
 - 1) **intervention is** _____ causing wastage of resources expended for the intervention
 - 2) **intervention produces** _____ & **more serious problems**.

Chapter 7 – Public Finance

Unit 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

I) Basics

II) The Process Of Budget Making

III) Sources Of Revenue

IV) Public Expenditure Management

V) Public Debt Management

I) Basics

- Budget is a powerful policy instrument → to regulate & restructure a country's priorities.
- The **need for budgeting** arises from the need to-
 - ✓ **efficiently** _____ **limited resources** to ensure maximum social welfare.
 - ✓ to ensure _____ **of income** and wealth.
 - ✓ reduce/**eliminate economic** _____ & bring in _____,
 - ✓ sustainable **increase in** _____ and
 - ✓ **reduction in** _____
- In simple terms, a **budget**-
 - ✓ Is a statement showing '**where money** _____' & '**where the money** _____'
 - ✓ Is a _____ of **entire revenues & exp.** that govt expects to receive & plans to spend during following year.
 - ✓ contains **estimates** of govt's accounts for **next fiscal year** → _____ **estimates**.
 - ✓ includes **projections** of economy & its **various sectors** → agri, industry, and services.
 - ✓ is the **most** _____ **report** of **government's finances**.

II) The Process Of Budget Making

- **Budgetary process** is means by which **executive & legislative branches** together **formulate** a coherent set of **taxing & spending proposals**.
 - Finances of govt of India have traditionally been controlled by _____.
 - The budget is **prepared by** _____ in consultation with _____ & other relevant ministries.
 - Budget must be **presented & approved by** _____ **houses** of parliament before beginning of the fiscal year (April 1 to March 31).
 - The term 'budget' has _____ **been used** in the **Indian Constitution**, the **process of making it** is referred to as **budgeting**.
 - **Article _____** of the constitution → for every financial year '**_____** shall cause to be **laid before** _____ **houses** of parliament a **statement** of _____ **receipts & expenditure** of the government for that year, referred to as "**_____**".
- | | |
|--|--|
| <ul style="list-style-type: none"> ➤ The budgetary procedures are – i. Preparation of the budget ii. Presentation & enactment iii. Execution of the budget. | <p>Budget process consists of two activities:</p> <ol style="list-style-type: none"> 1. Administrative process → budget along with accompanying documents are _____ 2. Legislative process wherein the budget is _____ by the parliament after discussions. |
|--|--|

PROCESS OF BUDGET (SUMMARY)

Aug-Sep '25

1/4/26

FY 26-27

31/3/27

Budget
Prep start

National Institution
for Transforming India

Budget is prepared by MoF in consultation with NITI Aayog.

1) MoF → Budget



Budget

• Detailed instructions & formats for preparing estimates of exp

Ministries
State
UTs
Autonomous
Bodies

2) Pre-Budget Consultations

• Union FM → State FM, Industry Associations, Representatives from various sectors, experts from NITI Aayog & economists etc.

3) Proposed Budget is prepared

4) Union FM →

Minister of Budget

5) Ceremony → Marking budget documents & printing of

• Budget Documents

a)

(AFS) →

Govt. Receipts & Expenditure

Consolidated Fund of India
Contingency Fund of India
Public Account.

b)

c)

d) Statements mandated under FRBM Act.

i) Macro Economic

Statement

ii)

e) other documents → Explanatory statements.

• Budget shows info of REC. & Exp. of 2 years.

FY 2026-27
i.e. Budget year

Year Preceding CY → FY 2024-25
 Current Year → FY 2025-26
 Ensuing Year → FY 2026-27

Actual Receipts & Exp

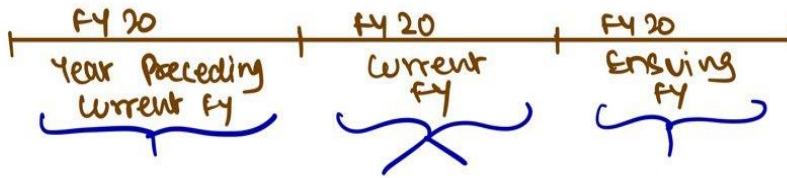
Year Preceding
the current F.Y.

Budgeted Estimates

• Current FY
• Ensuing FY

Revised Estimates

• Current FY



6y Budget Speech → FM → Lok Sabha.

Part A

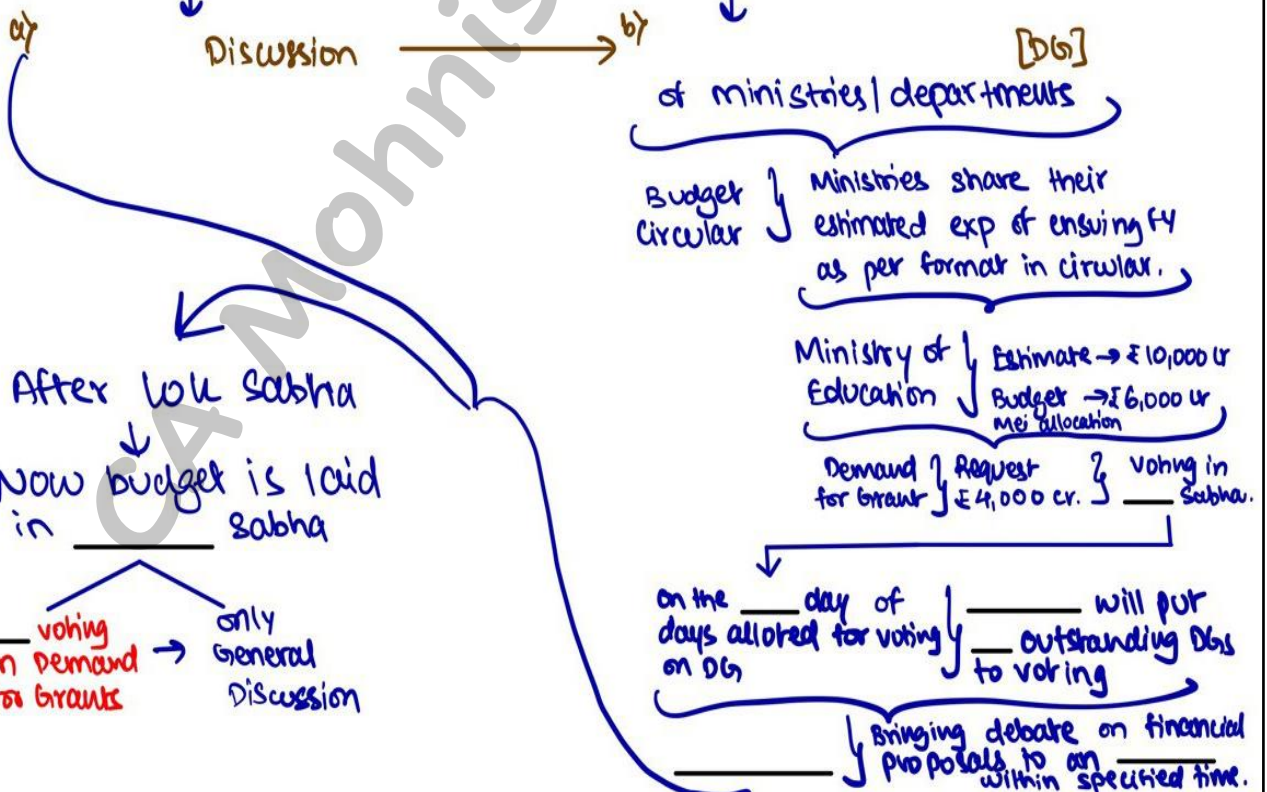
- Economic Situation
- Estimates for Ensuing FY. of Govt.
- raised by Taxes & Borrowing.
- Proposed to diff. sectors [Appropriation Bill]
- schemes for Diff. sectors.

Part B

- of Govt on various developmental measures
- Direction of policies
- proposals & variations in current taxation system [Finance Bill]

Budget Presenter hone ke baad

7y Budget is discussed in 2 stages in Lok Sabha



8) After general discussion & Voting on Dn,
now Govt. introduces -

→ Bill → Give authority to Govt. → _____
from Consolidated Fund of India

↓ After Appr. Bill
is passed

→ Bill is taken up for consideration

- Motion for leave to introduce FB _____ be opposed.
- Parliament has to pass F.B. within _____ days

9) After Finance Bill Passed by Lok Sabha

- sent to Rajya Sabha → Has to return it with _____ days with/without recommendations
- Recommendations of RS _____ accepted or rejected by LS.

Lastly, FB will be sent to _____

After Assent of FB → Finance Act.

10) from FY _____,
Date of presentation of Budget _____

11) Earlier Railway Budget was presented separately by Minister of Railways.

But ↓

from FY _____,
Railway Budget is merged with General Budget

Central Government

Revenue Receipts

- Neither create liability
- Nor cause any reduction in assets

Tax Revenue

Corp. Tax, Income Tax, GST, custom Duty etc.

Non-Tax Revenue

Interest Recd., Dividend Recd., Surplus from RBI etc.

CG Net Tax = Total Tax (-) SG (-) NCCD Revenue Recd by CG share

Revenue Expenditure

- Exp which does not lead to creation of assets
- Exp for normal functioning of Govt. Departments.
- Eg - Interest on loan, Grant to SG, Salary, Rent, Electricity etc.

Capital Expenditure

- Creation of Assets
 - Physical Assets
CG acquired land, M/L, Bldg. etc.
 - Financial Assets
Invst in Shares, CG giving loan & adv.
- Reduction in Liabilities
 - Repayment of Loans & Adv. (Principal Amt)
 - Payment of P.F. etc.

Capital Receipts

Increase in Liabilities

Debt Capital Receipt

Market loan, Treasury Bill, Security against small savings, External debt, State Provident fund

Reduction in Assets

Non-Debt Capital Receipt

Recovery of loans & Adv., Dis-investment, Sale of Govt. Assets.

Repayment of Debt Capital Receipts is Capital Expenditure

III) Sources of Revenue

- The **Department of** _____ of Ministry of Finance **controls the revenue matters** relating to **direct & indirect union taxes** through two statutory boards, namely,
 1. _____ (CBDT)
 2. _____ (CBIC).
- It is also entrusted with **administration & enforcement** of **regulatory measures** of all taxes.
- Levy & collection of **direct taxes** → looked after by _____, whereas
- Levy & collection of **GST, Customs & central excise duties & other IDTs** → looked by _____
- Centre's **net tax revenue** = Total tax revenue (-) States' share (-) National Calamity Contingent duty (NCCD)
- Various _____ **services** provided by govt. also yield revenue for govt., like-
 - ✓ medical services, public health, broadcasting, education, sports, housing and economic services such as communication, energy, transport, railways etc.

IV) Public Expenditure Management

- In view of _____ resources → govt to ensure that **level of public expenditure** is **consistent** with a **sustainable** _____.
- **Developing economies** require _____ amount of public spending to accelerate **economic** _____ & **promote** _____ opportunities.
- _____ in **fiscal deficit** requires **mix** of **revenue and expenditure policies**.
- Government expenditure **affects allocation of resources** → care should be taken to **channelize resources to** _____ areas.
- **Public expenditure management** → process to make governments **fiscally** _____.
- **Economic costs** of **unproductive public expenditures** can be **extensive** & may lead to:
 - ✓ _____ deficits
 - ✓ higher levels of _____,
 - ✓ _____ economic growth,
 - ✓ _____ resources available for use elsewhere, and
 - ✓ greater _____ burden in the future.
- ❑ The **Department of** _____ of Ministry of Finance → nodal department for **overseeing** the **public financial management system** of government.
- It is responsible for-
 - **implementation** of **recommendations of Finance Commission & Central Pay Commission**,
 - _____ of **audit comments/observations**, and
 - _____ of central government **accounts**.
 - **assisting central ministries/departments** in-
 - ✓ _____ **costs & prices** of public services,
 - ✓ **reviewing systems & procedures** to optimize outputs & outcomes of public exp.
 - The **requirements of funds** for all types of expenditure & **receipts** of departments are **discussed** during the **pre-budget meetings** chaired by _____ (**Expenditure**).
 - **Expenditure estimates** are **provisionally finalized** & **communicated** to ministries/departments after the approval of Finance Minister.
 - One of the **explanatory documents** of the budget document is the '_____' (earlier known as expenditure budget) → consists **data of all ministries/departments** to outline a **profile** of the **general** _____ of government of India.
 - It gives an _____ of various types of expenditure and certain other items across demands.

➤ In Expenditure budget, **Central govt expenditure** is classified into **six broad categories**:

A. **Centre's Expenditure**:

- ✓ _____ **Expenditure** of Centre;
- ✓ _____ **schemes**, and
- ✓ **Other** central expenditures including those on CPSEs and Autonomous Bodies

B. **Centrally Sponsored Schemes and other Transfers**:

- ✓ _____ **schemes**
- ✓ _____ **transfers**, &
- ✓ **Other** transfers to states

IV) Public Debt Management

➤ In developing economies, **government** is generally the _____ **borrower**.

➤ Government debt from **internal** & **external** sources contracted in the _____
_____ is defined as _____.

➤ **Public debt** - means **debt incurred by government** in **mobilizing** _____ of people in the form of **loans**, which are to be **repaid at a future date** with **interest**.

➤ Public debt is _____ **a one-time exercise** of borrowing and repaying.

➤ **Debt** _____ is a _____ **exercise** as a portion of debt falls due each month, government does not cut expenditure or raise taxes → rather, it _____ **debt**, i.e. it **sells** _____ **bonds** and uses the proceeds to **pay off holders of maturity bonds**.

➤ Productive use of public debt → contributes to economic **growth** & **welfare**.

➤ **Sustainability of sovereign debt** is an **indicator** of **overall** _____

➤ Debt sustainability is a **function** of-

- _____ **of debt**, &
- govt's _____ the outstanding debt.

➤ **Public debt management** refers to task of determining-

- ✓ the **size** and **composition** of debt, ✓ **interest rates**,
- ✓ the **maturity pattern**, ✓ **redemption of debt** etc.

➤ The **overall objective** of central govt's **debt management policy** is to-

- ✓ meet central govt's _____ **needs** at **lowest possible costs** &
- ✓ to **keep total debt within** _____
- ✓ It also aims at **supporting development** of _____

➤ **Debt management strategy** is based on **three broad pillars** namely,

- 1)
- 2)
- 3)

IV) Public Debt Management

Institutions responsible for public debt management are

Domestic marketable debt i.e., dated securities, treasury bills and cash management bills.

External Debt

- ✓ _____ loans- (loan from one country/govt)
- ✓ _____ loans (_____ part of external debt)- loans from from multilateral agencies (International Bank for Reconstruction and Development, Asian Development Bank, etc.)

Other liabilities such as small savings, deposits, reserve funds etc.

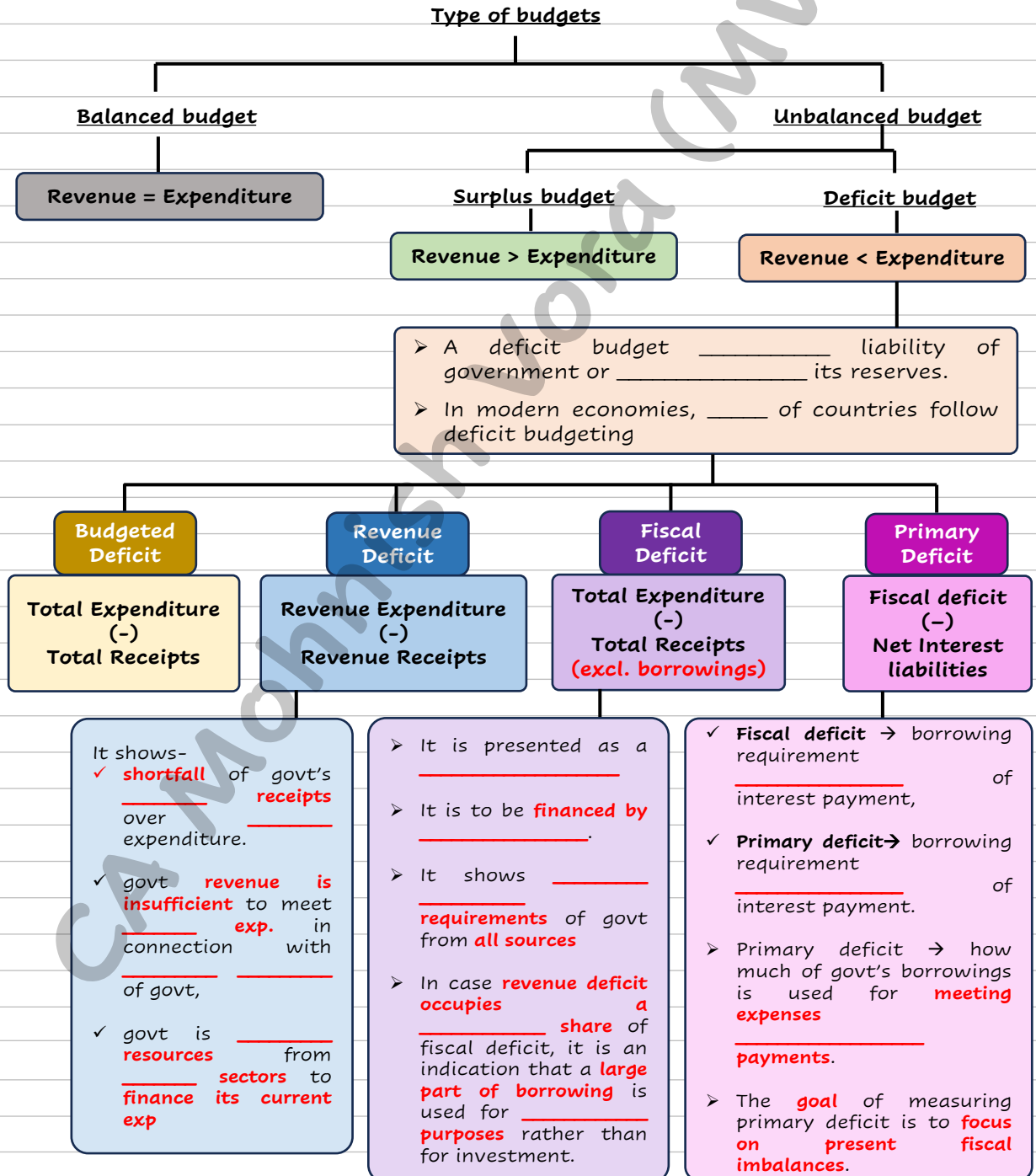
- _____ acts as **debt manager** for **marketable internal debt**.
- _____ are issued to meet **short-term** cash req. of govt.
- _____ are issued to mobilise **longer term** resources to finance fiscal deficit.
- There is _____ sovereign borrowing from **international capital markets**.
- **Risk of external debt** is _____ in value of _____ currency compared to currency of external loans leading to _____ in government's debt servicing cost.
- ❑ From _____ onwards, RBI also provides **short-term** credit up to _____ months to **state governments** banking with it in the form of _____ (WMA) to bridge temporary mismatches in cash flows.

Fiscal Responsibility and Budget Management (FRBM)

- It was passed in _____ to provide a legislative framework for _____ & thereby debt of central government to a sustainable level.
- The **objectives** of the act are:
 - 1) _____ in fiscal management,
 - 2) long run _____,
 - 3) better _____ between **fiscal** and **monetary** policy, and
 - 4) _____ in **fiscal operation** of the government.
- _____ (**PDMC**) was created in 2016 under the Department of Economic Affairs.
- _____ **Strategy** or MTDS 2021-24 is a framework to determine appropriate **composition of debt portfolio**.

- As part of continuing efforts to increase retail participation in G-sec, '_____ ' facility was announced on February 5, 2021:
- ✓ for improving **ease of _____ by retail investors** through **online access** to primary & secondary government securities market
 - ✓ to provide the facility to _____ **their government securities** _____ ('Retail Direct') with the Reserve Bank.

Budget concepts



Topic	Meaning
Outcome budget	<ul style="list-style-type: none"> ➤ They establishes a direct link between budgetary _____ of schemes & its annual _____ measured by output & outcome indicators. ➤ It is a _____ on what various ministries & departments have done with outlays in previous annual budget. ➤ It measures the _____ of all government programs and whether the money has been spent for the _____ it was sanctioned including the outcome of the fund _____.
Guillotine	<ul style="list-style-type: none"> ➤ Parliament has very _____ time for examining the expenditure demands of all the ministries. ➤ Once prescribed period for discussion on demands for grants is over, the _____ of Lok Sabha puts _____ outstanding demands for grants, whether discussed or not, to vote of house. ➤ This process is known as 'Guillotine'.
Cut Motions	<ul style="list-style-type: none"> ➤ Motions for _____ to various demands for grants are made in form of cut motions seeking to _____ the sums sought by govt. on grounds of- <ul style="list-style-type: none"> ✓ _____ or ✓ _____ of opinion on matters of policy or ✓ just in order to _____.
Public Account	<ul style="list-style-type: none"> ➤ Under provisions of Article _____ of the Constitution of India, public account is used in relation to all the fund flows where government is acting as a _____. ➤ Eg- _____ & _____. ➤ This money does _____ belong to govt but is to be returned to depositors. ➤ Expenditure from this fund need _____ be approved by the parliament.
Consolidated Fund of India	<ul style="list-style-type: none"> ➤ All _____ received, _____ raised and all _____ received by government in repayment of loans are credited to the Consolidated Fund of India and all _____ of the government are incurred from this fund. ➤ Money can be spent through this fund only if appropriated by the _____. ➤ The consolidated Fund has further been divided into '_____' & '_____' divisions.
Contingency Fund of India	<ul style="list-style-type: none"> ➤ A fund (Rs 30,000 cr.) placed at the disposal of the _____ to enable him/her to make advances to the executive/Government to meet _____ expense. ➤ It does _____ require prior legislative approval, unlike with the Consolidated Fund. ➤ For meeting such exigencies, advances are made to the executive from the contingency fund which is subsequently reported to the Parliament for _____ from the Consolidated Fund of India.

Chapter 7 – Public Finance

Unit 4 – FISCAL POLICY

I) Basics

II) Types of fiscal policy

III) Instruments of Fiscal Policy

IV) Fiscal policy for long-run economic growth

V) Fiscal policy for reduction in inequalities of income and wealth

VI) Limitations of fiscal policy

I) Basics

➤ Fiscal policy involves use of government

- ✓ _____, _____ & _____
- to influence both-
- ✓ **pattern of** _____ and
- ✓ level of growth of _____ & **employment**

□ Objectives

➤ The most common objectives of fiscal policy are:

- ✓ Achievement and maintenance of _____
- ✓ Maintenance of _____
- ✓ **Acceleration** of rate of _____
- ✓ _____ of income and wealth

➤ The **importance** as well as order of **priority** of these objectives may _____ **from country to country** and from time to time. For instance-

- ✓ _____ & _____ may be the priorities of **developed** nations,
- ✓ **economic** _____ & _____ → more priority in **developing** country

II) Types of Fiscal Policy

Expansionary fiscal policy

To **stimulate** **economy** during _____ phase.

- _____ **aggregate exp**, and
- _____ **in taxes**

Thus _____ **aggregate demand** **in future**

It leads to _____ **government budget deficit** or smaller budget surplus.

Contractionary fiscal policy

To **stimulate** **economy** during _____ phase.

- _____ **aggregate exp**, and
- _____ **in taxes**

Thus _____ **aggregate demand in future**

It leads to _____ **government budget deficit** or larger budget surplus.

CFP is resorted to **close the** _____ **gap**

If **growth rate is very** _____ causing **inflation** & **asset bubbles** → CFP will be used to control it.

III) Instruments of Fiscal Policy

III)a) Government (Public) expenditure

- Public expenditures are income-generating and include-
 - ✓ **Current expenditures** to meet the _____ **running** of government
 - ✓ **Capital expenditures** - **investments** made by Govt in _____ & **infrastructure**,
 - ✓ **Transfer payments** - government **spending** which **does** _____ **contribute to GDP** because income is only transferred, _____ any direct contribution from the receivers
- **During Recession**
 - ✓ It may **initiate** _____ **of public works**, such as construction of roads, irrigation facilities, ports, electrification of new areas etc.
- **During Inflation**
 - ✓ To reduce severity of _____ & to bring _____ prices
 - ✓ Govt **reduces expenditure** → Reduced incomes → _____ excess aggregate demand.
- **From where will govt find resources to increase its expenditure, during recession?**
 - ✓ If govt **increases taxes** → _____ as increased taxes will reduce incomes & AD
 - ✓ The govt should in such cases go for a **deficit budget** which may be **financed** either
 - through _____ (but it may have risk of crowding out private spending) or
 - through _____ (creation of additional money to finance expenditure).
 - Programme of public investment
- Primary employment in public works will _____ employment, & economy will be put on an expansion track.

III)b) Taxes

- Taxation policies are used for establishing _____ in an economy.
- During **recession & depression**,
 - ✓ Taxes are _____ → to encourage private consumption & investment.
- During **inflation**,
 - ✓ _____ **taxes** can be levied & rates of existing taxes are raised → to **reduce disposable incomes** & to **wipe off surplus** purchasing power.
 - ✓ However, excessive taxation _____ & thus govt has to be cautious about it
- The _____ of tax reduction &/or increase in government spending required depends on the _____ **of recessionary gap** and _____ **of the multiplier**.

III)c) Public Debt

➤ Public debt may be;

1) Internal Debt

- When government **borrow from its _____ people** in country.

2) External Debt

- When government **borrow from _____ sources.**

3) Market Loans

- Government issues **treasury bills** and **government securities** of varying denominations and duration which are _____.
- For financing **capital projects** -> _____ are issued
- For meeting **short-term** government expenditure -> _____ are issued.

4) Small Savings

- Borrowings which are **_____ negotiable** & are **not _____ in market.**
- Eg- National Savings Certificates, National Development Certificates, etc.

➤ **Borrowing from public** through **_____ of bonds** & securities **_____ aggregate demand**.

➤ **Repayments of debt** **_____ the availability of money** & **_____ aggregate demand.**

III)d) Government Budget

- The budget is simply a **statement** of **revenues earned** from taxes and other sources and **expenditures made** by a nation's government in a year.
- The **net effect** of a budget on aggregate demand **depends on** the government's budget **balance**.

☐ Balanced budget: (Revenue = Exp)

- ✓ **No net effect** on aggregate demand since leakages (taxes) = injections (exp)

☐ Budget surplus: (Revenues > Exp)

- ✓ It has **negative net effect** on aggregate demand since leakages > injections
- ✓ It **reduces national debt**

☐ Budget deficit: (Revenues < Exp)

- ✓ It has **positive net effect** on aggregate demand since injections > leakages
- ✓ It **adds to the national debt**

IV) Fiscal policy for long-run economic growth

- Demand-side policies _____ by policies to stimulate aggregate _____ cannot produce long-run economic growth.
- For eg-
- ✓ Fiscal policies involving **infrastructure spending** have _____ **supply-side effects**.
- ✓ Government provision of **public goods** such as education, healthcare, etc. facilitate long-run economic growth through _____. Increase in human capital **makes** _____ **capital more productive**.
- ✓ **Taxes** can have either _____ or _____ impact on economic growth depending on whether it encourages or discourages saving and investment.
- A **well designed tax policy** that **rewards** _____ & entrepreneurship, without discouraging incentives will **promote private businesses** who wish to invest & thus help **economy grow**. For eg, an increase in corporate taxes to raise extra revenue may have adverse consequences on incentives and output.
- **Increase in environment taxes** increase the cost of firms and _____ **their output**
- **Subsidies** on inputs and **support prices** to producers (e.g. farmers) generate _____ **output**.

V) Fiscal policy for reduction in inequalities of income and wealth

- Distribution of income is influenced by fiscal policy-
 - ✓ **Directly**- _____ **incomes** of are dependent on direct taxes,
 - ✓ **Indirectly**- **Potential for** _____ **earnings** is indirectly influenced
- Few measures as to how **govt** can achieve **desired redistribution of income**-
 - ✓ _____ **direct tax** system
 - ✓ **Indirect taxes** can be _____ (More tax on Luxury goods, Less tax on Necessities)
- A **carefully planned policy of public exp.** helps in **redistributing income** from rich to poor. **Spending programmes** targeted on welfare measures for disadvantaged-
 - ✓ **Poverty alleviation** programmes
 - ✓ Free or subsidized _____, _____
 - ✓ _____ provision on a **selective basis**
 - ✓ **Subsidized production** of products of _____ consumption
 - ✓ Public production or grant of **subsidies** → for sufficient supply of essential goods,
 - ✓ **Strengthening** _____ for enhancing employability etc

VI) Limitations of fiscal policy

- 1) _____ – An expansionary policy initiated when economy is already on recovery.
- 2) Difficulties in _____ governments' spending & taxation policies
- 3) Practically **difficult to reduce government spending** on → _____ & _____ as well as on huge **capital projects** which are **already** _____.
- 4) **Public works** _____ **be adjusted easily** → as huge projects have **long gestation period**.
- 5) Certain fiscal measures cause _____. For eg, increase in profits tax may adversely affect incentives of firms to _____ & an increase in social security benefits may adversely affect incentives to _____.
- 6) **Deficit financing** increases the _____ of people. The **production** of G/S, in under-developed countries **may not catch up simultaneously**, resulting in **prices** _____ **beyond control**.
- 7) **Increase in government borrowing** creates _____ on **future generations**.
- 8) **Crowding Out**
 - During **recession**, **government** uses expansionary fiscal policy by _____ **govt exp**.
 - However, if **taxes** (revenue of govt) are **not sufficient** for the increased spending, then **government increases its spending** by _____ from market → thus _____ **demand for loans & pushes the interest rates** _____.
 - Similarly, when govt **increases budget deficit** by **selling bonds or treasury bills**, the **amount of money with private sector** _____ & thus **interest rates will be pushed** _____.
 - As a result, **private investments** → which are **interest-sensitive**, will be _____.
 - **Fiscal policy becomes** _____ as **decline in private spending partially or completely offsets expansion in demand** resulting from an increase in govt exp.
 - Thus, an increase in size of govt spending during recessions will ' _____ ' private spending in an economy &
 - lead to _____ in an **economy's ability to** _____ from recession,
 - possibly **reduce** economy's **prospects of** _____
- 9) **Lags**
 - i. **Recognition Lag**
 - **Lag in** _____ for a policy change
 - ii. **Decision Lag**
 - _____ on most appropriate policy.
 - iii. **Implementation Lag**
 - Delays in _____ and implementing them
 - iv. **Impact Lag**
 - _____ of a policy are _____ **visible for some time**

CA Foundation
(New Syllabus)

Business Economics

Abhyaas Notes

Chapter 8

Money Market

By CA Mohnish Vora (MVSIR)

Complete these notes by watching classes of MVSIR

Summary of Important Points

Chapter 8 – Money Market

Unit 1 – The Concept Of Money Demand: Important Theories

BASICS

- **Money** is something that **holds its value over time**, can be **easily translated into prices**, and is **widely accepted**.
- **Fiat Money-** aka. _____ money has _____ **intrinsic value** (materially _____) → no value if it were not used as money. It is used as medium of exchange as govt has, by law, made them " _____ " which means, **they serve, by law, as means of payment**.

DEFINITION OF MONEY

Money can be defined **for policy purposes** as the set of _____, **variation in the** _____ of which could **impact** on **aggregate economic activity**.

As a **statistical concept**, money could include certain _____ of a particular set **of financial intermediaries** or other issuers'.

CHARACTERISTICS OF MONEY

Money should be:

- generally _____
- _____ or long-lasting
- effortlessly _____
- **difficult to** _____ i.e. not easily reproducible by people
- relatively _____, but has elasticity of supply
- _____ or easily transported
- possessing _____; and
- _____ into smaller parts or fractions _____ **losing value**

FUNCTIONS OF MONEY

- 1) Convenient _____
- 2) Explicitly defined _____ or unit of account
- 3) Serves as a unit or standard of _____
- 4) _____

DEMAND FOR MONEY

- If **people** _____ **to** _____ **money**, we say there is **demand for money**.
- Demand for money is in the nature of _____ **demand**; it is **demanded for its** _____

THEORIES OF DEMAND FOR MONEY

I) CLASSICAL APPROACH: QUANTITY THEORY OF MONEY

- Given by _____ in his book 'The Purchasing Power of Money'
- As per QTM, **money in circulation (M)** & **price level (P)** are _____ **related** to each other. (Linear) That is, changes in prices or changes in the value or purchasing power of money are determined by changes in quantity of money in circulation.
- QTM is aka. '**equation of _____**' or '**_____ approach**'

$$MV =$$

- Later, Fisher **extended the equation** of exchange to **include demand (bank) deposits (M')** **and their velocity (V')**

Expanded Form :

- As per QTM, people would **hold money** in a quantity **proportional to total _____** irrespective **of interest rate** [More Transactions -> _____ Demand of Money]

II) CAMBRIDGE APPROACH

- Aka _____ **Approach** or _____ **Theory**
- **Money increases utility** in the following **two ways-**
 - 1) _____ **of sale and purchase** to two different points of time (transaction motive)
 - 2) _____ **against uncertainty**. (_____ of wealth)
- Since **sale & purchase** do **not take place simultaneously**, people need '**temporary _____**' of purchasing power as hedge against uncertainty.
- **How much money will be demanded as per Cambridge Approach?**
- ➔ **Higher the _____ -> greater the _____ -> greater demand for _____.**
- Md =**
- where, PY = nominal income ,
- k = _____ = **proportion of nominal income (PY) that people want to hold as cash**

iii) Keynesian Theory of Demand for Money

- Aka. ' _____ ' → people demand money for three motives:
Transactions motive, Precautionary motive, & Speculative motive

a) Transactions motive

Money for **current transactions** for

_____ & _____ exchange (income motive & business motive).

Money is demanded **to _____ time** gap between receipt of **income** & planned **exp.**

Transaction demand for money is _____ **related** to level of income

$$L_r =$$

k is the ratio of earnings which is kept for transactions purposes

b) Precautionary motive

Portion of income kept to **finance** _____ **exp** which occur due to _____ **contingencies**.

Precautionary money balances are **income** _____ and **interest** _____

c) Speculative motive

People also demand money to **take advantage of** _____, which is same as future changes in _____. (to **exploit** any **attractive investment opportunity**)

Assumed that **return on money is** _____, while **returns on bonds** are of **two types**: _____ & _____

Market Value of Bond inversely related to Market Rate of Interest

Current rate of interest (r_n) > Critical rate of interest (r_c)

People **expect a** _____ in **interest rate** (_____ in bond prices)

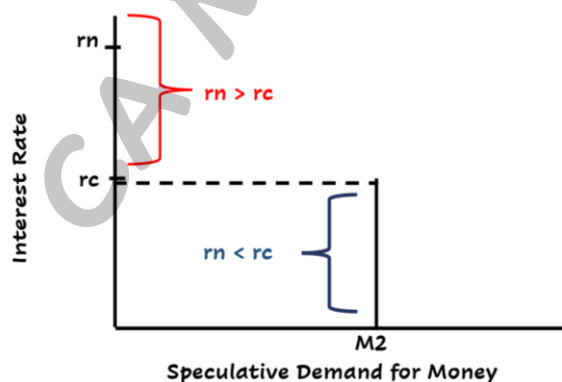
People will **convert their** _____ **balances into** _____ (SDM _____ & Bond _____)

Current rate of interest (r_n) < Critical rate of interest (r_c)

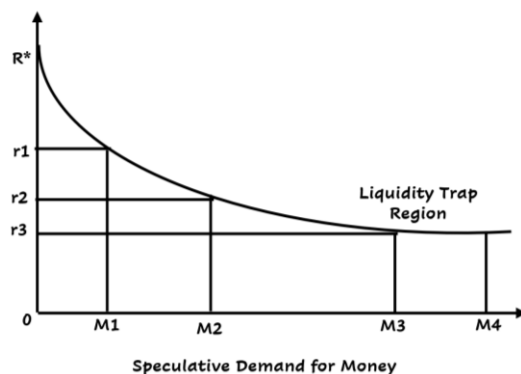
People **expect a** _____ in **interest rate** (_____ in bond prices)

People would hold their wealth in _____ **cash** rather than _____. (SDM _____ & Bond _____)

Individual's Speculative Demand for Money



Aggregate Speculative Demand for Money



❑ Liquidity Trap

- When **interest rates fall to very** _____, the **expectation** is that now _____ **go further** _____ & will **move** _____ in future.
- Thus, when **interest rates rise in future**, the **bond prices will** _____ leading to taking **risk** of a _____ in future
- Thus at such low interest rates-
 - ❑ desire to **hold bonds** is **very** _____ and **approaches** _____, and
 - ❑ demand to **hold money** in liquid form **approaches** _____.
- The **speculative demand of money curve** becomes **parallel to** the _____ **axis**, i.e., _____ with respect to interest rate.
- This situation is called a '**Liquidity trap**'. (**ineffective monetary policy**)
- Empirical evidence of Liquidity Trap is found during "_____ (2008)"

Post-Keynesian developments in Theory of Demand for Money

IV) Inventory Approach to Transaction Balances

- Aka. **Inventory Theoretic Approach**
- Given by **Baumol and Tobin**, in which money is viewed as an **inventory held for transaction purposes**.
- Inventory models assume that there are **two media for storing value**:
 - 1) _____ &
 - 2) **an interest-bearing financial asset**
- There is _____ of **making transfers** between money & alternative assets e.g. _____
- As per Baumol, people hold an **optimum** _____ of **bonds and cash balance**, i.e., an amount that **minimizes** _____ **cost**.
- The level of inventory holding (holding money in cash)-
 - is _____ **RELATED** to
 - ❑ **Income of person**
 - ❑ **Cost of making transfer between money and bonds**
 - &
 - is _____ **RELATED** to
 - ❑ **Carrying cost**
 - ❑ **Number of times bond transaction are made**

V) Friedman's Restatement of Quantity Theory

Milton **Friedman extended Keynes' speculative money demand** within the framework of **asset price theory**.

Friedman's _____ **determinants** of the demand for money

1. _____ = **Permanent Income / discount rate**

Where, discount rate is average return on five asset

2. Positively related to the _____, **P**
3. Rises if _____ of money holdings (i.e. returns on bonds and stock) decline
4. _____ - Positive inflation rate reduces the real value of money balances, thereby increasing the opportunity costs of money holdings

IV) Inventory Approach to Transaction Balances

Given by Tobin in his article, '**Liquidity Preference as Behaviour towards Risk**' This theory is based on the principles of "_____"

An individual would hold **optimally structured** _____ which is **comprised of** _____

> _____ - (provides return for the risk borne) and

> _____ - (No return, but also no risk)
Just as Keynes' theory, Tobin's theory also implies that **demand for money** depends _____ **on interest rate**.

Chapter 8 – Money Market

Unit 2 – CONCEPT OF MONEY SUPPLY

BASICS

- The term money supply denotes **the total quantity of money available with** _____
- Two things about any measure of money supply:

Supply of money is a _____
variable

Change in stock of money is
_____ **variable**

It refers to stock of money **available to**
'_____'.

This is **always** _____ **than** the
total stock of money that really exists in
economy.

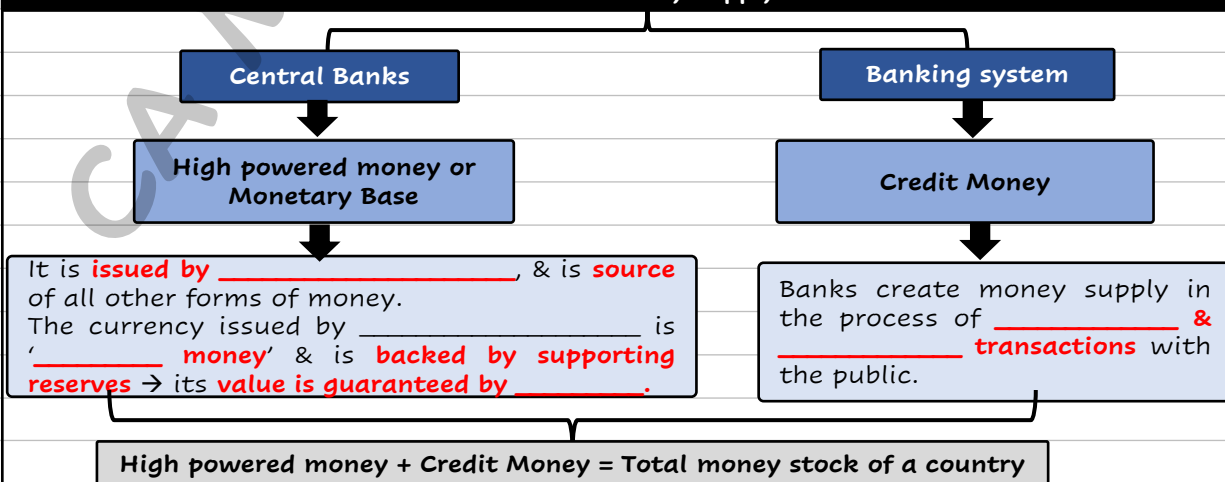
- **'Public'** **all economic units except the** _____ **of money** (i.e. the government and the banking system).
- **Government** = CG, all SGs, and local bodies.
- **Banking system** means **RBI** and all **banks that accept demand deposits**
- Thus, **'supply of money'** _____
 - ☐ **interbank deposits** and
 - ☐ money held by **government** and
 - ☐ money held by **banking system**

Rationale of measuring money supply

Empirical analysis of money supply is important because-

- 1) Facilitates **analysis of** _____ → to understand causes of money growth.
- 2) Provides a **framework** to evaluate whether money supply is consistent with **standards for** _____ and to **understand nature of deviations**. It helps in **making** _____

Sources of money supply



- The concept of money has experienced evolution from **Commodity** to **Metallic** to **Paper** to **Digital Currency**.
- Reserve Bank has introduced a concept of _____ (CBDCs)- **as legal tender issued by a central bank in a digital form**. It is like **sovereign paper currency** but takes a **different form, exchangeable at par with existing currency** and shall be accepted as a medium of payment, legal tender and a safe store of value. CBDCs would appear as liability on a central bank's balance sheet.
- Also, **Crypto currencies** are _____ **legally recognized** in India as currency & are not **money**.

Measurement of money supply

- **Reserve money (M0)** is aka.- **central bank money or base money or high-powered money**

Reserve money determines -

- ✓ level of liquidity and
 - ✓ price level in economy and,
- thus, its management is of crucial importance to stabilize the economy.

	Currency in circulation
+	
+	
	Reserve Money (M0)

	Currency with Public
+	
+	
	M1 (Narrow Money)

	M1
+	
	M2

	Notes in Circulation
+	
+	
-	
	Currency with Public

	M1
+	
	M3 (Broad Money)

	M3
+	
	M4

Difference M0 & M1	M0	M1
Bank Reserves		
Bank Deposits		

- The above are given in _____ order of liquidity -
M1 (_____ Liquid) & M4 (_____ Liquid)
- 'Other deposits' with the RBI _____ those **held by govt** (Central & State Govt.)

Money Multiplier (m)

The money multiplier process explains **how an increase in monetary base causes money supply to increase by a multiplied amount**

1st Formula

Money Multiplier (m) = _____

where, Monetary Base = Currency in circulation + Bank reserves

2nd Formula

Money Multiplier (m) = _____

where,

- **c = currency ratio** = currency / dep.
- **r = required reserve ratio**
= required reserves / deposits
- **e = excess reserve ratio**
= excess reserves / deposits

3rd Formula

If we **assume-**

- 1) **Banks never hold** _____ (e =)
- 2) Individuals and non-bank corporations **never hold** _____ (c =)

Then, money multiplier is _____ of **the required reserve ratio**.

Money Multiplier (m) = 1 / Required Reserve Ratio
= 1 / R

m = 1 / R

Above formula can also be referred as

_____ Multiplier or
_____ Multiplier or
_____ Multiplier

It describes **amount of additional money created by commercial bank** through process of **lending the available money** it has in excess of central bank's reserve requirements.

Determinants of Money Supply

- Money multiplier approach to money supply given by Milton Friedman and Anna Schwartz, (1963) considers **three determinants-**

1. **Stock of high-powered money (H)** → Depends upon Behaviour of _____
2. **Reserve-ratio (r) = R / D** → Depends upon Behaviour of _____
3. **Currency Deposit Ratio (c) = C / D** → Depends upon Behaviour of _____

1. Stock of high-powered money (H)

- Money supply **varies** _____ with supply of high-powered money.

2. Reserve-ratio (r) = R / D

- If required reserve ratio **increases -**

- ✓ banks will _____ lending,
- ✓ causing a _____ in deposits
- and hence money supply will _____ & vice versa

- **Smaller** the 'r' → _____ the 'm'

- ❑ **Excess Reserves (ER)** are funds that a bank keeps as reserve beyond what is required by regulation as a _____ against _____ requiring cash.

Excess reserves (ER) =

- Excess Reserves **do** _____ **lead to any additional loans.**
- **Smaller** the Excess Reserve Ratio 'e' → _____ the 'm'
- When **opportunity cost to bank of holding ER** _____, **level of ER** _____ → **m** will be _____
- If expected deposit outflows increase, banks will **increase ER ratio. Thus, m will** _____
- Eg- During festival season, people decide to use ATMs very often

3. **Currency Deposit Ratio (c) = C / D**

- If public keeps more **money in cash**, leads to an **increase in 'c'** & **banks can create less credit money**, thus **m** _____.

Eg- Fearing shortage of money in ATMs, people decide to hoard money

- Currency-deposit ratio (c) also represents **degree of** _____ **of banking habits** by people, affected by **degree of financial** _____, ease & access to financial services etc.

Eg- 1) Banks open **large number ATMs** all over the country, or

2) **E-banking becomes very common** and nearly all people use them

- ✓ Above factors will _____ 'c'; thus _____ 'm' & **money supply**

- ❑ The **time deposit-demand deposit ratio** (TD/DD ratio) i.e. how much money is kept as _____ deposits compared to _____ deposits.

- An **increase in TD/DD ratio** → _____ the 'm'

Monetary Policy and Money Supply

If the central bank of a country wants to _____ **economic activity** it does so by _____ **liquidity into the system.**

Eg - Open Market Operations (OMO) by central banks.

_____ **of govt. securities** _____ **high powered money** (monetary base) into system.

$$\Delta \text{ Money Supply} = \frac{1}{R} \times \Delta \text{ Reserves}$$

Effect of government expenditure on money supply

When **RBI lends to governments** under _____ **(WMA)/overdraft (OD)**

→ leads to **generation of** _____ **money supply in economy** through money multiplier process.

Chapter 8 – Money Market

UNIT 3 – MONETARY POLICY

Introduction

- RBI uses monetary policy to **manage economic** _____ & achieve **price** _____, which means that **inflation is** _____ and _____.
- RBI conducts monetary policy by adjusting supply of money, usually **through buying or selling** securities in open market.
- **Open market operations** affect short-term interest rates, which in turn influence longer-term rates & economic activity.
- ✓ When RBI **lower interest rates**, monetary policy is _____.
- ✓ When it **raises** interest rates, monetary policy is _____.

The Monetary Policy Framework

It has three basic components-

- (i) _____ of monetary policy,
- (ii) _____ of monetary policy which focus on transmission mechanisms, &
- (iii) _____ which focuses on operating targets & instruments

Objectives of monetary policy

The primary objective of monetary policy is maintenance of **judicious balance** between _____ & _____.

Objectives of Monetary Policy in case of developing countries

- 1) maintenance of _____
- 2) ensuring _____ of credit to _____
- 3) sustaining a **moderate structure of** _____
- 4) creation of an **efficient market for** _____

Transmission of Monetary Policy

It describes **how changes** made by RBI to its monetary policy settings _____ to _____ and inflation.

The transmission has _____ stages.

1. Changes to monetary policy **affect** _____ in economy.
2. Changes to interest rates **affect** _____ & _____

Channels of Monetary Policy Transmission

- 1) Saving and Investment Channel
- 2) Cash-flow Channel
- 3) Asset Prices and Wealth Channel
- 4) Exchange Rate Channel

Operating Procedures and Instruments

Quantitative toolsCredit control tools that **impact money supply of entire economy**

1.	Reserve Ratio	Reserve ratio is of two types-
1a.	Cash Reserve Ratio (CRR)	Banks are required to set aside a portion of NDTL in cash with _____. RBI _____ required to pay interest on CRR amount.
1b.	Statutory Liquidity Ratio (SLR)	Banks are also required to set aside a portion of NDTL with _____, in form of _____ assets- cash, gold or RBI approved securities . Banks are _____ to earn interest on these securities.
2.	Open Market Operations (OMO)	RBI buys and sells government securities in the market. When RBI _____ government securities, liquidity is _____ from market → it is done to _____ inflation. The objective is to keep a check on temporary liquidity mismatches in market owing to foreign capital flow.

Qualitative tools

These are selective credit control tools that have affect money supply of specific sector & not whole economy.

1.	Margin requirements	When margin requirements are _____ → customers borrow _____
2.	Moral suasion	By way of _____, the RBI convinces banks to keep money in government securities, rather than certain sectors.
3.	Selective credit control	Controlling credit by _____ lending to selective industries.

Market Stabilisation Scheme (MSS)Under MSS, the _____ **borrow from** _____ (additional to its normal borrowing) and issues treasury-bills, for _____ **liquidity** from market arising from large capital inflows.Policy Rates

1.	Bank Rate	The interest rate at which RBI lends _____ term funds to banks. Aka. Discount rate. Bank rate is used to prescribe _____ to bank if it does not maintain prescribed SLR or CRR
2.	Liquidity Adjustment Facility (LAF)	RBI uses LAF as an instrument to adjust liquidity and money supply. The following types of LAF are-
2a.	Repo Rate	Repo rate is the rate at which _____ borrow from _____ on a _____- term basis against a repurchase agreement .
2b.	Reverse Repo Rate	It is the reverse of repo rate, i.e., this is the rate _____ pays to _____ in order to keep additional funds in RBI . It is _____ to repo rate → Reverse Repo Rate = Repo Rate -
3.	Marginal Standing Facility (MSF) Rate	MSF Rate is the _____ rate at which _____ lends money to banks , _____ the rate available under the repo policy . Banks availing MSF Rate can use a maximum of _____ of SLR securities . MSF Rate = Repo Rate +

Organisational Structure For Monetary Policy Decisions

- It is an **agreement** reached between **Government of India & RBI** on _____ **inflation rate** that RBI should target to **achieve price stability**.
- Announcement of an official target range for inflation is known as **inflation** _____. ('Flexible inflation targeting framework')
- The **inflation target** is to be **set by the Government of India**, in **consultation with RBI**, _____ in every _____ years.
- Accordingly, Central Government has notified-
 - **4 per cent Consumer Price Index (CPI)** inflation as the **target** for period from **Aug 5, 2016 to Mar 31, 2021** with the-
 - ✓ **upper tolerance limit of** _____ and
 - ✓ **lower tolerance limit of** _____
- **Monetary Policy Report** is to be published every _____ **months**, explaining **sources of inflation & forecasts** of inflation for the coming _____ **months**
- The following are factors lead to a **failure to achieve inflation target**
 - **Average inflation upper tolerance** level, for any _____ **quarters**; or
 - **Average inflation lower tolerance** level, for any _____ **quarters**.

Monetary Policy Committee (MPC)

It is a **member committee** consisting of-

- **RBI** _____ (Chairperson),
- **RBI** _____ in charge of monetary policy,
- **One official** nominated by the _____ and
- **Remaining three** _____ **nominees** representing Govt of India

MPC is required to **meet at least** _____ **times** _____ & **decisions** adopted by MPC are **published** after conclusion of every meeting.

MPC shall determine _____ required to achieve inflation target.

CA Foundation – June 2024
(New Syllabus)

Business Economics

Abhyaas Notes

Chapter 9

International Trade

By CA Mohnish Vora (MVSIR)

Complete these notes by watching classes of MVSIR

Summary of Important Points

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Chapter 9 – International Trade

Unit 1 – Theories of International Trade

Basics

- International trade is **exchange of G/S** as well as resources **between countries**.
- It involves **transactions-**
 - ✓ **between residents of _____.**
 - ✓ **involves transactions in _____.**
 - ✓ **greater _____ as it involves _____ of customers & currencies, differences in legal systems, business practices, more elaborate documentation etc**

Benefits of International Trade

- 1) **Stimulus to economic _____ & contributes to economic _____ & rising incomes.**
- 2) Efficient deployment of productive resources → leading to productivity gains. It also **_____ likelihood of domestic monopolies.**
- 3) Trade provides **_____ to new markets** & materials internationally at competitive prices. This reflects in **_____ products at _____ prices** & wider choice for consumers. It also **enables nations to acquire _____ reserves** necessary for imports.
- 4) It necessitates **increased use of _____, supports technological change, stimulates innovations,** & facilitates **greater investment in R&D & productivity improvement.**
- 5) **Stimulus to innovative _____** in banking, insurance, logistics, consultancy services etc
- 6) For emerging economies, **improvement in the _____ of output** of G/S, superior products, finer labour etc. enhance value of products & lead to move up the **global _____.**
- 7) Opening up of **new markets** results in **broadening the productive base & facilitates _____ diversification** so that new production possibilities are opened up.
- 8) Trade can also **contribute to _____, by facilitating research & exchange of _____ & best practices** between trade partners.
- 9) Strengthens bonds between nations → **promotes _____ & _____ in nations.**

Major arguments put forth against trade openness

- 1) **Not _____ to all nations.** Potential **unequal market _____** & disregard for principles of _____.
- 2) **Economic _____ → growing political power of corporations operating globally.** Domestic entities can be _____ by financially stronger transnational cos.
- 3) **Substantial environmental _____ & _____ of natural resources.**
- 4) Trade cycles & **associated economic crises** in a country get _____ to other country
- 4) **Risky _____ of underdeveloped countries on foreign nations,** impairs economic _____ & endangers their **political _____ → exploitation & _____ of cultural identity.**
- 5) Too much export orientation may **_____ actual investments _____.**
- 6) **Lack of _____ & _____ of trade policies of trading partners**
Changes in govts' policies → imposition of import _____, _____ import tariffs or _____.

Theories of international trade

- 1) The Mercantilists' View of International Trade
- 2) The Theory of Absolute Advantage
- 3) The Theory of Comparative Advantage
- 4) The Heckscher-Ohlin Theory of Trade
- 5) New Trade Theory – An Introduction

The Mercantilists' View of International Trade

- **Mercantilism** → derived from word 'mercantile' → "_____ & _____ affairs".
- Mercantilism → was **economic policy** in _____ from 16th to 18th centuries.
- Mercantilism advocated _____ exports → to bring in more "_____" (money in form of _____) & _____ **imports** through **imposing very high tariffs**.
- This view argues that trade is a '_____ **game**' → winners win only at _____
 → **one country's gain** is _____ to **another country's** _____
 → so that **net** _____ or benefits **among the participants** is _____.

The Theory of Absolute Advantage

- According to _____, a country will **specialize in production and export** of commodity in which it has an _____.
- The principle of absolute advantage refers to the **ability of a country to produce a _____ quantity of a G/S than competitors, using the _____**
- Principle of absolute advantage → uses _____ **as the only input**.
- **Exchange of goods** between two countries will take place **only if _____ of two countries** can **produce _____ commodity** at an **absolutely _____ production cost** than _____ country.

Commodity	Productivity of Labour of Labour	
	Country A	Country B
Wheat (units/hour)	6	1
Cloth (units/hour)	4	5

- _____ has **absolute advantage in production of wheat**, so country _____ will export & specialize in production of wheat
- _____ has **absolute advantage in production of cloth**, so country _____ will export & specialize in production of cloth
- ✓ The above theory explained that _____ **is possible**.

The Theory of Comparative Advantage

- This law, given by by _____ states that even **if one nation is _____ efficient than** (has an absolute _____ with respect to) **other nation in production of _____ commodities**, there is _____ **scope for _____**

Commodity	Productivity of Labour (Output per Hour of Labour)	
	Country A	Country B
Wheat (units/hour)	6	1
Cloth (units/hour)	4	2

- In above eg, _____ **has absolute advantage in production of both** wheat & cloth
- Wheat [_____]
 - Cloth [_____]
- However, A has _____ **(comparative advantage) in case of _____**. Hence A should specialize in **production & export of _____**
- Further, B has _____ **(comparative advantage) in case of _____**. Hence B should specialize in **production & export of _____**
- ✓ _____ **(2009)** calls comparative advantage “_____” for **economic development**. “Even if a developing country lacks an absolute advantage in any field, it will **always have _____ advantage** in the production of _____ goods,” and will **trade _____ with advanced economies**.

The Heckscher-Ohlin Theory of Trade

- Aka. _____ Theory or _____ Theory or Heckscher-Ohlin Samuelson theorem
- This theory states that **comparative advantage in cost** of production is explained exclusively by _____ of the **nations**.
- “**Factor endowment**” refers to **overall _____** of usable resources- **labour & capital**.
- It states that a country tends to-
- ✓ specialize in the **export** of a commodity whose **production** requires _____ **use of its _____ resources** and
 - ✓ _____ a commodity whose **production** requires intensive **use of its _____ resources**.
- **Capital abundant country-** **Produce and export _____-intensive goods**
- **Labour-abundant country-** **Produce and export _____-intensive goods**

Theory of Comparative Adv.	Modern Theory
Trade occurs due to difference between countries' _____	Explains causes of differences in comparative costs as differences in _____
Based on _____ theory of value	Based on _____ cost - more _____.
Considered labour as _____ factor of production one factor (labour) model	Widened scope - labour and capital as factors of production. It is _____- factor model
Treats international trade as quite _____ from domestic trade	International trade is only a _____ case of _____ trade.
Studies only _____ of the goods concerned	Considers _____ of factors which influence comparative costs
Diff. in cost due to differences in _____ of _____	Diff in cost due to differences in _____ .
Does _____ take into account the factor price differences	_____ factor price differences as the main cause price differences

New Trade Theory

- NTT (given by _____) helps in understanding **why developed & big countries** are trade partners when they **are trading** _____ G/S. Eg- electronics, IT, cars
- Those **countries with** _____ will dominate the market, & the market takes the form of _____ **competition.**
- **Two key concepts** give advantages to countries that import goods to compete with products from the home country
 - 1) **Economies of Scale**- If firm serves _____ as well as _____ market, then it can reap **benefit of large scale of production & increase profits.**
 - 2) **Network Effects**- The value of G/S is enhanced as _____ using it _____. This is called '**_____ effect**'. **Consumers like _____, but they also want G/S with _____, & network effect _____ utility.** Eg- **WhatsApp, Instagram, Windows** etc

Chapter 9 – International Trade

Unit 2 – The Instruments of Trade Policy

Basic Definitions

- **Free Trade-** Buyers and sellers from separate economies voluntarily **trade with** _____ **of** _____.
- **Protectionism:** It is a state policy aimed to **protect** _____ **producers** against **foreign competition** through the **use of** _____, _____ & **non-tariff trade policy instruments**.
- **Trade liberalization:** It refers to _____ **of domestic markets** to G/S from rest of world by _____ **trade barriers**.
- **Trade policy:** It consists of **all instruments** that govts may use to _____ **or** _____ **imports & exports**. Instruments of trade policy are-
 - ✓ **price- related measures** such as _____ and _____
 - ✓ **Non-price measures** or _____ (NTMs).

Tariffs

- Tariffs, (aka) **customs duties** → _____ **or duties on G/S** which are _____ or _____
- It is a _____ in form of a **tax, imposed at the** _____ on goods going from one country to another.
- They are the **most** _____ and _____ **trade measures** that determine market access. Countries generally have a **tariff** _____
- Tariffs are aimed at _____ **the relative prices** of G/S imported, so as to _____ **domestic demand** & thus _____ **of their** _____.
- Tariffs also _____ **of government**.

Types of Tariffs

- 1) **Specific Tariff-** It is **fixed amount of money** per _____ or according to _____ or _____ of commodity.
 Eg- Specific tariff of Rs. 1000/- on each imported bicycle _____ of its value.
Disadvantage- Its **protective value varies** _____ with **price** of the import

- 2) **Ad Valorem Tariff-** When duty is levied as _____ of _____ of trade commodity.
Eg- A 20% ad valorem tariff on any bicycle.
This tariff _____ protective value of tariff on home producer, but it gives incentives to _____ **good's price on invoices** to reduce tax burden.
- 3) **Mixed Tariffs-** Expressed _____ on basis of _____ of imported goods (an ad valorem rate) _____ on **basis of a** _____ of the imported goods (a specific duty) **whichever is** _____.
- 4) **Compound Tariff-** Calculated by _____ up _____ duty to an _____ duty.
$$CT = ts.q + ta.p.q$$
- 5) **Technical/Other Tariff-** Calculated on basis of **specific** _____ of imported goods i.e. duties are payable by its _____ or related items.
- 6) **Tariff Rate Quota-** TRQs **combine two policy instruments:** _____ & _____.
Imports **under specified quota portion** → _____ or _____ tariff rate.
Imports _____ quantitative threshold of quota → _____ **tariff**
- 7) **Most-Favoured Nation Tariffs-** Import tariffs which **countries promise to impose on imports from other** _____. In practice, MFN rates are the _____ that **WTO members charge each other**.
- 8) **Variable Tariff-** A duty typically fixed to **bring the price of an imported commodity up to level of** _____ for the commodity.
- 9) **Preferential Tariff-** Countries promise to give another country's products _____ **tariffs than their MFN rate**.
These agreements are _____ → (Eg- preferential duties in EU region)
Countries, may also have '_____ **preferential treatment**' → Eg- GSP
- 10) **Bound Tariff-** A WTO member **binds itself with** _____ **commitment** _____ **to raise tariff rate** _____ (_____ level of import duty).
A member is **free to impose a tariff that is** _____ than bound level.
Once bound, a tariff rate becomes _____ & a member can only _____ it **after** _____ **with trading partners & compensating them for possible losses**.
- 11) **Applied Tariffs-** **Duty that is** _____ **on imports** on a MFN basis.
Applied tariff should _____ be higher than the bound level.

- 12) **Escalated Tariff**- Tariff **rates on imports of** _____ **goods** are _____ than tariff **rates on** _____ **&** _____. This type of tariff is _____ as it **protects** manufacturing industries in _____ countries & **adversely affects** industries of _____ countries.
- 13) **Prohibitive tariff**- It is **set** _____ **that no imports can enter.**
- 14) **Import subsidies**- It is simply a _____ **per** _____ **or as a** _____ **for importation of a good** (i.e., a _____ import tariff)
- 15) **Tariffs as Response to Trade Distortions**- **Countries affected by '_____'** foreign-trade practices, **respond** quickly by measures in form of tariff responses to offset distortion. (aka "_____ " mechanisms)
- 16) **Anti-dumping duty**- It is a **protectionist tariff** that a domestic govt imposes on imports that it believes are **priced** _____.
 • **Dumping** occurs when manufacturers sell goods in a foreign country-
☐ below the _____ in their _____ or
☐ below their full _____ of the product.
 • Dumping may also be used as _____ practice to **drive out** _____ **producers** from market and to establish _____.
 • Charging ADD is **justified** _____ domestic industry is _____ by import competition, & protection is in _____
- 17) **Countervailing duties**- CVD is charged in an importing country to _____ **advantage that** _____ **get from** _____ (from their govt.) to ensure fair pricing of imported G/S & thus **protecting** _____ firms.

Effects of Tariffs

- Create **obstacles to trade**, **decrease** imp & exp. **Mkt access of** _____ **country is worsened.**
- Tariffs **discourage domestic consumers from buying** _____ **goods.** _____ consumers suffer a **loss in** _____.
- Tariffs **encourage consumption & production of domestically produced** _____ & thus protect domestic industries.
- Producers in** _____ **country** experience an **increase in well being (_____ producer surplus)**
- Price increase **induces an increase in output of existing firms** & possibly **addition of new** _____ **to industry** to take advantage of high profits & hence **increase in** _____
- Tariffs **increase government** _____ of importing country.
- It discourage _____ production in _____ & encourage inefficient prod. in _____ country, by _____ **comparative advantage of foreign countries.**

Non – tariff measures (NTMs)

They comprise all types of measures which _____ **conditions** of **international trade**, including _____ that restrict trade & those that facilitate it.

Technical Measures

Technical measures refer to _____ **properties** such as **characteristics** of product, **technical specifications** and **production processes**

These measures are intended for **ensuring** **product** _____, **environmental** _____, national security and protection of animal and plant _____.

Sanitary & Phytosanitary (SPS) Measures

These are applied to **protect** _____ or _____ **life** from **risks arising from additives, pests**, etc. or disease-causing organisms and to **protect** _____.
Ban of import of certain goods due to **quality** and **hygienic requirements**.

For Eg- prohibition of import of **poultry** from countries affected by **avian flu** etc

Technical Barriers to Trades (TBT)

Covers both _____ & _____ **products** - refer to mandatory '_____ & **Technical Regulations**' - define specific _____ that product should have, like size, design, packaging, etc. excluding measures covered by SPS.

_____ **procedures** e.g. testing, & certification). Eg: **food law, quality standard**

Non-Technical Measures

They **relate to** _____; for eg- **shipping requirements, custom formalities, trade rules, etc**

These are further distinguished as:

- 1) **Hard measures** (e.g. Price and quantity control measures),
- 2) **Threat measures** (e.g. Anti-dumping and safeguards) and
- 3) **Other measures** such as trade-related finance & investment measures.

Furthermore, the categorization also distinguishes between:

- a) **Import-related measures**
- b) **Export-related measures**
- c) **Procedural obstacles (PO)** - **practical problems** in **administration**, transportation, delays in testing, certification etc
→ **difficult for org. to comply**.

Non – tariff Barriers (NTBs)

NTBs are _____ NTMs, which are used as means to _____ free-trade rules and _____ **domestic industries at expense of foreign competition**.
NTBs are thus a _____ **of NTMs** that have a 'protectionist or discriminatory intent'.

Types of Non-technical measures

1. **Import Quotas**- restriction → only certain **physical amount of good will be allowed into country** during a given time period, usually one year.
 - a) **Binding Quota**- Set _____ **free trade level of imports** & **enforced by issuing** _____.
 - b) **Non-binding quota**- Set _____ **free trade level** of imports → little effect on trade.
 - c) **Tariff rate quotas (TRQs)** combine _____ policy instruments → _____ & _____.
 - d) **Absolute quotas or quotas of a permanent nature**- They limit quantity of imports to a specified level during a specified period of time & imports can be done any time of year-
 - ✓ Either no condition of country of _____ of product. or
 - ✓ _____ can be specified.
 - e) **Seasonal quotas and**
 - f) **Temporary quotas**
 - With a quota, **government receives** _____ **revenue**. The **profits** received by holders of such **import licenses** are known as '_____ '.
 - If quota is set _____ **free trade level**, amount of imports will _____. It will **lower** _____ of good in domestic market & _____ domestic price. _____ of **consumer surplus** & _____ in **producer surplus**.
2. **Price Control Measures**- These are steps taken to **control prices of imported goods** in order to support _____ of products when **import prices** are _____.
 - ✓ Aka. '_____ ' **measures** & include measures → that **increase cost of imports** by a **fixed percentage** or by a **fixed amount**.
 - ✓ Eg: A minimum import price established for sulphur.
3. **Non-automatic Licensing and Prohibitions**- These are aimed at **limiting** _____ of goods that can be **imported**, _____ of whether they originate from **different** _____ or from one particular _____.
 - ✓ These measures include non-automatic licensing, or **complete prohibitions**.
 - ✓ Eg- **India prohibits import/exp of arms** and related **from/to Iraq**.
4. **Financial Measures**- The objective is to _____ import costs by regulating _____ to & _____ of foreign exchange for imports & to **define terms of payment**. It includes measures like _____ **requirements** & foreign exchange controls _____ of foreign exchange for certain types of imports
- 5) **Measures Affecting Competition**- These measures are aimed at **granting** _____ or **special preferences** to economic operators. It may include **government imposed** _____ or **enterprises**, and compulsory use of national services.
 - ✓ Eg, a **statutory marketing board** may be **granted exclusive rights to import wheat**: or a canalizing agency (like State Trading Corp.) may be given monopoly right to distribute palm oil.

- 6) **Government Procurement Policies**- It involve **mandates** that whole of _____ of government _____ should be from _____ firms rather than foreign firms. In **accepting public tenders**, a government may **give preference to** _____ rather than foreign tenders.
- 7) **Trade-Related Investment Measures**- These measures include rules on local content requirements that **mandate a specified fraction of a final good should be produced domestically**.
- a) requirement to **use certain minimum levels of locally made components**,
 - b) **restricting the level of imported components**, and
 - c) **limiting the purchase or use of imported products** to an amount related to the **quantity or value of local products that it exports**.
- 8) **Distribution Restrictions**- **Limitations imposed on distribution** of goods in importing country involving **additional _____ or _____ requirement**. These may relate to _____ **restrictions or restrictions as to _____ who may resell**.
Eg: a restriction that imported fruits → sold only through outlets having refrigeration facilities.
- 9) **Restriction on Post-sales Services**- Producers may be **restricted from providing _____ for exported goods** in the importing country. Such services may be **reserved to _____** of importing country.
- 10) **Administrative Procedures**- _____ & _____ administrative procedures which are **mandatory for import of foreign goods**. These will **increase _____ & _____ imports**.
Eg-specifying procedures & formalities, requiring licenses, **administrative delay**, corruption in customs clearing, procedural obstacles linked to prove compliance etc.
- 11) **Rules of origin**- **Country of origin** means **country in which a good was _____**, or _____ country of service provider. Rules of origin are criteria needed by governments of importing countries to **determine _____ of a product**. **Duties & restrictions** in some cases **depend upon _____ of imports**.
- 12) **Safeguard Measures**- Restrict imports of a product _____ if its _____ **industry is _____ with serious injury caused by a _____ in imports**. These measures are for _____ **time & _____**.
- 13) **Embargos**- _____ imposed by government **on import/export of some commodities** to **particular _____ for a specified period**. This may be done **due to _____** or for reasons such as **health, _____ sentiments** → _____ **form** of trade barrier.

Export-related measures

These refer to all measures applied by government of _____ country including both technical and non-technical measures.

Ban on exports

Eg- during periods of **shortages**, **export of _____ products** such as onion, wheat etc. may be **prohibited** to **make them available for domestic consumption**.

Export Subsidies and Incentives

Tariffs on imports hurt exports & thus countries have developed _____ **measures** of different types for exporters like **export _____**, **duty _____**, _____ access to imported intermediates etc.

Government usually **provide financial contribution to domestic producers** in form of **grants, loans**, equity infusions etc. or give some form of **income or price support**.

Export Taxes

An export tax is a **tax collected on _____ goods** & may be either _____ or _____.

The effect of an export tax is to _____ **price** of good & to _____ **exports**.

It _____ **domestic supply**, it also **reduces domestic _____** & leads to _____ **domestic consumption**.

Voluntary Export Restraints

They refer to a type of informal quota administered by an exporting country _____ **the quantity of goods that can be exported out** of that country during a specified period of time.

Such restraints originate from _____ considerations.

The inducement for exporter to agree to a VER is mostly to _____ **importing country** & _____ **effects of possible _____ trade restraints that may be imposed by the importer**.

VERs may arise when **import competing industries seek _____ from _____ of imports** from particular exporting countries.

VERs cause **domestic prices to _____** and cause _____ **of domestic consumer surplus**.

Chapter 9 – International Trade

Unit 3 – Trade Negotiations

Regional Trade Agreements (RTAs)

RTAs are defined as **groupings of countries** → with the **objective of** _____ **to trade** between member countries.

Types of RTAs

S. No.	Type of RTA	Meaning	Example
1.	Unilateral trade agreements	Importing country offers trade _____ in order to encourage exporting country, to engage in international economic activities that will _____ country's economy . (_____)	
2.	Bilateral Agreements	Agreements which set rules of trade between two countries , two blocs or a bloc and a country. (_____)	
3.	Regional Preferential Trade Agreements	Among a group of countries reduce trade barriers on _____ & _____ for only _____ of the group	
4.	Trading Bloc	Group of countries that have a _____ agreement between themselves & may apply a _____ to other countries .	
5.	Free-trade area	Group of countries that _____ all tariff & quota barriers . Members retain _____ in determining their tariffs with _____	
6.	Customs union	Group of countries that eliminate all tariffs on trade among _____ but maintain a _____ on trade with countries outside union (thus, technically violating MFN)	
7.	Common Market	It deepens a customs union by providing for the free flow of _____ & _____ by reducing or eliminating internal tariffs on goods and by creating a _____ set of external tariffs . There are also common barriers against non-members	
8.	Economic and Monetary Union	Here members share a _____. This requires strong _____ in macroeconomic policies.	

GATT

- General Agreement on Tariffs and Trade (GATT) was a **multilateral trade agreement** which **provided rules of international trade** from _____ to _____ (47 years)
- GATT governed international trade working along with World Bank & IMF.
- The _____ **round of GATT (_____ Round)** of 1986- 94, was _____ → lead to the **birth of _____**.

GATT lost its relevance by 1980s

- 1) _____ to **fast-evolving world trade** scenario
- 2) _____ **investments** had expanded substantially
- 3) _____ and trade in _____ were **not covered**
- 4) World _____ **trade increased** & was beyond its scope.
- 5) _____ in the **multilateral system** could be heavily exploited
- 6) Efforts at **liberalizing _____ trade** were **not successful**
- 7) There were **inadequacies in institutional _____** & _____ system
- 8) it was _____ **a treaty** & thus terms of GATT were binding only insofar as they are _____ incoherent with a nation's domestic rules.

Functions of WTO

- 1) Acts as a **forum for _____** among member govt,
- 2) Administering **trade _____**,
- 3) **Reviewing _____**,
- 4) **Assisting _____ countries** in trade policy issues, through _____
_____ & _____
- 5) **Cooperating** with other _____ **organizations**

Objectives of WTO

- The **principal objective** of the WTO is to **facilitate flow of international trade** smoothly, freely, fairly and predictably.
- The WTO has **six key objectives-**
 - 1) to set and enforce _____ for international trade
 - 2) to provide a _____ for _____ & _____
 - 3) **further trade _____**
 - 4) to _____ **trade _____**
 - 5) to **increase _____** of **decision-making processes**
 - 6) to **cooperate with other major international economic institutions** involved in global economic management, and
 - 7) to **help _____ countries** benefit fully from _____.

- The **objectives** of the WTO Agreements is also given in **preamble of Agreement creating WTO**,

- ✓ raising _____,
- ✓ ensuring full _____ & growth of _____ & effective _____,
- ✓ expanding the _____ of and _____ in G/S.

Structure of the WTO

- The WTO activities are supported by a _____ located in _____, headed by a _____.
- It has a _____-tier system of decision making

1st level
(Top-
Level)

**Ministerial
conference**

- It **takes decisions on all matters** under any of the _____ trade agreements.
- It **meets at least _____ every _____ years.**

2nd
Level

General council

- It **meets _____ times a year** at Geneva HQ.
- It also meets as the **trade policy Review Body and the dispute settlement Body**

3rd
Level

**Goods council,
services council
and intellectual
property (TRIPS)
council**

- These councils **report to _____** & are **responsible for overseeing _____ of WTO agreements** in their respective areas of specialisation

The Guiding Principles of World Trade Organization (WTO)

1) Most-favoured-nation (MFN) – [Trade without discrimination]

- Treating other countries equally → Countries **cannot _____ between their trading partners.**
- Grant **someone a special favour** (such as a lower duty rate) then you have to **do _____ for all other WTO members.**
- Some **exceptions** are allowed. For eg-,
- ✓ Countries can set up a _____ that applies **only to goods traded _____ the group – discriminating against goods from outside.** Or
- ✓ They can give _____ **countries special access** to their **markets.** Or
- ✓ A country can _____ **barriers against products** that are **traded unfairly.**

2) National treatment

- Treating foreigners & locals _____ → _____ & _____ **goods** should be treated **equally** – at least _____ **foreign goods have _____ market.** (giving others the same treatment as one's own nationals)
- Charging **customs duty on import is _____ a violation of national treatment** even if locally-produced goods are not charged an equivalent tax. (since it has _____ entered yet)

3) Freer trade: gradually, through negotiation

- From time to time issues such as _____ & _____ policies have also been discussed.
- WTO agreements allow countries to introduce changes gradually, through “_____ liberalization”. Developing countries are usually given longer time to fulfil this obligation.

4) Promoting fair competition

- WTO is described as a “free trade” institution, but it is _____ entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. More accurately, it is a system of rules dedicated to open, fair, and undistorted competition.
- Eg- Agreement on government procurement (a “plurilateral” agreement because it is signed by only a _____ WTO members) extends competition rules to purchases by thousands of government entities in many countries. And so on.

5) Predictability: through binding and transparency

- Sometimes, promising not to raise a trade barrier can be as important as lowering one, because the promise gives businesses a _____ of their _____ opportunities.
- With stability & predictability, _____ is encouraged, jobs are created and consumers can fully enjoy the benefits of competition – choice and lower prices.
- One achievement of Uruguay Round of multilateral trade talks was to increase amount of trade under _____ commitments.
- In _____, 100% of products now have bound tariffs → results in high degree of market security for traders & investors.
- Predictability & stability can be improve in other ways as well-

1) Discourage use of _____ – Administering quotas lead to red-tape & unfair play.

2) Make countries' trade rules as _____ & _____ (transparent) as possible.

6) Encouraging development and economic reform

- WTO agreements themselves allow for _____ & _____ for _____ countries.
- Over _____ of WTO members are developing countries & countries in transition to market economies.
- A decision adopted at end of Uruguay round says _____ countries should _____ implementing _____ commitments on goods exported by _____-developed countries, & it seeks increased technical assistance for them.
- Recently developed countries have started to allow _____- free & _____-free imports for almost _____ products from _____-developed countries.

WTO Agreements (aka. WTO's trade rules → WTO is described as "rules-based")

1. **Agreement on Agriculture** → binding commitments made by WTO Members in **three areas** of _____, _____ & _____.
2. **Agreement on the Application of Sanitary and Phytosanitary (SPS) Measures**
3. **Agreement on Textiles and Clothing (ATC)** later replaced **Multi-Fibre Arrangement (MFA)**
4. **Agreement on Technical Barriers to Trade (TBT)**
5. **Agreement on Trade-Related Investment Measures (TRIMs)**
6. **Anti-Dumping Agreement**
7. **Customs Valuation Agreement**
8. **Agreement on Pre-shipment Inspection (PSI)**
9. **Agreement on Rules of Origin**
9. **Agreement on Import Licensing Procedures**
10. **Agreement on Subsidies and Countervailing Measures**
11. **Agreement on Safeguards**
12. **General Agreement on Trade in Services (GATS):**
13. **Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS):** This agreement stipulates _____ treatment & _____ for **intellectual properties**, such as copyright, trademarks, geographical indications, industrial designs, patents, etc. It also requires member countries to **maintain high levels of intellectual property protection** and administer a system of enforcement of such rights.
14. **Trade Policy Review Mechanism (TPRM)** provides the **procedures** for the trade policy review mechanism to **conduct periodical reviews** of **members' trade policies** and practices conducted by _____ (TPRB).
15. **Plurilateral Trade Agreements:**
 - ✓ **Multilateral negotiations** are negotiations involving _____ **WTO contracting parties**.
 - ✓ **Plurilateral trade agreements** involve several countries with a common interest but **do** _____ involve _____ **WTO countries**.

The Doha Round

- The Doha Round was _____ round since Second World War was officially launched at the WTO's Fourth Ministerial Conference in Doha, Qatar, in Nov 2001.
- The negotiations include _____ areas of trade.
- Most controversial topic of Doha round was _____.

WTO Achievements

- G-20 was founded in _____, as a forum for countries to **discuss global** _____ & _____ **issues**.
- **620 members are:**

✓ Argentina; Australia;	✓ Japan;
✓ Brazil;	✓ Korea;
✓ Canada; China;	✓ Mexico;
✓ European Union;	✓ Russian Federation;
✓ France;	✓ Saudi Arabia; South Africa;
✓ Germany;	✓ Türkiye (Turkey);
✓ India; Indonesia; Italy;	✓ UK & USA
- The **WTO** _____ have been prepared by the **WTO Secretariat** since 2009.

Chapter 9 - Unit 4 & 5 are to be covered from Super Chart Book only.

CA Foundation
(New Syllabus)

Business Economics

Abhyaas Notes

Chapter 10

Indian Economy

By CA Mohnish Vora (MVSIR)

Complete these notes by watching classes of MVSIR

Summary of Important Points

STATUS OF INDIAN ECONOMY: PRE INDEPENDENCE PERIOD (1850 -1947)

- Between & century AD → India was **largest economy of ancient & medieval world**.
- It was prosperous & self-reliant → controlled between & of world's wealth.
- was **dominant occupation**, & main source of livelihood for majority of people.
- It also had a **highly skilled set of** & **craftsmen** who produced **handicrafts & textiles**.

Ancient Economic Philosophy of India

- The **earliest treatise on ancient Indian economic philosophy** is ' ' by Kautilya () (321–296 BCE).
- Arthashastra → important works on statecraft in the genre of
- It was handbook for **King Chandragupta Maurya**, founder of Mauryan empire → containing directives as to **how to reign** over kingdom & **encouraging direct action in political concerns**
- **Artha** is not wealth alone; → also includes all aspects of .
- **Arthashastra** → **science of 'artha' or material prosperity**, or "the means of subsistence of humanity," which is, primarily, ' ' and, secondarily, ' '.
- Major focus → means of **fruitfully maintaining and using land**.
- Kautilya emphasized on **robust agricultural initiatives** which will fill state's treasury.
- **Taxes** → charged **equal** for private & state-owned business, **fair** to all & **easily understood**.
- **True kingship** → **ruler's subordination of his** to the **good of his people**;
- King's policies should reflect → **concern for greatest good of greatest number of his subjects**.
- **__ vital elements** → **King, Ministers, Farmlands, Fortresses, Treasury, Military and Allies**.

Period of British Rule

- The period of **British rule** can be divided into two sub periods:
 - ❑ Rule of **East India Company** from
 - ❑ **British government** in India from
- **Industrial revolution in Britain** in latter half of 18th century → required & **for finished goods** → led to change in nature of India's foreign trade from **exporter of** to **exporter of**
- **Indian** of finished goods were subjected to **tariffs** & **imports** were charged **tariffs** → **tariffs** followed by the **British**.
- This made the India's **exports of finished goods** & **imports** . Thus, Indian goods lost their .
- The following led to **destruction of Indian handicrafts & manufactures**
 - **external & domestic demand** for **products fell sharply**
 - **imperial policies** to serve British interests & competition from goods
 - Problem aggravated by **in demand** by **consumers favouring** **goods** as Indians wanted to affiliate themselves with western culture & life.

Stagnated Nature of Industrialisation: During the Colonial Era

- Indian **cotton mill industry** had million spindles in 1930s → (**5th position** in **no. of spindles**)
- **Jute mills** expanded rapidly in → global demand for **ropes**. At the **end of the 19th** century, **Indian jute mill industry was** **in world** in amount of **raw jute consumed**.
- Heavy industries like **iron industry** were **established** in by British capital.
- India's **iron industry was ranked** **in world** in terms of **in 1930**.
- **Before Great Depression(1930), India was ranked** **largest industrialised country** measured by the value of .
- The **producer goods industries** → **did** **show expansion** → because of pressure exerted by the English producers to **development of industries in India** which were likely to compete with them.
- The **share in Net Domestic Product (NDP)** of **manufacturing sector** → **in 1946**.

Indian Economy: Post-independence (1947- 1991)

- **At time of independence**, India → **literacy rate** & **yrs life expectancy in 1951**. India's poverty was in terms of income & human capital.
- **Nehruvian model** which supported social & **economic** & directed by the state came to **dominate the post-Independence Indian economic policy**.
- **Planning Commission of India** established in → plan for **economic development** in line with **socialistic strategy** → through **5-year plans** (First FYP- **1951**)
- **Rapid** **of economy** was **cornerstone** of **Nehru's development strategy**.
- The concept of '**planned** ' meant a **systematic planning to support industrialization**. (bureaucrats and technocrats)

Industrial Policy Resolution

- The **Industrial Policy Resolution ()** → expanded role of sector & licensing to the sector. It granted **state (govt.) monopoly** for strategic areas such as-
 Also, rights to new investments in basic Industries were exclusively given to state.
- The **policies** in **1950's** were guided by two **economic philosophies**:
 1. to **build a socialistic society** with **emphasis on heavy industry**,
 2. of **small scale and cottage industry** and **village republics**

- The **Industrial Policy Resolution of _____** → framework for industrial development, but was _____ as it supported **enormous expansion of scope of _____ sector**. (lead to _____ of private sector initiatives)
- India followed an **open** foreign trade policy **until late 1950s**. A **balance of payments crisis** emerged in **1958** causing concerns **regarding foreign exchange depletion**.
- Consequently, it lead to **gradual tightening of trade & reduction in investment-licensing** of new investments requiring imports of capital goods. These import controls were till **1966**.
- In first **3 decades after independence (1950–80)**, India's average annual rate of growth of GDP- '**Hindu growth rate**'- was ____%.

Agriculture Issues & Green Revolution

- **Strategy for agricultural development** till mid 1960s was reliance on _____ **model i.e. land reforms, farm cooperatives** etc. and no importance given to technocratic areas like R&D , irrigation etc.
- With continuous failures of monsoon, two severe **droughts struck India in _____ & _____**
- The **agricultural sector recorded substantial _____ growth** and India faced a serious food problem. **India had to depend on the United States for food** aid under _____.
- Restructuring of agricultural policy → '**green revolution**' was initiated soon → which was materialised by-
 - _____ **farm technologies, including _____ seed varieties &**
 - **intensive use of water, _____ and _____**

Nationalisation of Banks

- The **government nationalized-**
 - ✓ _____ **banks in 1969** and
 - ✓ then followed it up with **nationalizing another _____ in 1980**.

Indian Economy - Worst Performance

- The **economic performance** during "_____" **is the worst in independent India's history**.
- This happened due to-
 - ✓ **decline in productivity**.
 - ✓ license-raj,
 - ✓ the autarchic policies that dominated the 1960s and 1970s,
 - ✓ external shocks such as **three wars** (in 1962, 1965, and 1971),
 - ✓ major droughts (in 1966 and 1967), and
 - ✓ oil shocks of 1973 and 1979.

Monopolies and Restrictive Trade Practices (MRTP) Act, 1969

- The MRTP Act, 1969 was aimed at **regulation of _____ firms** which had relatively **_____ market power**. Several **restrictions** were placed on them in terms of **licensing, capacity addition, mergers** and acquisitions.
- Thus, policies restricting the **possibility of expansion of big business houses kept their entry away** from nearly all but a **few highly capital intensive sectors**.

Reservation for Small Scale Sector

- In _____, many products were **reserved** for exclusive manufacture by the **small scale sector**
- It was thought that this policy will encourage **_____ -intensive economic growth & allow _____ of income**.
- However, this policy **excluded all _____ firms from labour intensive industries** and **India was _____ able to compete** in the **world market** for these products. **_____ labour laws** also discouraged labour intensive industries.

The Era of Reforms

- The initiatives, spanning **1981 to 1989**, were referred to as '**_____ liberalization**' which aimed at **changing** prevailing thrust on '**inward-oriented**' **trade and investment practices**.
- This liberalization is often referred to as '**reforms by _____**' to denote its **ad-hoc & not widely publicized nature**.
- The **average annual growth rate of GDP** during-
 - **sixth plan period (1980–1985)** was **5.7 %** and
 - **seventh plan period (1985–1990)** was **5.8 %**
- The **early reforms of 1980's** covered **three areas- _____, _____ & _____**.
- ❑ The prominent **industrial policy initiatives** during this period directed towards **removing constraints on growth** were:
 - ✓ In 1985 delicensing of **25 broad categories** of industries was done.
 - ✓ The facility of '**broad-banding**' was accorded for industry groups to **allow flexibility and rapid changes** in their product mix without going in for **fresh licensing**.
 - ✓ The **asset limit** above which firms were subject to **MRTP regulations** was **raised** from **20 crore** to **_____ crore**.
 - ✓ The **multipoint excise duties** was **converted** into a **modified value-added (MODVAT)** tax which reduced taxation on inputs.
 - ✓ **Establishment** of the Securities and Exchange Board of India (**SEBI**) in _____
 - ✓ The **open general licence (OGL)** list was expanded & the number of capital goods items reached **1,329** in April 1990.
 - ✓ Several **export incentives** were introduced and expanded

- ✓ **Exchange rate** was set at a **level** → to _____ **exports** & **reduced pressure on foreign exchange** needed for imports
- ✓ **Price & distribution controls** on **cement** and **aluminum** were entirely **abolished**.
- ✓ Based on the real effective exchange rate (REER), the rupee was depreciated by about **30.0 per cent** from 1985–86 to 1989–90.
- ✓ The **budget for 1986** introduced policies of-
 - ❖ _____ taxes,
 - ❖ _____ **imports &**
 - ❖ _____ **tariffs**.
- Thus, **liberalization in the 1980s** served as necessary _____ for the more **universal and organized reforms of the 1990s**.

The Economic Reforms of 1991

- The economic reforms in 1991 under the _____ **government**.
- The **causes** attributed to the immediate **need for such a drastic change** are:
 - 1) Large _____ **deficit** (financed by **huge debt**), & adverse balance of payments.
 - 2) Persistent huge deficits → _____ **public debt** → govt revenue used for _____ **payments**
 - 3) _____ **in oil prices** (due to gulf war in 1990) & thus **strain on a balance of payments**.
 - 4) The **foreign exchange reserves** touched _____ **point** → only \$ _____ **billion** → sufficient for only _____ of imports.
 - 5) **Tightening of import restrictions** to collect forex for essential imports resulted in **reduction in industrial output**.
 - 6) India had to **depend on** _____ **borrowing** from **International Monetary Fund** which in turn puts stringent conditions.
 - 7) **Fragile political situation** along with economic crises → led to '**crisis of confidence**'.
- 1991 reforms → known as **LPG- Liberalization, Privatization and Globalisation**, had **two major objectives**:
 - 1) _____ of economy from a centrally directed and highly controlled one to a '**friendly**' or _____ **oriented economy**.
 - 2) _____ **stabilization** by substantial reduction in fiscal deficit.
- The policies can be broadly classified as:
 - 1) **stabilization measures** → _____ **term** measures → for **problems of inflation & adverse balance of payment**, &
 - 2) **structural reform measures** → _____ **term** → aimed at **bringing in productivity & competitiveness** by **removing structural rigidities** in different sectors of economy.

Fiscal Reforms

- Bringing in fiscal discipline by reducing the fiscal deficit was vital because-
 - ✓ _____ domestic demand,
 - ✓ _____ in imports and
 - ✓ widening of the _____ (CAD)
 This was attempted by measures to **increase govt revenues** & **curtail govt exp.**
- Measures to this effect included:
 - 1) Introduction of a **stable and transparent tax structure**,
 - 2) Ensuring **better tax compliance**,
 - 3) Thrust on **curbing government expenditure**
 - 4) **Reduction** in **subsidies and abolition of unnecessary subsidies**
 - 5) **Disinvestment** of part of **govt's equity holdings** in select PSUs &
 - 6) **Encouraging private sector participation.**

Monetary & Financial Sector Reforms

- The focus was mostly on-
 - _____ the burden of _____ on government banks,
 - introducing and sustaining _____, and
 - _____ interest rates.
- These included many measures, important among them are:
 - 1) **Interest rate** _____ & _____ in controls on banks by RBI in respect of interest rates.
 - 2) **Opening of** _____ private sector banks & facilitating competition among public, private sector and foreign banks and removal of **administrative constraints.**
 - 3) _____ in reserve requirements namely, SLR & CRR, in line with recommendations of the _____ **Committee Report, 1991.**
 - 4) **Liberalisation of bank branch licensing policy** and granting of freedom to banks in respect of **opening, relocating or closure of branches**
 - 5) **Prudential norms of accounting** in respect of classification of assets, disclosure of income and provisions for bad debt, to ensure books of banks reflect truthful financial position.

Reforms in Capital Markets

- SEBI which was set up in _____ was given **statutory recognition in** _____.
- It is an **independent regulator of the** _____ market → creates a **transparent environment** which would **facilitate mobilization of adequate resources** and their efficient allocation.

The 'New Industrial Policy'

- The '**New Industrial Policy**' was announced on _____ → substantially deregulate industry to promote growth of a **more efficient and competitive industrial economy**.
- To facilitate **domestic industry**, a series of **reforms** were introduced-
 1. Ended '**_____**' by **removing licensing restrictions** industries **except for 18**, later reduced to 5, namely-
 - 1) arms and ammunition,
 - 2) atomic substances,
 - 3) **narcotic drugs** and
 - 4) **hazardous chemicals**,
 - 5) distillation and brewing of alcoholic drinks and cigarettes and cigars as these have **severe implications on health, safety, and environment**.
 2. Public sector was limited to eight sectors based on security and strategic grounds. Subsequently only two items remained – **railway transport and atomic energy**
 3. **MRTA Act** was restructured and the provisions relating to merger, amalgamation, and takeover were repealed. This has eliminated the need for pre-entry scrutiny of investment decisions and **prior approval for large companies for capacity expansion or diversification**.
 - 4) Products reserved for **small-scale industries** → **dereserved** enabling entry of large scale ind
 - 5) The policy **ended the public sector monopoly** in many sectors. Now industries reserved for public sector are only a part of **atomic energy generation** and **railway transport**.
 - 6) **Foreign investment** → liberalized → concept of **automatic approval** was introduced. FDI is prohibited only in **four sectors** viz. **retail trade, atomic energy, lottery business & betting and gambling**.
 - 7) **External trade** was further **liberalised** by substituting 'the positive list approach' of listing license-free items on the **OGL** list with the **negative list approach**.
 - 8) In **1990-91**, the **highest tariff rate** was ____%. The top tariff rate was brought down to 10% in 2007-08, with some exceptions such as automobile at 100%
 - 9) Rupee was **devalued by** ____% against the dollar.
 - 10) _____ of government holdings of equity in PSUs. PSUs were provided with **greater autonomy in decision making** and **opportunity for professional management**. The **budgetary support** to public sector was **progressively reduced**.

Notes**NITI AAYOG: A bold step for transforming India**

- Planning Commission was abolished in _____ → & on _____ it was replaced by _____ (NITI) Aayog.
- The major objective of such a move was to-
 - ✓ 'spur _____ thinking by objective 'experts', &
 - ✓ promote '_____ federalism' by enhancing the voice & influence of states'.
- NITI Aayog is expected to serve as a _____ of the government & a 'directional and policy dynamo'.
- The key initiatives of NITI Aayog are:
 1. _____ → envisions replacing the prevalent 'use-and-dispose' economy
 2. _____ (NDAP) facilitates and improves access to Indian government data
 3. _____ campaign aims to improve _____ in India by accelerating the _____ of electric vehicles
 4. _____ is a _____ destination for all information on electric vehicles

5. India Policy Insights (IPI)

6. 'Methanol Economy' programme → for **reducing India's** _____ **bill**, _____ **gas emissions**, & **converting** _____ **reserves** & _____ **solid waste into methanol**, and
7. 'Transforming India's _____ Market' → recommend measures for tapping into the potential of the sector and provide a **stimulus to exports and economic growth**.

❑ Shortcomings of NITI Aayog

- NITI has a _____ **role** → does not produce national plans, control expenditures, or review state plans.
- It is _____ **from the budgeting process**.
- It **lacks** _____ & **balance of power** within policy making apparatus of central govt.
- The termination of Planning Commission → strengthened Ministry of Finance, with its 'fixation of macroeconomic stability & natural instinct to limit expenditure'.
- It **lacks the independence** & **power** to perform as a '**counterweight**' to act as a "**voice of development**" concerned with inequities.

The Current State of the Indian Economy: A brief overviewI) **The Primary Sector**

- Agriculture, with its allied sectors, is the _____ **source of livelihood** in India.
- **India** has **emerged as-**
 - ✓ **world's** _____ **producer** of **milk**, **pulses**, **jute** and **spices**.
 - ✓ **largest** _____ under **wheat**, **rice** and **cotton**.
 - ✓ _____ **largest producer** of **fruits**, **vegetables**, **tea**, **farmed fish**, **cotton**, **sugarcane**, **wheat**, **rice**, **cotton**, and **sugar**.
 - ✓ **world's** _____ **largest food and grocery** market is the
 - ✓ **world's largest** _____ (buffaloes).
- _____ of **India's population** is **directly dependent on agriculture** for living. It contributed **18.80%** to the Gross Domestic Product (**GDP**).
- **Food grains production** has reached **315.7 million tonnes** in **2021-22**.
- **Private investment** in agriculture has increased to **9.3%** in **2020-21**.
- Agri sector had a growth of **3.50%** in **2022-23**, driven by **buoyant rabi sowing**
- **Export of agricultural** → touched an all-time peak of **Rs 3,74,611 crore** during last one year, & it **rose by 25 percent within 6 months of current financial year 2022-23** (Apr-Sep)
- _____ (APEDA)
is entrusted with the **responsibility** of **export** _____ of **agri-products**.

A large number of measures were undertaken by government to improve agri. sector-

- 1) Allowing _____ **FDI** in marketing of food products and in food product _____ under the _____ route
- 2) **Income support** to farmers through _____
- 3) Fixing of **Minimum Support Price (MSP)** at _____ **times** the **cost of production**
- 4) **Institutional credit** for agriculture sector at _____ **rates**
- 5) Launch of the **National Mission for Edible Oils**
- 6) _____ **Bima Yojana (PMFBY)** – a novel **insurance scheme** for financial support to farmers **suffering crop loss/damage**
- 7) **Mission for Integrated Development of Horticulture (MIDH)** for the holistic growth of the **horticulture** sector
- 8) Provision of **Soil Health Cards**
- 9) _____ (PKVY) supporting and promoting **organic farming**, and **improvement of soil health**.
- 10) **Agri Infrastructure Fund**, a medium / long term debt financing facility for investment in viable projects for post-harvest management Infrastructure and community farming assets
- 11) Promotion of **Farmer Producer Organisations (FPOs)** to **ensure better income** for the producers through an organization of their own.
- 12) _____ (PDMC) scheme to **increase water use efficiency** at the farm level
- 13) Setting up of **Micro Irrigation Fund**
- 14) Initiatives towards **agricultural mechanization**
- 15) Setting up of _____ **-a pan-India _____ trading portal** which networks the existing _____ **mandis** to create a **unified national market** for agricultural commodities.
- 16) Introduction of _____ for **improvement** in farm produce **logistics**, and
- 17) Creation of a **Start-up Eco system** in agriculture and allied sectors

II) **The Secondary Sector**

- Secondary sector contributes _____ of **total gross value added** in the country and employing over **12.1 crores** of people.
- The industrial sector in India broadly **comprises of-** manufacturing, heavy industries, fertilizers, pharmaceuticals, chemicals and petrochemicals, oil and natural gas, food processing, mining, defence products, textiles, retail, micro, small & medium enterprises, cottage industries and tourism.
- The **share of informal sector in the economy is more than 50% of GVA**.
- Manufacturing sector accounts for **78% of total production**.
- In **Jan 31, 2023** the Manufacturing Purchasing Managers' Index (PMI) in India stood at 55.4. **India's rank in the Global Innovation Index (GII) improved to 40th in 2022 from 81st in 2015.**

➤	(DPIIT) has a role in formulation and implementation of industrial policy and strategies for industrial development .
➤	Some of the policies are presented below:
1)	Introduction of GST on _____ single indirect tax replacing many indirect taxes.
2)	Reduction of corporate tax to domestic comp. giving an option to pay income-tax at 22%
3)	' _____ ' is a 'Vocal for Local' initiative launched in 2014 to- facilitate investment, innovation, infrastructure in India.
4)	'Ease of Doing Business' → simplification of procedures, rationalization of legal provisions, digitization of government processes, and decriminalization of minor defaults. India ranks _____ in the World Bank's annual Doing Business Report (DBR), 2020
5)	The National Single Window System is a one-stop-shop for investor related approvals & provide continuous facilitation and support to investors .
6)	PM Gati Shakti National Master Plan to facilitate data-based decisions related to integrated planning of multi-modal infrastructure , thereby reducing logistics cost.
7)	National Logistics Policy (NLP) → aims to lower cost of logistics
8)	To become 'Atmanirbhar', the Production Linked Incentive (PLI) Scheme was initiated for 14 key sectors to enhance India's manufacturing capabilities and export competitiveness.
9)	Industrial Corridor Development Programme: Greenfield Industrial regions with sustainable infrastructure and to make available 'plug and play' infrastructure at the plot level .
10)	_____ -India Scheme (Faster Adoption and Manufacturing of Hybrid and Electric Vehicles) to promote _____ of electric and hybrid vehicle technology
11)	' _____ ' → empowerment of Micro Small and Medium Enterprises (MSMEs).
12)	PM _____ (PM MITRA): ensure world-class industrial infrastructure & boost FDI and local investment in the textiles sector .
13)	Opening up for global investments: Make India a more attractive investment destination
14)	_____ FDI under _____ route is permitted for the sale of coal , and coal mining activities, & insurance intermediaries.
15)	Foreign Investment Promotion Board (FIPB) was abolished in May 2017, and replaced by _____ (FIFP). Under FIFP, process for granting FDI approvals has been simplified. FDI has increased jumped by 39% since FIFP came.
16)	Remission of Duties and Taxes on Export Products (RoDTEP) _____ formed to replace the existing _____ (Merchandise Exports from India Scheme) to boost exports. It provides for rebate of all hidden central, state, and local duties/taxes/levies on goods exported
17)	Start-up India Programme → facilitator for ideas & innovation in the country. India's rank in the Global Innovation Index (GII) → _____ in 2022.
18)	Public Procurement (Preference to Make in India) Order, 2017 gives preference to locally manufactured goods/serv. in public procurement thereby giving boost to industrial growth.
19)	Emergency Credit Line Guarantee Scheme (ECLGS) is a fully guaranteed emergency credit line to monitor lending institutions .
➤	India is gearing up for 4th industrial revolution or Industry 4.0 in which focus will be on- cloud computing, IoT, machine learning, & artificial intelligence (AI) .
➤	The _____ which aims to increase the share of manufacturing in GDP to 25% by 2025 is a step in this direction.

III) **The Tertiary Sector**

- Unlike the usual economic development process of nations where **economic growth has led to a shift from- agriculture to industries**, India has unique experience of _____ **the secondary sector** in the growth trajectory by a **shift from agriculture to _____ sector**.

The broad classification of services as per the National Industrial Classification, 2008

1.	Wholesale and retail trade and repair of vehicles
2.	Transportation and storage
3.	Accommodation and food service activities
4.	Information and communication
5.	Financial and insurance activities
6.	Real estate activities
7.	Professional, scientific and technical activities
8.	Administrative and support services
9.	Public administration, defence and compulsory social security
10.	Education
11.	Human health and social work activities
12.	Arts, entertainments and recreation
13.	Other service activities
14.	Activities of households as employers, undifferentiated goods and services producing activities of households for own use
15.	Activities of extra territorial organizations and bodies

- The **service sector** refers to **industry producing _____ goods** viz. services as output.
- The services sector is the **largest sector of India** & accounts for _____ of total India's GVA. Gross Value Added (GVA) of services sector is estimated at **₹ 96.54 lakh crore** in 2020-21.
- The service sector is the _____ **growing sector** in India and has the **highest labour productivity**. The exceptionally rapid expansion of **knowledge-based services** such as **professional** and **technical services** has been responsible for the faster growth of the services sector.
- The start-ups which have grown remarkably over the last few years mostly belong to the **services sector**.
- **India** is among **top _____** WTO members in **service exports and imports**.
- India's **services exports** at **US\$ 27.0 billion** recorded robust growth in November 2022 due to software, business, and travel services.

- While exports from all other sectors were adversely affected, India's services exports remained **resilient during the Covid-19 pandemic**. The reasons are the **higher demand** for **digital support** and need for **digital infrastructure modernization**.
- Services sector is _____ of **FDI inflows**. FDI equity inflows into the services sector accounted for **more than 60 per cent** of the total FDI equity inflows into India.
- The **World Investment Report 2022 of UNCTAD** places India as _____ **largest recipient of FDI in the top 20 host countries in 2021**.
- In 2021-22, India received the **highest-ever FDI inflows of US\$ 84.8 billion** including **US\$ 7.1 billion** FDI equity inflows in the **services sector**.
- To ensure liberalisation, government permitted **100% foreign participation** in **telecommunication services** through Automatic Route.
- The **FDI ceiling in insurance companies** was also raised from 49 to _____ %.
- Measures undertaken by the Government, such as the launch of the **National Single-Window system** and **enhancement in the FDI ceiling** through the **automatic route**, have played a significant role in facilitating investment.

Conclusion

- The **India Development Update (IDU) of the _____** published in November 2022, observes that India had to face an unusually challenging external environment-
 - Russia-Ukraine war,
 - **increased crude oil and commodity prices,**
 - **persistent global supply disruptions,**
 - **tighter financial conditions** and
 - **high domestic inflationary pressures.**
- Despite all these, the **real GDP of India grew by 6.3 percent in July-September of 2022-23 driven by strong private consumption and investment.**
- The report observes that **India's economy** is relatively **more _____ from global spillovers** than other emerging markets
- As such, compared to other emerging economies, **India is much more resilient to withstand adversities in the global arena.**

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