CA Foundation – Business Economics

Economics (All 10 Chapters)

Last Minute Notes

(Only Important Points)

Just 102 Pages 🔥

By CA Mohnish Vora (MVSIR)

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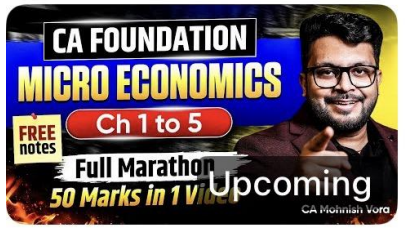

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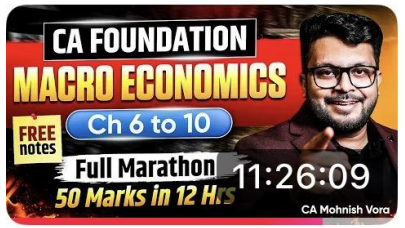

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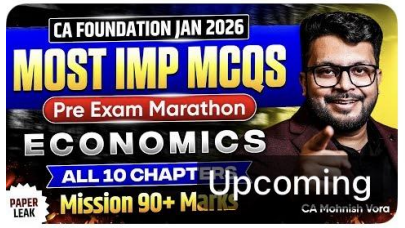

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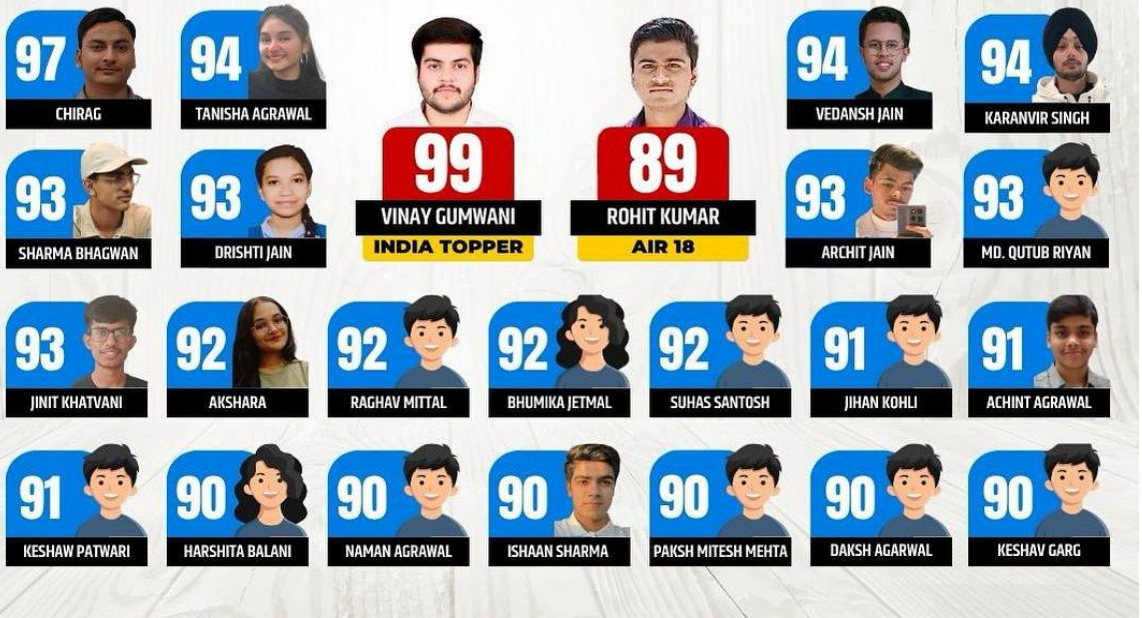

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CA Foundation – Business Economics

Micro Economics (Chp 1 to 5)

Last Minute Notes

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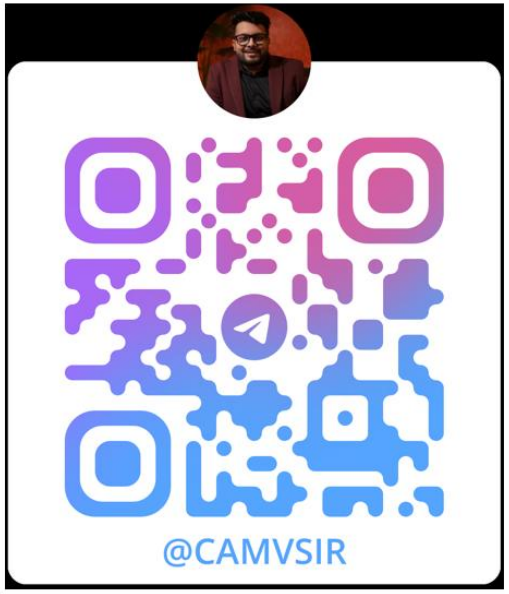

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Last Minute Notes
Micro Economics

INDEX

Chapter No.	Chapter Name	Pages
1	Nature & Scope of B.E.	1.1 – 1.4
2	Demand & Supply	2.1 – 2.13
3	Production & Cost	3.1 – 3.9
4	Markets	4.1 – 4.9
5	Business Cycles	5.1 – 5.3
	Total	**38 Pages**

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Last Minute Notes

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Economics Chapter 1

Nature & Scope of Business Economics

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CHAPTER 1 - NATURE & SCOPE OF BUSINESS ECONOMICS | UNIT 1 - INTRODUCTION

1

Two fundamental facts of Economics
- **Unlimited Wants**
- **Resources→ relatively scarce resources** (Problem of Scarcity) & have **alternative uses**

2

We cannot have everything we want with resources we have, we are **forever forced to make choices**.

3

Problem of scarcity is faced by **EVERYONE** & EVERY COUNTRY.

4

'Economics' is derived from **Greek** word **'Oikonomia'**. Its meaning is **'household management'**.

5

Till 19th century, Economics was known as '**Political Economy**'

6

Economics Definition
- **Adam Smith (Father of Economics)-** Wealth Definition→ wrote book- Wealth of Nations (1776)
- **JB Say-** Economics science deals with wealth
- **Alfred Marshall-** Welfare Definition
- **Lionel Robins (Robinson)-** Scarcity Definition

7

Most economic problems are of **complex nature,** & are affected by **several forces**

8

Study of economics helps us in-
- Developing an **analytical approach**
- **Choosing best course of action**

But Economics-
- **cannot** ensure→ **all** problems are **tackled**
- Helps to examine a problem in its **right perspective.**

9

Joel Dean defined "Business Economics" as use of economic analysis in formulation of business policies. Aka. **Applied** or **Managerial Economics**

10

Micro Economics	Macro Economics
Study of **individuals** or **group of units**. How individual **efficiently allocate resources**	Study of **economy as a whole**. Analyzes **overall eco. environment**. **Aggregate** Economics
Eg- Product pricing, **Factor pricing**, economic **conditions of section of people**, Location of industry.	Eg- National Income, **General price level** Balance of trade (BoT) & payments (BoP), **savings & investment,** level of **employment** & economic growth rate

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CHAPTER 1 - NATURE & SCOPE OF BUSINESS ECONOMICS | UNIT 1 - INTRODUCTION

11	Micro-economics deals primarily with: **comparative statics, partial equilibrium**, & **positive economics.**
12	**Nature of Business Economics** **1) Science** (Social science) 2) Based **largely on Micro Economics** **3) Incorporates** elements of **Macro Analysis** **4) Art** **5) Pragmatic** in Approach Micro-Economics → abstract & purely theoretical Business Eco → pragmatic (tackles practical prob.) **7) Interdisciplinary** in nature **8) Normative** in Nature • Positive Economics – **Descriptive**, "**What is**" current situation, analyses cause & effect relationship • Normative Economics – **Prescriptive**, "**What should be**" done for **welfare**, involves value judgements
13	**Scope of Business Economics** ➢ Operational / Internal Issues (solved using **Micro**-Economics- **Arise within org** & are **within control** ➢ Environmental / External Factors (solved using **Macro**-Economics)- **Not within control of mgt**; thus org. should fine-tune its policies accordingly

14	Economics	Business Economics
Meaning	**Framing** of principles	**Application** of principles
Character	**Micro** & **Macro**	**Micro** economic
Nature	**Positive** & **normative**	**Normative**
Scope	**Wider** Scope	**Narrow** scope

CHAPTER 1 | UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

15	**Economic system**→ Sum total of arrangements for the **production** and **distribution** of goods and services in a society.
16	**Every economic system** has to deal with **central problem of scarcity of resources** relative to wants. **4 Central economic problems**- **1) What to produce?** → What & how much to produce **2) How to produce?** → Capital or Labour Intensive **3) For whom to produce?** → How G/S distributed **4) What provisions are to be made for economic growth?**

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CHAPTER 1 | UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

3 Types of Economies	Capitalism (free market or laissez-faire)	Socialism (Command or Controlled or Centrally Planned)	Mixed Economy
Meaning	➢ **All resources→ private indv. for profit.** ➢ Eg- USA, UK, Hong Kong etc.	➢ **Karl Marx & Frederic Engels →** '**Communist Manifesto**' (1848)	Includes best features of **both capitalism & socialism**
Characteristics	➢ **Profit motive** is driving force ➢ Right to **private property** ➢ Freedom of **enterprise** & **choice** ➢ **Consumer sovereignty-** cons. is **king** ➢ **Absence** of Govt Interference ➢ **Regulatory mechanism- COMPETITION-** (optimum allocation of resources & cost minimized)	Production by Govt. is aimed at **maximizing welfare** of public **1) Collective Ownership** **2) Economic planning** by CPA **3) Absence of Consumer Choice** **4) Equal Income Distribution** **5) Administered prices→** set by Govt. **6) No Competition**	**There are three sectors of industries:** 1) Private sector 2) Public sector 3) Combined sector
Merits	➢ Consumers benefitted – **many good quality** goods at **low prices-** results in **higher standard of living** ➢ Self-regulating and resources allocated by **price mechanism** ➢ Functions in a **democratic framework** ➢ Offers **incentives** for efficient **economic decisions** ➢ Encourages **enterprise** & **risk taking**	1) No waste on advertisement exp **2) Unemployment** is **minimised**, **3) Business fluctuations are eliminated** **6) Avoids class war** 7) Right to work & **min. standard of living** 8) Labourers & cons.→ **no exploitation** **9) Comprehensive social security**	➢ Economic freedom & private property ➢ **Consumers' sovereignty & freedom of choice.** ➢ **Economic planning & rapid development** ➢ **Greater equality** ➢ **Disadv. of competition averted** by **legislations**

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CHAPTER 1 | UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

3 Types of Economies	Capitalism (free market or laissez-faire)	Socialism (Command or Controlled or Centrally Planned)	Mixed Economy
Demerits	➢ **Vast economic inequality-** 'haves' & 'have-nots' ➢ Precedence of property rights over human rights ➢ **Exploitation** of labour & consumers. ➢ **Resource misallocation** ➢ **Waste of resources** - huge spent on advertisement	1) **Bureaucracy & red tapism**, corruption, favouritism 2) **Not** provide incentive to hard work 3) **State monopolies - uncontrollable** 5) **No freedom of choice** 6) No importance to **efficiency**. 7) **Extreme form** of socialism is not practicable (This economy is **myth**)	(Mixed economy is **not a golden path** between capitalism & socialism) ➢ **Excessive controls by state**→ constrained growth ➢ Poor implement of plans ➢ Higher rates of **taxation** ➢ Undue delays, Lack of efficiency, Corruption ➢ **Poor performance** of public sector
How it solves central problems?	1) **What to produce?** → decided by **consumers** 2) **How to produce?**→ LIT or CIT whichever is **cheaper** 3) **For whom to produce?**→ Higher the income, higher buying capacity & higher demand for goods. 4) **Provision (Saving & Invt)** ➢ Interest Rate high- more saving ➢ More profit expectation- more invt	**Central Planning Authority**	It uses a **mix of both price mechanism & central planning**

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Economics Chapter 2

Theory of Demand & Supply

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

1	**Demand** is **not same** thing as **desire** to purchase.
2	**Effective Demand = Desire + ATP + WTP**
3	Two things about quantity demanded. i. Qd → **expressed at a given price**. ii. Qd → **flow concept** (Time period is important)
4	**Determinants of Demand** **i) Price of the good-** **price increases** → **demand decreases** & vice versa **ii) Price of related goods** • **Complementary goods** (goods used together) → Eg **Car & Petrol** → **inverse** relation • **Substitute/Supplementary/Competing goods** (goods which satisfy same want) → Eg **Tea & Coffee** → **direct** relation **iii) Disposable Income of Consumers** Depends on **nature of goods**. **iv) Taste & Preferences** **Modern or fashionable** → **higher demand**. **v) Consumers' Expectations** If consumer **expects** → **Increase in future price** **OR** future income **OR** Shortage in future→ **Curr. Dem. Incr**

5) Nature of Good	Meaning
Normal Goods	**Increase** in income → **higher** demand.
Essential Consumer Goods	Satisfies **basic needs** of consumers. **Incr. in demand < incr. in income.**
Durable Goods (can be used more than once)	As people become **richer** → **rise in importance** of durable goods.
Inferior Goods	**Increase** in income → **lesser** demand. A same good may be **normal** for one condition & **inferior** in another.
Luxury / Prestige Goods	Demand rises beyond a level of income & **keep rising as income incr.**

6) 4 Types of "Effects" influences Tastes & preferences	
Demonstration Effect (Dekha-Dekhi)	Given by **James Duesenberry**, **Desire** of people to **emulate (imitate)** others.
Bandwagon Effect (Bhed-Chaal)	Extent to which **demand** is **increased** since **others are also consuming same**. Purchasing goods **to be fashionable or stylish** or to **conform to people.**

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

Snob Effect (function of **consumption of others**)	Extent to which **demand** is **decreased** since **others are also consuming same.** **Desire** to be **exclusive** (to **dissociate** from common herd)
Veblen Effect (function of **price**)	Given by **Thorstein Veblen.** People buy high priced goods to **show-off,** style, money **(conspicuous consumption).**

7) Other Factors (Determinants of Demand)

a) Size of population	**Larger size** of population→ **higher demand**
b) Age Distribution of population	**More old** people, then demand for spectacles, sticks, etc. will be high. If **more of children**, demand for toys, toffees, etc. will be more. **Migration from rural** areas **to urban** areas, there **decrease in demand in rural** areas.
c) Consumer-credit facility & int. rates	**Low interest** rate, **high demand** **More credit** available, then **high demand**
c) The level of National Income & its Distribution	**Higher national income→ higher demand** **Rich→ lower** propensity to consume (PTC) **Poor → higher** PTC. **Uneven** Distribution→ **PTC less**, demand less **Even** Distribution→ **PTC more**, demand more
e) Govt. policies and regulations	**Tax increase→** demand **decrease** **Subsidy increase→** demand **increase** **Ban** or restriction **incr→** demand **decrease**

8	As per **Alfred Marshall**, **Law of demand→** ceterus paribus (other things equal), if **price falls**, **qty dem** will **rise** & vice versa
9	**Demand schedule→ table** showing **qty** that **buyers** demand at **different prices**, **per unit of time** It **obeys** (follows) **law of demand**.
10	**Demand curve→ graphical presentation** of demand schedule → **Price on Y-axis** & **Qty Dem on X-axis**. **Slope of demand curve** is → **- ΔP/ΔQ** **-ve sign** in slope → consistent with law of demand.

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

11

Market demand→ total qty that **all buyers** are **willing to buy**

Market demand curve→ horizontal (lateral) summation of all **individual demand curves.**

12

Demand function states relationship between
- demand (dependent variable) &
- its determinants (independent variables)

Dx= f(Price of Good, Income, Price of Related Goods)

13

Demand Equation of straight-line demand curve

$$Q = a - bP$$

'a' → vertical intercept & 'b' → slope.

14

Rationale of the law of demand

i) Utility maximising behaviour of Consumers

ii) Arrival of new consumers

iii) Different Uses

iv) Price effect

Total fall in qty demanded due to an **increase in price** is → **Price effect**.

It has **two components** (given by **Hicks & Allen**) **substitution** effect & **income** effect.

15

iv) a) Substitution effect

When **price** of X **falls**, **it becomes relatively cheaper** than other goods→ thus qty dem of X **increases.**

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

Substitution effect will be **stronger** when:
(a)goods are **closer substitutes**
(b)there is **lower cost of switching**
(c)there is **lower inconvenience while switching**

iv) b) Income effect

- When **price falls**, consumer can
  - buy **same quantity** with **lesser money**, or
  - **buy more** of same good **with same amount.**

- **In case of inferior goods**,
  - income effect **works in opposite direction** to substitution effect.
  - **expansion in demand** due to a **price fall** will take place **only if SE > IE.**
  - Here, **violation of law of demand** takes place when **Negative IE > SE**

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Exceptions to the law of demand

1) Conspicuous goods

- Aka. **Prestige** or **Snob** or **Veblen** goods
- Price of jewellery rises, demand may also rise as consumers attach a **snob value** to owning & expensive items. **Eg- Diamonds**
- By **Veblen** in **doctrine of Conspicuous Consumption**

2) Giffen Goods

- Given by **Robert Giffen**→ as **price of bread incr.**, British workers **purchased more bread.**
- **Direct price-dem** relation→**upward** slope **dem** curve
- **Indirect income-dem** relation→**downward** slope **engel** curve
- All Giffen Goods are inferior Goods, but **all inferior goods are not Giffen** Goods

3) Conspicuous necessities

- Demand affected by **demonstration effect** of **consumption pattern of their social group**. These goods, due to **constant usage**, become **necessities** of life. Eg- **TV**, refrigerators, etc.

4) Future expectations about prices

When **prices are rising**→ **expect** that **prices in future** will be **still higher**→ **buy larger quantities** currently.

5) Irrational Consumer

- **Ignorant** of ruling price
- **Irrational**→ **impulsive purchase** without calculation

6) Demand for necessaries

Irrespective of price changes→ have to consume minimum quantities of necessities. Eg- **Food** etc.

7) Speculative goods

In stock market→ **more demand** when **price incr** & vice-versa.

17

Changes in Demand vs Qty Demanded

Demand	Quantity Demanded
It is the **entire relationship** between **price** & **qty demanded**.	It is the quantity which is demanded at a **specific price**.
Represented by **entire demand schedule & demand curve**.	Represented by a **point on demand curve**.
"Changes in Demand" occur due to **changes in factors other than price of the good.**	"Changes in Qty Demanded" occur due to **changes in price of goods concerned.**
Favourable change **Increase** in Demand → **Rightward shift** in demand curve **Unfavourable change** **Decrease in Demand** → **Leftward shift** in demand curve	**Increase in price** **Contraction** → **Upward movement** along same demand curve **Decrease in price** **Expansion** → **Downward movement** along same demand curve

18 **Objective of advertisement** is to-
✓**shift** demand curve to **right,** &
✓**reduce elasticity** of demand

19

Price Elasticity of demand (Ep)
Responsiveness of qty dem to change in price

Percentage Method

$$\frac{\%\,\Delta Qd}{\%\,\Delta P}$$

OR

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

OR

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

Point Method

- **Using Derivative**

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

- **Geometric Method**

$$\frac{\text{Lower Segment}}{\text{Upper Segment}}$$

Arc Method

$$\frac{Q1 - Q2}{Q1 + Q2} \times \frac{P1 + P2}{P1 - P2}$$

Total Outlay Method

Change in Price	Demand		
	Unitary Elastic	Elastic	Inelastic
Price Increase	TR remains same	TR Decreases	TR Increases
Price Decrease	TR remains same	TR Increases	TR Decreases

New Point in Total Outlay	Price Effect vs Qty Effect
Ep < 1	QE < PE
Ep > 1	QE > PE
Ep = 1	QE = PE

20 Value of Ep varies from **-∞ to 0**, **however** while **interpreting** its value **we ignore –ve sign**

Value of Ep	Term	Meaning	Shape of Demand Curve
Ep = 0	Perfectly Inelastic Demand	Qd does not respond to change in price→ %ΔQd = 0	Vertical-parallel to Y-axis
0 < Ep < 1	Inelastic Demand	%Δ Qd < %Δ Price	Steeper
Ep = 1	Unit Elastic Demand	%Δ Qd = %Δ Price	Rectangular Hyperbola
Ep > 1	Elastic Demand	%Δ Qd > %Δ Price	Flatter
Ep = ∞	Perfectly Elastic Demand	%ΔPrice = 0 Small price reduction raises demand from 0 to ∞	Horizontal-parallel to X-axis

21 **Advt Elasticity of Dem. (Ea)**→ Value always **positive**

Percentage Method (Ea)

$$\frac{\%\,\Delta \text{ Qty Dem.}}{\%\,\Delta \text{ Advt Exp}} \quad \textbf{OR} \quad \frac{\Delta Q}{\Delta A} \times \frac{A}{Q}$$

Arc Method (Ea)

$$\frac{Q1 - Q2}{Q1 + Q2} \times \frac{A1 + A2}{A1 - A2}$$

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22

Determinants of Price Elasticity of Demand

Availability of Substitutes	Goods having **substitutes**→ **Elastic** **No substitutes**→ **Inelastic**
Position of good in budget	**Greater the proportion of income spent** on a good→ **greater elasticity**
Nature of need	**Luxury** goods (possible to **postpone**) → **elastic** **Necessities (cannot** be **postponed)**→ **inelastic**
No. of uses	**More uses** of a good→ **greater elasticity**
Time period	Long time to adjust to price change→ **elastic** Short time period→ **inelastic**
Habits	Consumer is **habitual** → inelastic
Tied demand	Tied demand→ inelastic
Price Range	**Very high price** or **very low-price range**→ **inelastic** **Middle range** → **elastic** demand.
Minor items	**Cheap** & **complementary items**→ used with **costlier product** → **inelastic demand**.

23

Income Elasticity of Dem. (Ea)

Percentage Method (Ey)

$$\frac{\%\Delta \text{ Demand}}{\%\Delta \text{ Income}} \quad \textbf{OR} \quad \frac{\Delta Q}{\Delta Y} \times \frac{Y}{Q}$$

Arc Method (Ey)

$$\left[\frac{Q1 - Q2}{Q1 + Q2} \times \frac{Y1 + Y2}{Y1 - Y2}\right]$$

Value of Ey	Type of Good
Ey = 0	No specific type of good
Ey is +ve → Ey > 0	Normal Goods
0 < Ey < 1	Necessities
Ey > 1	Luxury goods
Ey is –ve → Ey < 0	Inferior goods

24

Cross Elasticity of Dem. (Ec)

Percentage Method (Ec)

$$\frac{\%\Delta \text{ Demand(x)}}{\%\Delta \text{ Price(y)}} \quad \textbf{OR} \quad \frac{\Delta Qx}{\Delta Py} \times \frac{Py}{Qx}$$

Arc Method (Ec)

$$\left[\frac{Q1 - Q2}{Q1 + Q2} \times \frac{P1 + P2}{P1 - P2}\right]$$

Ec = 0	Unrelated Goods

Ec is +ve & Low	Remote Substitutes
Ec is +ve & High	Close Substitutes
Ec is +∞	Perfect Subst.

Ec slightly below zero	Weak Complements
Ec is –ve & High	Strong Complements
Ec is -∞	Perfect Compl.

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 2 – CONSUMER BEHAVIOUR

1

All **desires, tastes and motives** of human beings are **wants**

Nature of Human Wants

- **Unlimited**
- **Differ in intensity**
- **Satiable**
- **Competitive**
- **Complementary**
- **Alternative**
- **Subjective**→ vary from **person**, **time** & **place**
- Some wants **recur** whereas others **do not**
- May become **habits** & **customs**
- Affected by **income**, **taste**, **fashion**, **ads** & **customs**

2

Classification of Wants

Necessaries	**Necessaries for life**	Meet **minimum physiological needs**
	Necessaries for efficiency	To **maintain longevity, energy & efficiency** of work.
	Conventional necessaries	Arise due to **pressure of habit** or **compelling customs**.
Comforts		**They** make life **comfortable & satisfying. Comforts are less urgent than necessaries.**
Luxuries		Wants which are **superfluous & expensive**. **Not essential** for living.

3

Utility

- Utility→ **anticipated / expected** satisfaction
- Commodity has utility **even when it is not consumed**

Cardinal Utility Approach	Ordinal Utility Approach
Here utility can be **measured numerically.**	Utility **cannot** be measured **numerically**→ but can be **ranked.**
Law of Diminishing Marginal Utility (DMU)→ by **Marshall**	**Indifference Curve Analysis** → by **Hicks & Allen**

4

Law of DMU

The **additional benefit** which a person derives from a given **increase in stock** of a thing **diminishes with every increase** in the stock that he already has.

Total Utility (TU) - sum of marginal utilities

- **TU= MU1 + MU2 +.....+ Mun**

Marginal Utility (MU) - MU is **addition made to TU** due to **one additional unit** of good.

- **MUn = TUn - TUn-1**

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5

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

6

Observations

1) **MU** can be **+ve** , **0** or **-ve**.

2) **MU diminishes** throughout.

3) **TU rises** as long as **MU is +ve**, but at a **diminishing rate.**

4) When **MU = 0**, **TU is maximum**. It is a **satiation point** or **saturation point**→ **refuse any extra unit** even if free

5) When **MU is –ve**, **TU is diminishing**.

6) **MU = Slope of TU**.

7

Assumptions of Marginal Utility Analysis

a) Rationality
b) Cardinal Measurability of Utility
c) Money is the measuring rod of utility
d) Other factors 'constant'
e) Continuity in consumption
f) Homogenous Units
g) Standard Units
h) Constancy of Marginal Utility of Money
i) The Hypothesis of Independent Utility

8

Assumptions of Marginal Utility Analysis

a) Unrealistic assumptions
b) Case of related goods
c) Law is **not universal** (law does not apply in)

✓ **Prestigious goods → gold, cash, diamond**
✓ **Hobbies, rare collections**
✓ People who **seek greater knowledge & info.**
✓ **Creative art, painting, music, poetry**
✓ **Habit forming commodities**
✓ People with **miserly behaviour**

9

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

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 2 – CONSUMER BEHAVIOUR

10

Consumer Equilibrium in Single Commodity

- Consumer in **equilibrium** → **deriving maximum satisfaction** from some qty of **one good,** where, **MU = Price.**
- At equilibrium **marginal utility of money spent** → **MUm = MUx / Px = 1**
- **When price falls** → **Buy more** of good
  When price rises → **Buy less**
  so as to equate the marginal utility to price.

11

Law of Equi-Marginal Utility

(MUx / Px) = (MUy / Py) = MUm
or
(MUx / MUy) = (Px / Py)

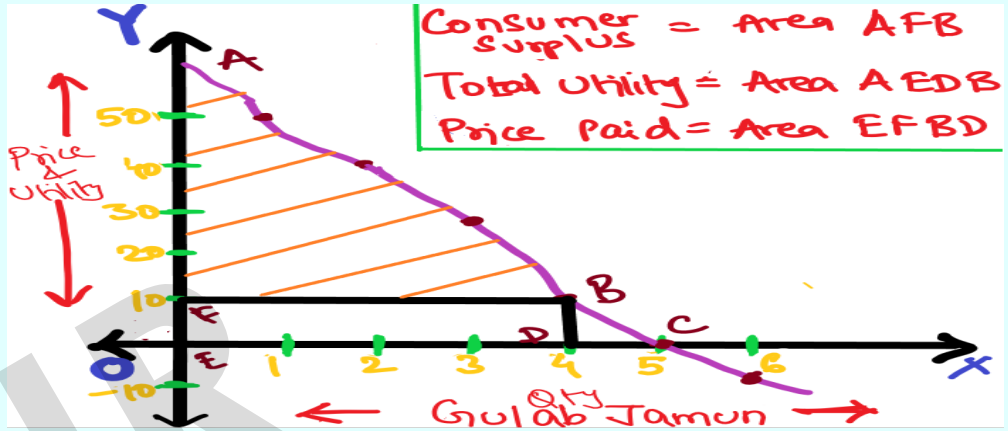
12

Consumer Surplus (CS)

Alfred Marshall gave concept of CS.

CS = what consumer is ready to pay - what he actually pays **OR** **CS = MU - Price**

13

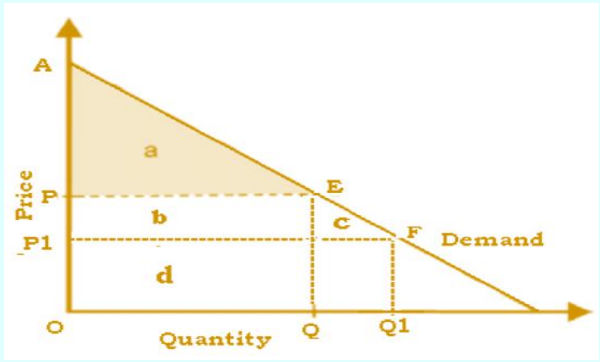


14

- Concept of CS is **derived from law of DMU.**
- **Individual CS** → Area **below** indv. demand curve & **above** price line
- **Total CS** → Area **below market** demand curve & **above** price line

15

Consumer Surplus – New Point



If **price falls** from P to P1, then-

- ✓ Increase in CS of **existing buyers** (area "**b**")
- ✓ CS now available to **new buyers** (area "**c**")

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Important Limitations of CS

1) In case of **necessaries**→ CS is always infinite.
2) CS is affected by **availability of substitutes**.
3) **No simple rule for deriving utility scale** of **prestige** goods (e.g., diamonds).

17

Ordinal Approach

As per this, **satisfaction** → is a **psychological phenomenon** & **cannot be measured.**

18

Assumptions of Indifference Curve Analysis

1) Consumer **knows his own tastes & preferences**
2) Consumer is **rational**
3) Utility is **ordinally** expressible.
4) **Transitive choices**→ If consumer **prefers combi. A to B**, & **B to C,** then he must prefer **A to C**
5) If combi. **A** has **more commodities** than B, then **A must be preferred** to B.

19

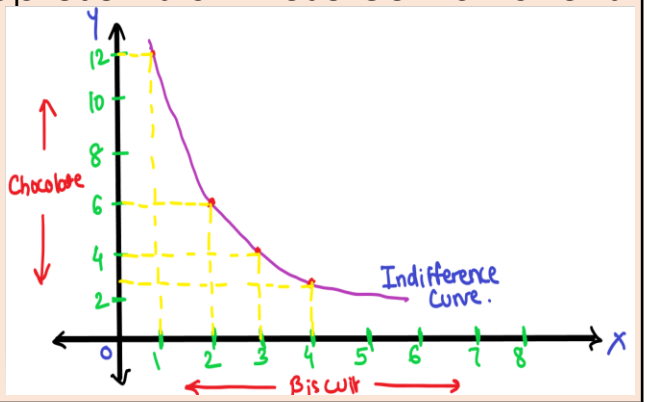
A consumer's preferences are **monotonic**, **if & only if** between 2 bundles, consumer prefers bundle which has-

✓**More of atleast one** of the goods, &
✓**No less of the other** good

20

Indifference Curve

➢ IC is a curve which represents all those combinations of **two goods** which give **same satisfaction**.
➢ IC aka. **iso-utility** or **equal utility curve**.



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Marginal Rate of Substitution (MRS)

➢ **MRS of X for Y** → **qty of Y** whose **loss can just be compensated** by a **unit gain of X**→ such that **satisfaction remains same**.
➢ MRS→ absolute **slope of IC** → **MRS = ΔY / ΔX** or
➢ **MRS = MUx / Muy**

23

Properties of IC

1) **Downward sloping** to **right**
2) **Always convex to origin** (since MRS is falling)
3) ICs **can never intersect** each other (but **may or may not** be **parallel**)
4) **Higher IC** represents **higher level of satisfaction**
5) IC **never** touch either **axes**

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24 **Indifference Curve in case of**

Substitute Goods	Complementary Goods
➢ Downward Sloping	➢ L-shaped
➢ Straight Line	➢ Convex to origin
➢ MRS is constant	➢ 2 straight lines with right angle bent

25 **Indifference map**

Collection of many ICs → depicts **complete picture** of consumer's tastes.

26 **Budget Constraint**

➢ Shows all **combi. of 2 goods** which **consumer can buy, spending his given income** on two goods.

✓ Any point **on BL** → **spends all** his money income

✓ Any point **above** BL (pt B) → **over-spending**

✓ Any point **within** BL (pt A) → **under spending**

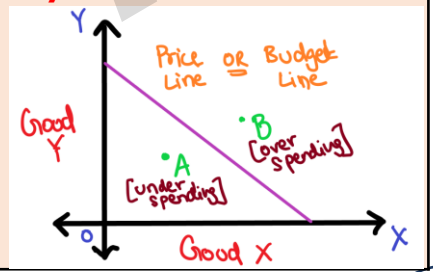
➢ **Slope of BL** = '**Price Ratio**' = **Px / Py**

➢ BL will **shift** when there is:

❑ **Change in price** of goods, or

❑ **Change in income**, or

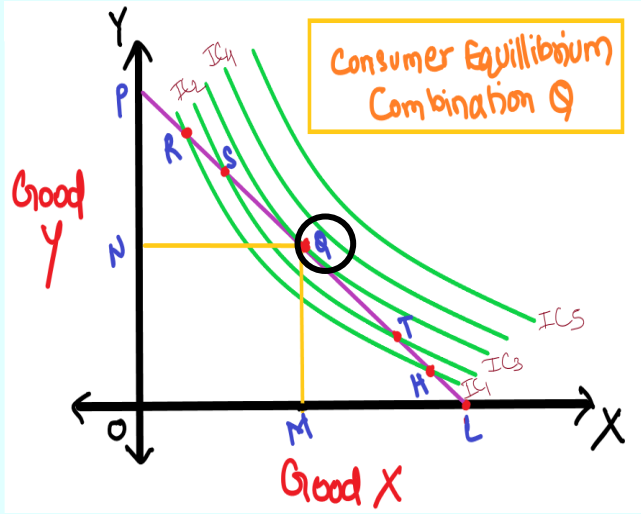
❑ **Change** in **both**



27 **Consumer's Equilibrium (2 commodity- Ordinal Approach)**

Consumer is in **equilibrium** → deriving **max possible satisfaction** from goods.

Equilibrium at '**Combination Q**', where **budget line** PL is **tangent** to **indifference curve** IC3



At equilibrium point, Slope of IC = Slope of BL

[MUx/Muy] = [Px/Py]

28 **IC Analysis Vs Utility Analysis**

IC analysis is **superior** to **utility** analysis, as:

1) No assumption of **measurability** of **utility**

2) Studies **more than 1 commodity** at a time

3) Does **not assume constancy** of MU of money

4) Segregates income effect from **substitution** effect.

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 3 – THEORY OF SUPPLY

1

Introduction

- ❑Demand → Consumer point of view
- ❑Supply → Seller point of view
- ❑'**Supply**' refers to qty of G/S that producers are
  - ➢ **willing &**
  - ➢ **able to offer** to the market
  - ➢ at various **prices**
  - ➢ during a given period of **time**.
- ❑Three important things about supply

1) Supply→ what a **firm offer for sale**

2) Flow concept→ **'so much' per unit of time**

3) Supply requires → **willingness** & **ability** to supply.

2

Determinants of Supply

1) Price of the good

Ceterus paribus, **price increases** → **Qs increases**

2) Price of related goods

A farmer sells wheat & soya. If **price of wheat rises**, **supply of soya** will **decrease.**

3) Prices of factors of production

Rise in price of factors of prod. → increase in cost → **supply decreases**

4) State of technology

Use of **advanced tech**→ **supply increases**

5) Government Policy

- ❑**Increase in Taxes**→ supply **decr.**
- ❑**Increase in Subsidy**→ supply **incr.**
- ❑**More Restrictions**→ supply **decr.**

6) Number of sellers, Nature of competition and size of industry

No. of sellers rise→ **Competition** increase→ **More supply**.

8) Expectations

Increase in anticipated future price → reduces its supply today

3

Law of Supply

- ➢ **Other things remaining constant**, **quantity supply** will **increase as price rises** and vice versa.
  - ✓In **short run**→ **not easy to increase supply**,
  - ✓In **long run**→ supply can be **easily adjusted**
- ➢ Supply curve→ **upward sloping**
- ➢ **Slope** of supply curve is → **ΔP/ΔQ**

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4

Changes in Supply vs Quantity Supplied

Supply	Quantity Supplied
It is the **entire relationship** between price & **qty supplied**	It is the quantity which is supplied at a **specific price.**
Represented by **entire supply schedule & curve.**	Represented by a **point on the supply curve.**
"Changes in Supply" occur due to **Changes in factors other than price of good.**	"Changes in Qty Supplied" occur due to **Changes in price of goods concerned.**

Favourable Change	**Unfavourable Change**	**Increase in Price**	**Decrease in Price**
Increase In supply → Rightward shift in supply curve	**Decrease In supply → Lefttward** shift in supply curve	**Expansion → Upward movement** along same supply curve	**Contraction → Downward movement** along same supply curve

5

Elasticity of Supply

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

Percentage Method

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

OR

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

OR

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

Point Method

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

Arc Method

$$\frac{Q1 - Q2}{Q1 + Q2} \times \frac{P1 + P2}{P1 - P2}$$

6

Interpretation of Values of Elasticity of Supply

Value of Es	Term	Meaning	Shape of Supply Curve
Es = 0	Perfectly Inelastic Supply	Qs does not respond to change in price → %ΔQs = 0	Vertical- parallel to Y-axis
0 < Es < 1	Inelastic Supply	%Δ Qs < %Δ Price	Steeper
Es = 1	Unit Elastic Supply	%Δ Qs = %Δ Price	Supply Curve passes through origin
Es > 1	Elastic Supply	%Δ Qs > %Δ Price	Flatter

	Es = ∞	Perfectly Elastic Supply	%ΔPrice = 0 Small price increase raises supply from 0 to ∞	Horizontal- parallel to X-axis

7

Determinants of Elasticity of Supply (Only IMP Points)

Incr. in Production → leads to huge cost incr.	Inelastic
Complex production process → require long time to produce (Eg- aircraft, cruise ship)	Inelastic
If after increase in price → short time period	Inelastic
Sellers expect → rise in future price	Inelastic
Inputs→ Short in supply→ require longer delivery period→ highly specialized nature	Inelastic
Labour→ highly skilled→ scarce→ require longer training period	Inelastic Supply
More no. of sellers → More competition	Elastic
Not working on full capacity → more spare capacity	Elastic
Key raw material → easily & cheaply available	Elastic

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- **Market Equilibrium** is a situation where, **Qty dem = Qty supplied**
- **Intersection** of **demand** & **supply** determines **equilibrium price** (aka. **market clearing price**)

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

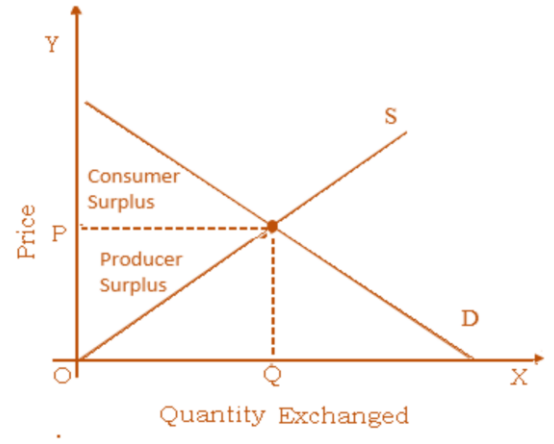
9

Social Efficiency

- **Social efficiency**→ **net gains to society** from **all exchanges** in a market→ **achieved** when both **producers** & **consumers** enjoying **maximum possible surplus**.
- **Consumer surplus** → MU – Price

Area **below** demand curve **& above** price line

- **Producer surplus** → benefit derived by **producers** from **sale of goods above their cost of producing**. [SP – Cost]
- Area **above** supply curve & **below** price line.



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Last Minute Notes

(Only Important Points)

Economics Chapter 3

Theory of Production & Cost

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ECONOMICS CHAPTER 3 – UNIT 1 – THEORY OF PRODUCTION

1	**Production**→ **process** by which **man utilises resources** to **transform** them into G/S to make them **satisfy human wants**. **(**definition by **James Bates & J.R. Parkinson)**
2	**Production**→ also be defined as **creation or addition of utility.** During production we can confer **4 types of utility-** **1) Form Utility** **2) Place Utility** **3) Time Utility** **4) Personal Utility**
3	Production **does not include-** • **work done** out of **love & affection**, • **voluntary services** & • goods produced for **self consumption.**
4	**Factors of Production (Inputs)** ✓**Natural Resources**- Land ✓**Human Endeavour**- Labour, Capital & Enterpreneur
5	**Land** Soil or earth's surface & **all free gifts of nature.** **IMP Characteristics** ✓ **Supply** of land is **fixed** ✓**Perfectly inelastic** from **economy** view ✓**Relatively elastic** from a **indv. firm** view ✓ **Permanent** & has **indestructible** powers ✓ **Passive** ✓ **Immobile** ✓ **Multiple uses** ✓ **Heterogeneous**
6	**Labour** Human efforts which require use of **physical exertion**, **skill** and **intellect**. Labour must be done with **motive** of **economic reward**. **IMP Characteristics of Labour** ➢**Perishable**, requires **human effort**, **active factor**, **inseparable from labourer**, **mobile**, ➢**Labour power differs** ➢**Poor bargaining power** ➢**Supply curve** of labour- **backward bending** shape

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7

Capital

- **'Produced means** or **Man-made instruments of production'.** It refers to all assets that are a **part of wealth** (total assets) & are **used for further production** of wealth.
- **Capital** is a **stock** concept→ yields a periodical income which is a **flow** concept

IMP Types of Capital

1) **Fixed capital - Durable nature**
2) **Circulating capital –** For **single use** & is **not available for further use.** Eg, seeds, fuel, raw materials etc
3) **Social capital - Belongs to society** as a whole in form of roads, bridges, etc.

8

Capital Formation (aka Investment)

- It means a **sustained increase in stock of real capital** in a country.
- It involves **production of more capital goods** like, machines, factories, etc. which are **used for further production** of other goods.
- Required for **creating additional productive capacity**.

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Stages of Capital Formation

1) Savings
2) Mobilisation of savings
3) Investment

9

Entrepreneur

Entrepreneur is a factor which

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

Functions of Entrepreneur

1) **Initiating business**
2) **Risk bearing or uncertainty bearing** (**cannot** be **delegated**)
3) **Innovation** – **Most Important Function**

10

Enterprise Objectives

1) **Organic objectives-** Basic minimum objective- survival, growth & expansion.
2) **Economic objective-** Profit & sales maximization.
3) **Social objectives**
   - It lives in society & it cannot grow unless it **meets the needs of the society**.
   - Supply of **unadulterated goods** & of **standard quality**.
   - **Create opportunities** for **employment**.

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4) Human objectives
- Provide **fair deal to employees** at different levels

5) National objective
- **Remove inequality 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.

11

Production Function

Production function is a mathematical statement of **relationship** between **dependent** variable (**output**) & **independent** variable (**inputs**). [definition given by **Samuelson**]

Q = f (Labour , Capital) = f (L,K)

Assumptions of Production Function

1) Relationship between inputs & outputs exists for **specific period of time**
2) Production **technology** remains **constant**
3) **Output** resulting from use of inputs is **at maximum level**

12

Short Run

Short run→ is a time period when a firm is doing **actual production** & where **atleast one input is fixed (Capital fixed** & **Labour variable)**

13

Long Run

Long run→ is a time period when a firm is **planning stage** & where all **inputs are variable**

14

Aka. **Law of returns to a variable input** OR **Law of diminishing returns**

As per this law, as we **increase quantity labour** (variable input), its **marginal product (MP)** eventually **declines**.

Assumptions of Law of Variable Proportions

1) **Technology constant**
2) **Some inputs** must be **fixed**
3) **Does not apply** where factors used in **fixed proportions**
4) Consider **only physical inputs & outputs**

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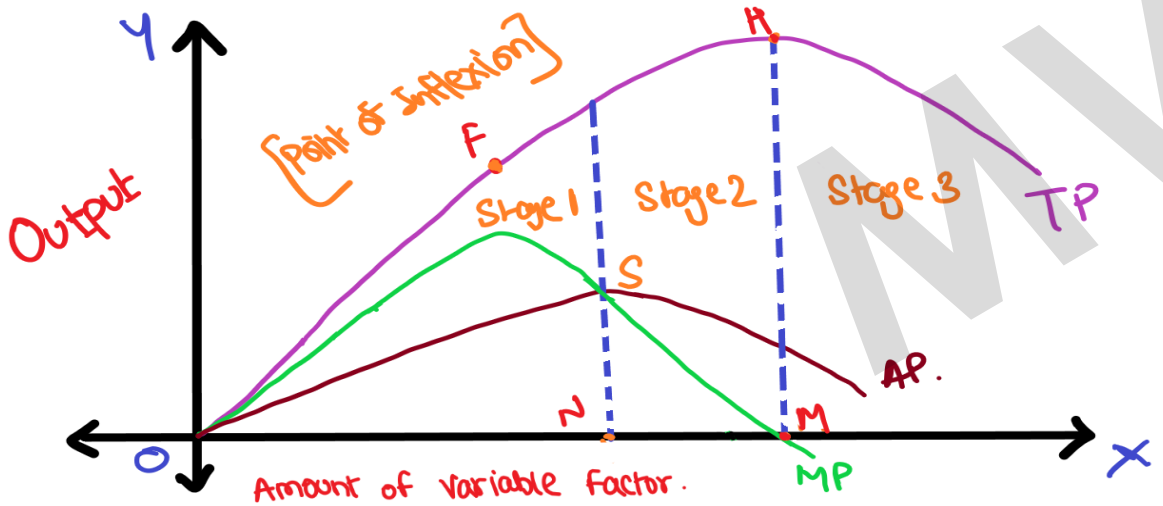
TP vs AP vs MP

Total Product (TP) : **Total output** resulting from using all inputs together.

Average Product (AP) = TP / No. of Units of Variable Factor

Marginal Product (MP): **Change in TP** per **unit change in quantity of variable factor**.

MP = ΔTP / ΔQ
or MP = TPn – TPn-1



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Relationship between AP & MP

- When AP rises → MP > AP
- When AP is maximum → MP = AP
- When AP falls → MP < AP

17

Stage of Operation

- Never produce in Stage 1 & 3 are → '**economic absurdity**' or '**economic non-sense**'
- **Rational producer→ Produce in stage 2**

18

Returns to Scale (applies in Long Run)
Change in scale → **all factors of production** are **increased** or **decreased** in **same proportion**.

19

When **ALL inputs are increased**, a firm initially realizes-

I. **Increasing Returns to Scale (IRS)**
% Increase in Output **>** % Increase in Input
then,
II. **Constant Returns to Scale (CRS)**
% Increase in Output **=** % Increase in Input
It is also referred to as "**Linear Homogeneous Production Function**"
then,
III. **Decreasing Returns to Scale (DRS)**
% Increase in Output **<** % Increase in Input

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ECONOMICS CHAPTER 3 – UNIT 1 – THEORY OF PRODUCTION

20

Cobb-Douglas Production Function

Applies not to individual firm but to **whole of manufacturing industry.**

Labour contributed about **3/4th** and **capital** about **1/4th** of **increase** in **production**

Earlier formula…… $Q = K. L^a. C^{(1-a)}$

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

If, a + b > 1 …… IRS

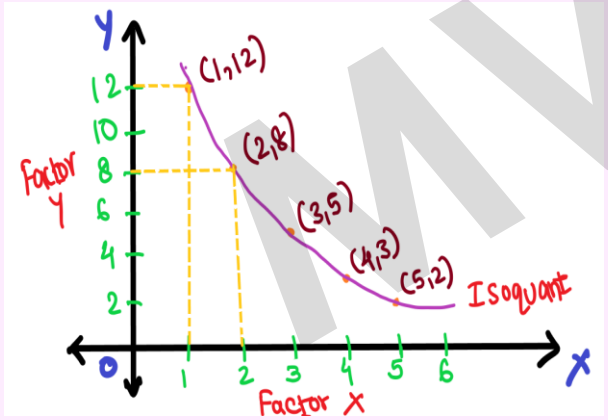
a + b = 1 …… CRS

a + b < 1 …… DRS

21

Isoquants

It represents **all those combinations** of **inputs** which can **produce** the **same level of output**.



Aka.- equal-product curves, production indifference curves or iso-product curves.

MRTS- Marginal Rate of Technical Substitution→ **Absolute value of Slope of Isoquant**

22

Properties of Isoquants

a) **Negatively sloped**, **(Slope of Isoquant = MRTS)**
b) **Convex to origin** due to diminishing MRTS
c) Curve on **right** represents a **higher level of output**,
d) **non-intersecting**.

23

IMP difference between isoquant & IC-

- Isoquant – **qty of production** can be **quantified**
- In IC- **not possible to quantify satisfaction**

24

Isocost

- **Isocost line**, aka. **Equal-Cost Line** or **budget line** or **budget constraint line**,
- It is **downward sloping straight line**→ shows various alternative **combinations of two factors** which **firm can buy with given outlay (same exp amt)**.
- **Slope of Isocost = w / r** (Slope will be negative & constant)

25

Producer Equilibrium

It will be achieved where **isocost line is TANGENT to isoquant** (at point C)

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ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

1	**Cost Concepts** **1) Accounting Costs & Economic Costs** ✓ **Accounting (Explicit or Outlay) costs→** expenses which will **have to be incurred** by firm & are **recorded in financial statements**. ✓ **Implicit Cost** is **cost of using self-owned factors.** (not recorded in BOA) ✓ **Economic Cost = Explicit + Implicit Cost**
1.1	**2) Outlay costs & Opportunity costs** ✓ **Outlay costs** involve **actual expenditure** ✓ **Opportunity cost** is **cost of next best alternative opportunity which was foregone** to pursue certain action.
1.2	**3) Traceable (Direct) costs & Non-Traceable (Indirect) costs** ✓ **Direct costs→readily identified** & **traceable** to **product** ✓ **Indirect costs→ not easily** & **definitely identifiable**
1.3	**4) Incremental costs & Sunk costs** ✓ **Incremental cost→ additional cost** incurred **as a result of a business decision** ✓ **Sunk Costs→** costs which are **already incurred once & for all** & **cannot be recovered**. ✓ Eg- advertising, R&D etc.
1.4	**5) Historical costs & Replacement costs** ✓ **Historical cost→ cost incurred in past** on **acquisition of an asset** ✓ **Replacement cost→** exp. that has to **be incurred for replacing an old asset**
1.5	**6) Fixed Costs & Variable costs** **a) Fixed** or **constant** or **supplementary costs→** do **not** vary with output. (function of **capacity**) ❑ Eg- rent, property taxes, interest on loans etc ❑ If **firm shuts down** for short period→ fixed cost **CANNOT be avoided (inescapable)** **b) Variable Costs (VC)→** costs which **vary with level of output** (function of **output**) ❑ If a **firm shuts down** for a short period, then VC **can be avoided** ❑ **Eg- wages**, **price of raw material**, **fuel**, **transportation** cost etc
1.6	**Shut down costs→** costs which will **continue even after operations are suspended**. Eg- storing old machines.
1.7	**7) Semi – Variable Cost** Costs which are **neither perfectly variable**, **nor absolutely fixed.**

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ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

1.8

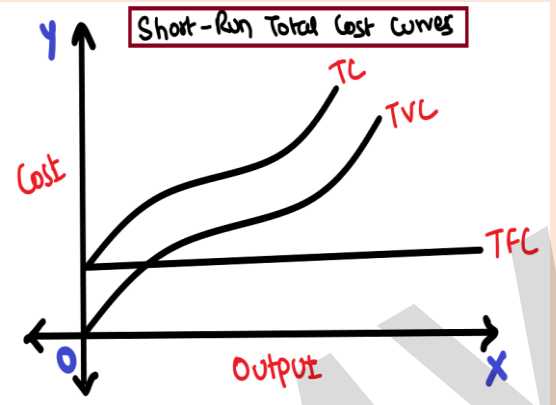
9) Stair-Step Variable Cost

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

2

Short Run Total Costs

- **TC = TFC + TVC**



Total Fixed Cost curve (TFC)

- **horizontal** straight line parallel to **X-axis**
- Starts from a point on the **Y-axis**

Total Variable Cost (TVC)

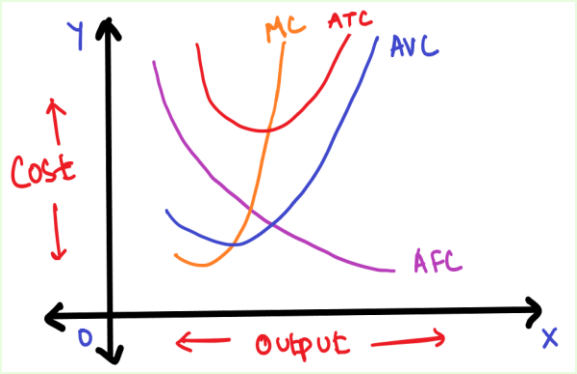
- Initially **increases at a decreasing rate** and then at an **increasing rate**. (**Inverted-S** shaped)

Total Cost Curve (TC)

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

3

Short Run Average Costs



Average Fixed Cost curve (AFC)

- **AFC = TFC / Q**
- AFC is **fixed cost per unit of output**.
- AFC **falls** as **output increases**.
- Shape- **rectangular hyperbola**
- AFC **never touch the X-axis** as AFC **cannot be zero**.

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 or SAC)

- **ATC = TC / Q or ATC = AFC + AVC**
- ATC curve is **U-shaped**
- **SAC** Curve is aka. **PLANT Curve**

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ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

4

Marginal Cost Curve (MC)

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

MC = Δ in TC / Δ in Output

Or

MC = Δ in TVC / Δ in Output

- MC is **independent of fixed cost.**
- Value of MC comes **due to changes in variable costs.**
- MC curve is **"U" shaped**
- MC Curve **intersects AC & AVC** curve at their respective **minimas (minimum points)..**

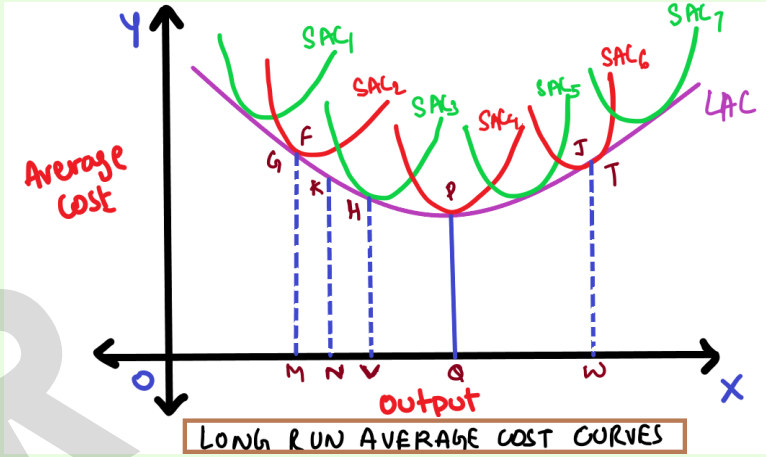
MC & AC	MC & AVC
AC falls → MC < AC	AVC falls → MC < AVC
AC rises → MC > AC	AVC rises → MC > AVC
AC min. → MC = AC	AVC min. → MC = AVC

5

Long Run Average Cost (LAC) Curve

- A firm **plans for long run** & **operates in short run.**
- In long run→ can **build any size or scale of plant** & **move from one plant to another.**
- Long run is **planning horizon**.

6



LONG RUN AVERAGE COST CURVES

- LAC Curve→ aka. **Planning** or **Envelope** or **Boat Curve**
- **It is tangent to each of SAC curves**
- When **LAC is declining**→ tangent to **falling portions of SAC**
- When **LAC is rising**→ tangent to **rising portions of SAC**
- **"OQ" is optimum output** → LAC is at minimum (here production is done at **FULL CAPACITY**)
- **Falling portion (negatively sloped)** of **LAC-** due to **IRS** or **Economies of Scale**
- **Rising portion (positively sloped)** of **LAC-** due to **DRS** or **Diseconomies of Scale**

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ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

4

SCALE OF PRODUCTION

Economies of scale → **Decrease in Avg cost** due to increase in production.

Internal Economies

They accrue to firm when it **expands its output** → arise due to **endogenous (internal) factors**

Internal Economies & Diseconomies

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

External Economies

They are **benefits** accruing **to each member firm** of industry as a result of **expansion** of **industry**.

External Economies & 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

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CA Foundation – Business Economics

Last Minute Notes

(Only Important Points)

Economics Chapter 4

Price Determination In Different Markets

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ECONOMICS CHAPTER 4 – UNIT 1 – MEANING AND TYPES OF MARKETS

1

From where does the concept of price arises ?

Free Goods - Goods are free or **have zero prices**, **abundant in supply** & **do not have scarcity**. Example: air, sunlight etc

Economic Goods – Scarce in relation to their demand & have **opportunity cost→ exchangeable in market** & command a **price.**

2

Value in exchange or **exchange value** (given by **Ricardo)→ amount of G/S** which we may obtained in market **in exchange** of money.

In Economics, we are **only concerned with exchange value**.

3

Meaning of Market

Market→ **collection of buyers & sellers** with **potential to trade**.

Market **need not be formal** or held in a particular place.

Elements of Markets

1) Buyers & **sellers**;
2) Product or service;
3) Bargaining for a price;
4) Knowledge about market conditions;
5) One price for G/S at a given time.

4

Classification of Markets

I) General Classification

a) **Factor Market –** Where **firms buy the inputs** to **produce G/S.**

b) **Product Markets –** Where **households buy G/S they want from firms.**

4.1

II) Geographical Area Classification

a) **Local Market – Limited** to a **local area**. **Highly perishable goods bulky articles**.

b) **Regional Market –** Cover **wider area** like **few adjacent cities** or **states**.

c) **National Markets - Demand** is **limited to national boundaries of country.** Eg- **Hindi books**

d) **International Markets – High value** & **small bulk goods**. Eg- **Gold** & **Silver**.

4.2

III) Regulation

a) **Regulated Market –** Transactions are **statutorily regulated**. Eg. Stock exchange

b) **Unregulated Market –** Aka. free market - **no stipulations on transactions**.

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ECONOMICS CHAPTER 4 – UNIT 1 – MEANING AND TYPES OF MARKETS

4.3	**IV) Time (Given by Alfred Marshall)** **a) Very Short Period Market –** Aka. **Market period –** here **supply is fixed.** Price is dependent on **demand.** **b) Short Period Market –** Here, **supply** can be **moderately adjusted.** **c) Long-period Market - All factors** become **variable** & **supply** can be **fully adjusted.** Here price is called '**normal price**'. **d) Very long-period Market –** Aka. **secular** period
4.4	**V) Nature of Transaction** **a) Spot / cash Market** **b) Forward or Future Market**
4.5	**VI) Volume of Business** **a) Wholesale Market-** Goods sold in **bulk or large quantities**. Transactions **between traders** **b) Retail Market-** Goods sold in **small qty**. Market for **ultimate consumers**.

5	**Concepts Of TR, AR & MR** **I) Total Revenue (TR)** **Amount** of money which a **firm realises by selling a commodity. [TR = P x Q]** **II) Average Revenue (AR)** AR is **revenue earned per unit of output.** **AR = Price = TR / Q** Also, **AR curve = Demand Curve** of firm **III) Marginal Revenue (MR)** MR is **change in TR resulting from sale of an additional unit of commodity.** (MR is slope of TR) **MR = ΔTR / ΔQ or MRn = TR n – TR n-1** **or MR = dTR / dQ**
6	**AR = Price** → Happens in ALL types of market **AR = Price = MR** → ONLY in Perfect Comp.
7	**Concepts of TR, AR & MR in Imperfect & Perfect Competition** For **falling AR (in Imperfect Competition)** ❑AR curve slopes **downward** ❑**MR < AR** → MR declines more rapidly than AR → bcoz any reduction in price applies to **all** units sold. ❑TR→ Inverted U shaped ❑When MR = 0, then TR is maximum

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ECONOMICS CHAPTER 4 – UNIT 1 – MEANING AND TYPES OF MARKETS

8

For **constant AR (in Perfect Competition)**

- **MR = AR = Price**
- AR Curve = Demand Curve = MR Curve → **Horizontal straight line** parallel to X axis → **Perfectly elastic** demand (Ep = ∞)
- TR → **upward sloping straight line**

9

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

$$MR = AR \times \frac{e - 1}{e}$$

Ignore –ve sign in "e" while using above formula

Value of e	MR
e = 1	MR = 0
e > 1	MR → positive
e < 1	MR → negative

10

Behavioural Principles

Principle 1

- A firm should **not produce** at all if its **total variable costs** are **not met (TR ≤ TVC)**
- **At shut down point** :
  - Price is equal to AVC
  - TR = TVC
  - Total loss = TFC

Principle 2

A firm will **maximum profits** (or minimize losses) at **MR = MC**

CHAPTER 4 – UNIT 2 – DETERMINATION OF PRICES

1

	Situation	Effect	
1.	**Mkt Price > Equi Price** i.e., Qty Sup. > Qty Dem. (Surplus)	Downward Pressure on Price	Qs decreases & Qd increases Upto Equilibrium
2.	**Mkt Price < Equi Price** i.e., Qty Sup < Qty Dem (Shortage)	Upward Pressure on Price	Qs increases & Qd decreases Upto Equilibrium

2

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

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ECONOMICS CHAPTER 4 – UNIT 2 – DETERMINATION OF PRICES

3	➢ When **both demand & supply increase**, but no other data given→ then **EQ increases**, but effect on **EP cannot be determined** ➢ Similarly, when **both demand & supply decrease**, but no other data given→ then **EQ decrases**, but effect on **EP cannot be determined**
4	➢ When **demand increases** & **supply decreases**→ **EP rises** but effect on **EQ cannot be determined** ➢ When **demand decreases** & **supply increases**→ **EP falls** but effect on **EQ cannot be determined**

CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

1	**Features / Characteristics of Perfect Competition** **1) Large number of buyers and sellers –** ➢ Share of **each seller** & **buyer** in market → is too small - **unable to influence price, demand or supply** **2) Homogenous or Identical Products –** ➢ **Perfect substitutes** ➢ **Buyers have no preference between different sellers** **3) Free Entry & Exit - No legal or market related barriers**
	Above 3 characteristics are conditions for **pure competition**
	4) Perfect knowledge of market condition – ➢ Both **buyers & sellers have all information** **5) Very low transaction costs –** ➢ **No advertisement** required. **6) All firms individually are price takers –** ➢ Firms & buyers **have to accept price determined by market forces** ➢ There is **perfect knowledge** and **perfect mobility** of resources
2	➢ Perfect comp is a **myth**. ➢ Eg- **agricultural products**, financial instruments (**stock**, bonds, **foreign exchange**), precious metals (gold, silver, platinum)

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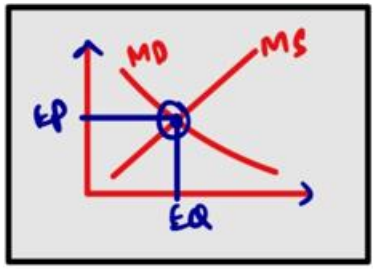
CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

Equilibrium Perfect Competition

PC Industry

Short Run

Market Demand = Market Supply



Long Run

3 Conditions

1) All Firms are at equilibrium (maximum Profit)

2) No incentive for firms to enter or exit, Since all firms earning just normal profits

3) Price - MD = MS

PC Firm

Short Run

2 Conditions

1) MR = MC

2) MC Curve should cut MR from below MC → +ve Slope

Above conditions are same for Monopoly & Monopolistic Comp.

A PC firm can in short run-
- ❑Normal Profit→ AR=AC or
- ❑Super Normal Profit → AR > AC or
- ❑Losses → AR < AC

Long Run

When firm has adjusted plant, to produce at min. point of Lac curve

Which is tangent to Demand Curve (AR)

AR = LMC = SAC = SMC = MR = Price

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CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

3

- **Firm is in equilibrium → maximizes its profit.**
- PC Firms are **price-takers**. They **have to accept price determined by market forces.**
- Demand curve of each PC firm is **perfectly (or infinitely) elastic**
- In PC firm, **MC curve above AVC** has identical shape of firm's **supply curve.**

4

- In PC (long run)→ market mechanism leads to **optimal allocation of resources** which is shown by-
- ✓Consumers pay minimum possible price→ just covers MC i.e. **MC = AR → Productive Efficiency**
- ✓Plants are used to full capacity → no wastage of resources i.e. **MC = AC → Allocative Efficiency**

5

Monopoly

'Monopoly' = "**alone to sell**"→ **single seller**.

Pure monopoly is **never found in practice**.

Natural monopoly arises when there are **very large economies of scale**.

6

Features of Monopoly

1) **Single seller - No distinction between firm and industry** (absence of competition)

2) Barriers to Entry - Strong barriers to entry

7

3) Market power –

- Ability to charge a **price above MC & earn a positive profit (AR > MC)→ Allocative Inefficiency**
- Due to above reason, **supply curve of monopoly** is **indeterminate.**

4) No close substitutes –

- **Extreme** Product Differentiation
- **Cross elasticity** of demand **= zero or very small.**
- **Price elasticity** of demand = **less than 1.**
- **Steep downward sloping demand curve.**

8

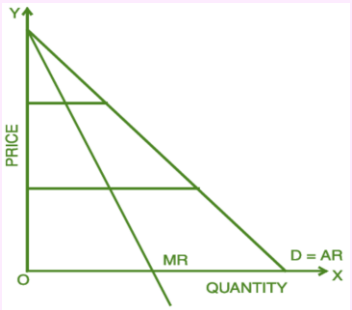
Monopolist's Revenue Curves

❑AR & MR **both** are downward sloping curves.

❑**Slope of MR = 2 x Slope of AR**

MR curve lies half-way between **AR curve & Y axis**. i.e. it **cuts** horizontal line between Y axis & AR into **two equal parts.**

❑**AR cannot be zero**, but **MR** can be **zero or even negative**.



9

Monopolies are mainly of two types

Simple monopoly

Monopolist charges **uniform price** from all buyers

Discriminating monopoly

Monopolist **charges different prices** from **different buyers** of same g/s

CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

10

Can a monopolist incur losses in short run?
YES, if **AR < AC**

Should firm shutdown ?
It depends,
If **AR < AVC** , then shutdown or else continue

11

Equilibrium of Monopoly in Long Run

- In **absence of competition**, monopolist **need not produce at optimal level**. He **need not reach minimum of LAC** curve.
- **Monopolist will not continue** if he makes **losses in long run.**
- He will **continue** to make **super normal profits** even in **long run** → due to **blocked entry**.

12

Price Discrimination

- It occurs when a **producer sells** a G/S to **different buyers** at **two or more different prices** for **reasons not associated with differences in cost**.
- Adopted by **monopolist** → **to earn abnormal profits**.
- Price discrimination **cannot happen under PC**

13

Conditions for Price Discrimination

1) **Seller** should have **some control over supply**
2) Seller should be **able to divide his market** into **two or more sub-markets**.
3) **Price-elasticity** of product should be **different in different sub-markets**.
4) **Not possible** for **buyers of low-priced market** to **resell** to **buyers of high-priced** market **(no market arbitrage)**

14

Degrees Price Discrimination by Prof. AC Pigou

First Degree (Customer Wise)	Extract entire consumer surplus)
Second Degree (Quantity wise)	**There are two possibilities here:** 1) Larger quantities available at lower unit price. 2) Each consumer pays **different price for consecutive purchases**.
Third Degree (Attribute wise)	**Divide consumers into separate sub-markets** & charge **different prices in different sub-markets**.

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CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

15

Monopolistic Competition

- Large no. of sellers selling differentiated (similar but not identical) products → to attract customers on some basis other than price.
- Eg- soaps, detergent, toothpaste etc
- Contains some features of both markets– monopoly & perfect comp.

16

Features of Monopolistic Competition

1	Large no. of sellers	Each seller small share in mkt
2	Product differentiation	Differentiated on basis of brands→ close substitutes→ price elasticity of demand elastic (e>1).
3	Freedom of entry and exit	Free to enter or exit market
4	Non-price competition	Avoid price wars

17

Equilibrium of Monopolistic Comp Firm in Long Run

- In long run → all monopolistic comp. firms → earn only normal profits.
- At equi.
  - ✓ do not produce at min point of LAC
  - ✓ but at falling portion of LAC curve→ leading to excess capacity.

18

PC	Monopolistic Comp.	Monopoly
Price is lowest	Price is high compared to PC	Highest equilibrium price
Eq Qty is highest	Eq Qty less than PC	Eq Qty is lowest

19

Features / Characteristics of Oligopoly

- ❑ Strategic Interdependence,
- ❑ Importance of advertising and selling costs,
- ❑ Group Behaviour

20

Types of Oligopoly

1) **Pure or perfect oligopoly**→ product is **homogeneous** in nature, e.g. Aluminium industry.
It tends to **process raw materials** that **used as inputs by other industries**.

Differentiated or imperfect oligopoly→ goods are **differentiated**→ e.g. Talcum powder.

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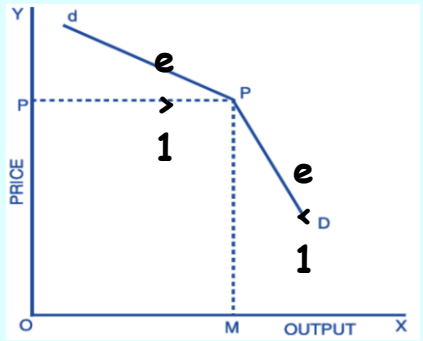
CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

20.1	**Open oligopoly** → **new firms can enter** market In **closed oligopoly** **entry is restricted**.
20.2	**Collusive oligopoly**→ When few firms **act in collusion** → **fixing price or output or both**. **Competitive oligopoly**→ When there is **absence of such an understanding**.
20.3	**Partial Oligopoly**→ when **industry is dominated by one large firm** (price leader) **Full oligopoly**→ **Absence of price leadership**.
20.4	**Syndicated oligopoly**→ Firms **sell** products through **centralized syndicate**. **Organized oligopoly** → Firms organize themselves into a **central association** for **fixing prices, output, quotas**, etc.
21	**Oligopoly Models** a) **Cournot model** → **firms' control variable** is **output**. They do **not collude**. b) **Bertrand model**, **price** is **control variable** c) **Stackelberg's model** **leader commits** to an output → rest of firms are **followers**
22	Oligopoly cartel→ Eg- **OPEC**

23	**Kinked Demand Curve** ➢ Demand curve of oligopoly is **INDETERMINATE** ➢ But **Paul A. Sweezy**, **gave concept of kinked demand curve** (based on many assumptions). ➢ **Price rigidity (**sticky**) & Qty rigidity** under oligopoly is explained by **Sweezy's Model** ➢ Kinked demand curve has '**kink**' at **level of prevailing price**. ❑ Demand curve **above prevailing price is elastic** (when a firm raises price, competitors **do not follow**) ❑ Demand curve **below prevailing price** level is **inelastic**. (when a firm decreases price, competitors **will follow**)
24	**Other Forms of Market**



Duopoly	Oligopoly of **only two firms**.
Oligopsony	Only **few buyers**.
Monopsony	**Single buyer** of G/S
Bilateral monopoly	**Combination** of **monopoly** & **monopsony** market

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Last Minute Notes

(Only Important Points)

Economics Chapter 5

Business Cycles

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CHAPTER 5 – BUSINESS CYCLES

1 The **rhythmic fluctuations** in **aggregate economic activity** over a **period of time→** business cycles or trade cycles. (How Real GDP changes wrt. time)

2 **Good trade→ rising prices** & **low unemployment**
Bad trade→ falling prices & **high unemployment**

3
- **Phases of Business Cycles-** Expansion, Peak, Contraction, Trough
- Peak & Trough→ called **Turning Points**

4 **I) Expansion (Boom) Stage**

Increase in national output (production of G/S)
- **Increase in employment;**
- **Involuntary unempl.** is almost **zero**

Increase in income

Increase in agg. Demand (demand for **all** types of G/S **rises)**

Increase in capital & consumer exp.

Increase in sales, profits, rising stock prices & bank credit

5 **In later stages of expansion→ increased cost of living** & greater strain on **fixed income earners**.
Consumers begin to **review their consumption expenditure** on durable goods.

8 **II) Peak (Prosperity) Stage**
Actual **demand stagnates**.
Top or **highest point** of business cycle.

9 **Contraction (Downswing or Recession)**
- **Producers do not instantaneously recognize pulse** of economy (that contraction is coming) & **keep anticipating high level of demand→** Leading to **Supply > Demand**.
- Later, producers cancel **future investment** plans & **orders of inputs** incl. **labour**.
- Decline of agg. economic activity **over a period of time** is **RECESSION**

Decrease in input demand pulls **input prices down**

Decrease in **employment**; Leads to **decr.** in **income**

Producers **lower their prices** to **dispose off inventories**

Consumers, **expect further decreases in prices** and **postpone** their purchases

Aggregate demand further falls, & gap between **demand** & **supply** gets further **widened** and **recession** becomes severe

Business firms become **pessimistic** about future and **Investments**, **prodn** and **emp.** further **decline**

Bank credit decreases

Investor confidence is at its **lowest** & **stock prices fall**

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CHAPTER 5 – BUSINESS CYCLES

10 **Trough (aka Depression)**
- **Growth rate becomes negative→ national income & exp. declines** rapidly.
- **Prices are lowest** - forcing some firms to **shutdown**.
- **Mounting unemployment**.
- Typical feature **fall in interest rate→** people hold **more liquid money**
- May Lead to **possible banking or financial crisis**.
- Large number of **bankruptcies & liquidation.**

11 **Recovery**
- Process of **reversal** is **initially felt in labour market**. Pervasive unemployment **forces workers to accept lower wages**.
- **Spurring of investment** causes **recovery** of economy.

12 **Indicators**
Economists use **changes in a variety of activities** to **measure** business cycle & **predict** where economy is headed towards.

13 **Leading Indicators**
Changes **before** economy starts to follow a particular pattern.
Eg- **Changes in Stock Price**, **new orders** for goods, **building permits for private houses**, delayed deliveries

14 **Lagging Indicators**
Reflect historical performance & these indicators change only **after** economic **trend** has already occurred.
Eg- **unemployment**, **corporate profits**, **labour cost per unit**, interest rates, **prime rate**, **consumer price index**, commercial lending activity

15 **Coincidental / Concurrent Indicators**
They **coincide or occur simultaneously** with business-cycle movements→ describe **current state**.
Eg- **GDP**, **industrial production**, **inflation**, personal income, retail **sales**

16 **Features Of Business Cycles**
a) Occur periodically, but **do not exhibit same regularity→ duration** & **intensity varies**.
b) Phases **seldom display smoothness & regularity**.
c) Originate in **free market economies**.
d) Capital & **durable consumer** goods industries are **disproportionately affected**. **Industrial sector is more prone** compared to agri. sector
e) Complex phenomena→ do **not** have uniform characteristics & causes.

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CHAPTER 5 – BUSINESS CYCLES

f) **Repercussions** get **simultaneously** felt on **all economic variables**
g) **Contagious** & **international**.
h) Have **serious consequences** on **well-being** of society.

17 **Causes of Business Cycles**

Internal or Endogenous Causes	External or Exogenous Causes
Fluctuations in Effective Demand	Wars
Fluctuations in Investment	Post War Reconstruction
Variations in govt spending	Technology shocks
Macroeconomic policies	Natural Factors
Money Supply	Population growth
Psychological factors	

18

Name	Cause of Business Cycle
Keynes	Fluctuations in **aggregate effective demand** (& investments)
Pigou	Anticipations → **optimism or pessimism**
Schumpeter	**Innovation** theory.
Nicholas Kaldor	**Cobweb** theory
Hawtrey	**Monetary** phenomenon→ changes in **supply of money**

19 **Cyclical Business**
Businesses whose **fortune** is **linked to rate of economic growth**
Eg- **fashion retailers**, **electrical goods (white goods)**, **house-builders**, **restaurants**, etc.

20 **Demand-Pull Inflation**
Inflation when→ **demand** is **more than supply**

21 **Examples of Business Cycles**
1) Great Depression of 1930
2) Information Technology bubble burst of 2000 (Aka. Dot.Com bubble)
3) Global Economic Crisis (2008-09) (Aka. sub-prime crisis)

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CA Foundation – Business Economics

Macro Economics (Chp 6 to 10)

Last Minute Notes

(Only Important Points)

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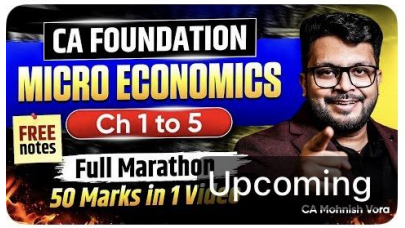

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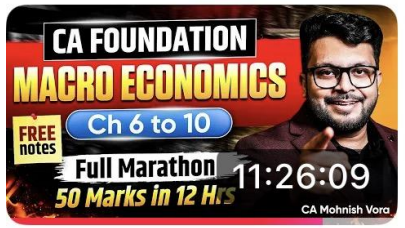

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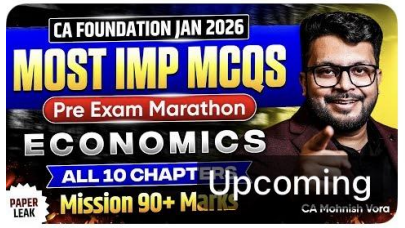

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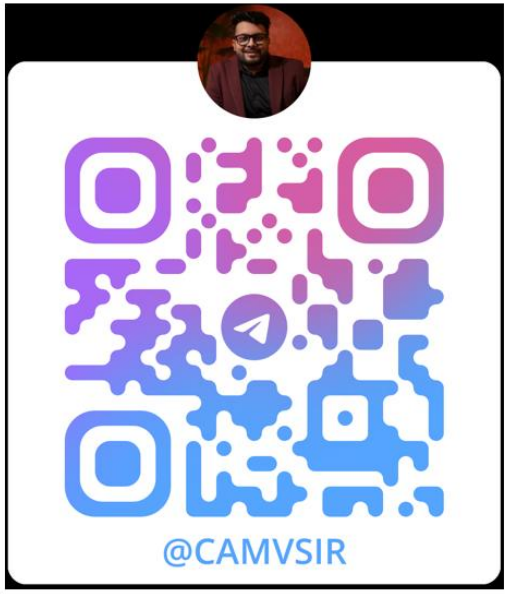

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INDEX

Chapter No.	Chapter Name	Pages
6	National Income	6.1 – 6.11
7	Public Finance	7.1 – 7.22
8	Money Market	8.1 – 8.9
9	International Trade	9.1 – 9.15
10	Indian Economy	10.1 – 10.7
	Total	**64 Pages**

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Last Minute Notes

(Only Important Points)

Economics Chapter 6

National Income

By CA Mohnish Vora (MVSIR)

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CHAPTER 6 – NATIONAL INCOME | UNIT 1

1

Gross domestic product (GDP) is-
- **monetary value** of
- all **final**
- **economic** G/S,
- **gross of depreciation**,
- **produced**
- **within domestic territory**
- during a given **time period**.

2

Final Goods

Goods **used either** for **consumption** or **investment**.
Neither **resold** nor undergo **further transformation**.
Only final goods is considered in GDP, to **avoid double counting.**

3

Intermediate goods
- Used either for-
  - **resale** or
  - for **further production in same year**.

They **do not end up in final consumption**, and are **not capital goods** either.

- They have **derived demand**.
- If they remain for more than one year→ treated as **final goods**.

4

NI & GDP is a **'flow' measure of output per time period** & **includes only those G/S produced in current period**

5

Exclusions from GDP
- **Transfer Payments - Making a payment**, **without G/S** being **received in return.**
- **Financial transactions -Stocks & bonds exchanged during the period** are **not included**.

However, value of services that accompany sale & purchase (e.g. brokerage) is included.
- **Sale of 2nd Hand goods**
- **Non-reported output - illegal transactions.** Eg - narcotics & gambling

6

Nominal GDP (aka. GDP at current year price)
- CY output (x) CY Prices
- **Nominal GDP changes** for **two reasons.**
  1) **Qty of G/S** produced changes, &
  2) When **market prices change**.

7

Real GDP (aka. GDP at constant price)
- CY Output (x) BY Price
- It is **inflation adjusted** GDP
- It **changes only when** there is **change in Qty prod.**
- **Not affected by changes in prices**
- Real GDP- **better measure** of **economic well being**

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CHAPTER 6 – NATIONAL INCOME | UNIT 1

8	GDP Deflator = $\frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$
8.1	Inflation rate in Yr 2 = $\frac{\text{GDP deflator in Yr 2 - GDP deflator in Yr 1}}{\text{GDP Deflator in Yr 1}} \times 100$
9	**Domestic Vs National** '**National**' → **normal residents** within or outside domestic territory → **broader concept** compared to '**domestic**'. '**Domestic**' → production done **WITHIN domestic territory**
10	**Resident Unit**- Unit having **predominant (major) economic interest** in economic territory of country for **1 year or more irrespective of nationality** or legal status
11	**Net Factor Income From Abroad**= **Factor Income from abroad (-) Factor Income to Abroad**
12	**Operating Surplus** = **Rent + Interest + Profit → (R,I,P)**
13	**Mixed Income of Self Employed** Difficult to separate **labour income from capital income** when **people provide both labour and capital services**.
14	**Net Domestic Product at Factor Cost (NDP FC)** **(AKA - Domestic Income or Factor Income earned in Domestic Territory) =** Compensation of employees (+) Operating Surplus (R,I,P) (+) Mixed Income of Self- employed
15	**National Income (NNPFC) = NDPFC + NFIA**
16	As per CSO → '**National income** is **sum total of factor incomes** generated by **normal residents** of a country like **wages, rent, interest & profit** in an **accounting year**'.
17	**3 Golden Rules of NI** **1) Gross – Depreciation = Net** **2) MP = FC + IDT - Subsidy** **or** **MP = FC + NIT** **3) Domestic + NFIA = National**

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CHAPTER 6 – NATIONAL INCOME | UNIT 1

18	**GDP Per Capita** ➢ Measure of country's **economic output per person**. ➢ **Indicator** of the **standard of living** of a country. ➢ **GDP Per Capita = Real GDP / Total Population**
19	**Indirect Taxes and Subsidies** **1) Production Taxes & Production Subsidies** **Independent** of volume (qty) of actual production **2) Product Taxes & Product Subsidies** Paid or received **on per unit of product**
20	**Basic Price= FC + Production Tax – Production Subsidy** **Market Price= BP + Product Tax – Product Subsidy**
21	**Personal Income (PI)** **Income received** by **household sector** including **Non-Profit Institutions Serving Households** from all sources PI = National Income + income recd but not earned - income earned but not received
22	**Disposable Personal Income (DI)** It is a measure of **amount of money in hands of individuals** → **available for consumption or savings**. **DI = Personal Income – PI Tax – Non Tax Payment**
23	➢ **Income from domestic product (NDPfc) accruing to public sector (Govt Income)** **= Income from P/E accruing to govt admin dep** **+ Savings of Non dep enterprises** ➢ **Income from domestic product (NDPfc) accruing to private sector** **= NDPfc (-) Govt Income**
24	**Private Income** A measure of income (**both factor & transfer income**) which **accrues to private sector** from **all sources within & outside** the country. **Private Income** **=** Income from domestic product accruing to private sector + Net factor income from abroad + National debt interest + Current transfers from government & rest of world
25	**Net National Disposable Income (NNDI)-** The amount of G/S domestic **economy** has at its disposal. ➢ **NNDI** = NNPfc + Net IDT + Net Current Trf. from rest of world ➢ **GNDI** = NNDI + Depreciation (**Ignore** "**Govt transfer pay**" in GNDI/NNDI **)**

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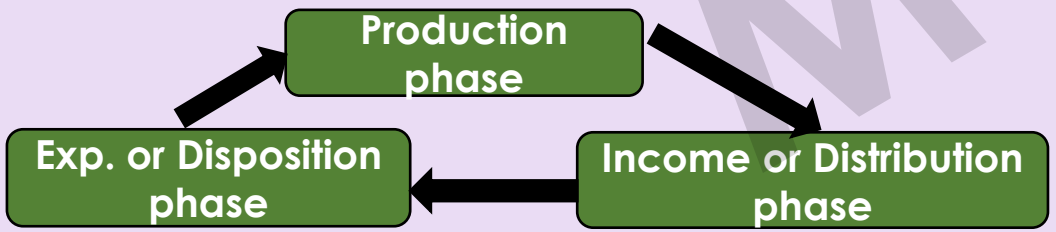
CHAPTER 6 – NATIONAL INCOME | UNIT 1

Particulars	Includes	Remarks
National Income	Earned Income recd. or not recd.	All sectors
Personal Income	Earned Income recd. & Transfer Income recd.	Household sector including NPISH
Private Income	Earned Income recd. or not recd. & Transfer Income recd. or not recd.	Private Sector

26

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-



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Method	Data Required	What is measured?
Value Added or Product 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 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

27

Value Added Method

Value of Output
(-) Intermediate Cons. (of all sectors: PS, SS, TS)
= **GVA mp** or **GDP mp**

CHAPTER 6 – NATIONAL INCOME | UNIT 1

28

- **GVAmp (-) Dep (+) NFIA (-) NIT = NNPfc (NI)**
- If Value of Output is **not given, then**

Value of Output
= Sales + Change in Stock
Where, **Change in Stock** = Cl Stock (-) Op Stock

29

If Value of Output is not given separately
Value of Output = Sales + Change in Stock
Where,
Change in Stock = Cl. Stock – Op. Stock

30

Income Method
Compensation of Employees
+ Operating Surplus (R, I, P)
+ Mixed Income of Self-Emp
= NDP fc
+ NFIA
= **NNP fc (National Income)**

O.E. **includes** - wages and sal., bonus, D.A., commission, **employers' contri.** to PF and imputed value of pay in kind.

Profit = Corp. taxes + Dividend + Undistributed Profits

31

Expenditure Method
GDP mp = PFCE + GDCF + GFCE + (X-M)

- GDCF includes-
  - Gross Domestic Fixed Capital Formation, i.e Invt in Fixed Assets by household, Pvt Business, Govt
  - Changes in Inventory OR Inventory Investment
  - Net Acquisition of Valuables
- GDCF – Dep = NDCF

32

Who is responsible for calculating National Income in India ?

MoSP&I → CSO → National Accounts Division which compiles **National Accounts Statistics (NAS)**

33

Combination of methods used in **India** to measure NI-
- **Value-added method** → commodity producing sectors like agri & mfg.
- **income method** → small scale sector
- **expenditure method** → construction sector

34

Method for measurement of NI in developed economies:
Mostly **Income method**→ sometimes expenditure method also used.

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CHAPTER 6 – NATIONAL INCOME | UNIT 1

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System Of Regional Accounts In India

State Income or Net State Domestic Product (NSDP) → value in **monetary terms** of qty of **all G/S produced** in **state** within a given **period of time** accounted **without duplication**.

Per Capita State Income → NSDP (State Income) divided by **mid-year projected population** of the state.

Prepared by State Income Units of respective State Directorates of Economics and Statistics (DESs). **CSO assists** them.

Certain activities like **railways, communications, banking** etc→ **cut across state boundaries**, & their **contribution cannot be assigned to any one state** → known as the '**Supra-regional sectors**'

30

Can GDP a country be taken as an index of welfare?

No, since GDP measures **exclude** the following-

a) **Income distributions**
b) Quality improvements due to **tech** & **managerial innovations.**
c) **Productions hidden from govt.** (**drugs, gambling etc**.).
d) **Non-market production & Non-economic contributors → health, education levels etc.**
e) **Disutility of loss of leisure time**
f) **Economic 'bads': crime, pollution, traffic congestion etc which make us worse off.**
g) **Volunteer work rendered without remuneration**
h) **Things that contribute to economic welfare- leisure time, fairness, gender equality etc.**
i) **Distinction between production that makes us better off & which prevents us from becoming worse off, for e.g. defence exp → Increased exp on police due to increase in crimes may incr. GDP but these exp only prevent us from becoming worse off.**

31

Limitations And Challenges of NI

Conceptual difficulties

1) **lack** of an **agreed definition** of NI
2) **accurate distinction** between **final** & **intermediate** goods,
3) issue of **transfer payments**,
4) **difficulty** of **incorporating distribution of income**,
5) valuation of a **new good** at **constant prices**,
6) services of **durable goods**,
7) **valuation** of **govt. services**

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CHAPTER 6 – NATIONAL INCOME

	Challenges 1) **Inadequacy of data** & **lack of reliability** of available data, 2) **absence** of **recording of incomes** due to **illiteracy** & ignorance, 3) **lack** of **proper occupational classification** 4) accurate **estimation** of **consumption of fixed capital** 5) production for **self-consumption** 6) presence of **non-monetised sector**,
32	**Usefulness And Significance Of National Income Estimates** 1) **Framework** for analyzing **short-run performance**. 2) Helps **businesses to forecast future demand**. 3) **Economic welfare** depends on **value of national income** 4) **Composition of NI** of **different sectors** & **variations** in them. 5) Provides **quantitative basis** for **assessing & evaluating economic policies** 6) Shows **income distribution** & **inequality in its distribution**. Make **comparisons** using **ratios** of **investment, taxes, to GDP**. 7) Guide to make **policies for growth & inflation**.

CHAPTER 6 | UNIT 2 - Keynesian Theory of National Income

33	➢ In **previous unit, 'ex post' (realized)** values were used **Eg- aggregate consumption (C)** denotes what **people have actually consumed** ➢ In this unit variables are defined in **'ex-ante' (anticipated)** terms or in terms of **what is intended or planned.** ➢ Ex-ante values are used to **predict** what **equilibrium value of output or GDP** is.
34	➢ **Natural level of real GDP→** Level of GDP where **resources are fully employed.** ➢ Before Keynes, **classical economists** said that **economy is self-regulating** & **capable of automatically achieving equilibrium** at '**natural level**' of **real GDP** ➢ But, Keynes said that **markets** do **not automatically** lead to **full-employment equilibrium.** ➢ So, **output will remain at less than full employment level unless** there is **insufficient spending**.

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CHAPTER 6 – NATIONAL INCOME | UNIT 2

35

3 models of economy as per Keynes

1) **Two-sector** = household + business,
2) **Three-sector** = household + business + government,
3) **Four-sector** = household + business + govt. + foreign

36

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.
- In the figure-

❑Circular **broken lines** - factor and product flows- '**real flows**'

❑**Continuous line** with arrows show **money flows**

37

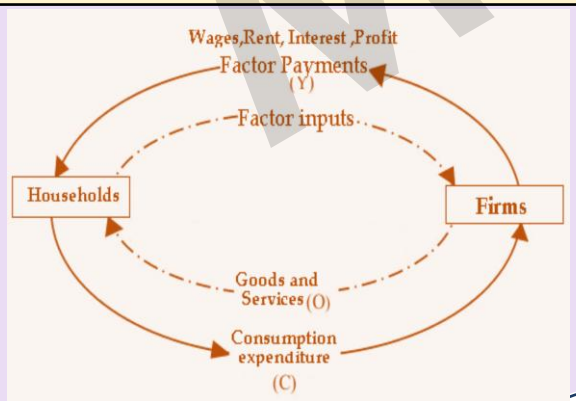
Factor Payments

= Household Income

= Household Expenditure

= Value of Output

= Total Receipts of Firms



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Consumption function → C = a + b.Yd

39

Average Propensity to Consume

APC = C / Y

Consumption is **decreasing function of level of income.** (As income increases, APC decreases)

40

Marginal Propensity to Consume (MPC = "b")

MPC = ΔC / ΔY = b

Keynes **assumes→**

increase in cons. **<** increase in Yd

(b <1). i.e. **0 < b < 1**

MPC is slope of consumption line

41

Saving function → S = -a + (1-b).Yd

42

Marginal Propensity to Save

MPS = ΔS / ΔY = 1- b

MPC + MPS = 1 ; MPS 0 < b < 1

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

43

Average Propensity to Save

APS = S / Y

Saving is **increasing function of level of income.** (As income increases, APC decreases)

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CHAPTER 6 – NATIONAL INCOME | UNIT 2

44

Y	C	S	MPC	MPS	APC	APS
0	50	-50	-	-	∞	-∞
100	125	-25	0.75	0.25	1.25	-0.25
200	200	0	0.75	0.25	1.00	0
300	275	25	0.75	0.25	0.92	0.08
400	350	50	0.75	0.25	0.88	0.12

45

Aggregate Supply (AS)

Ex ante AS→ **total supply of G/S** which firms **plan on selling** during a specific time period.

AS = Agg. Production = Factor Payments = Factor Incomes [National Income→ Y]

46

Aggregate Demand (AD)

Ex-Ante AD is total **planned expenditure** in the economy.

47

Equilibrium output

When **desired amount of output demanded equals amount produced**. (AS = AD)

48

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 I = S

49

Three Sector Model

- Household + Business + Government Sector
- AD = C + I + G

(I & G are constant)

- AS = C + S + T
- Equilibrium is achieved when -

AD = AS or C + I + G = C + S + T or **I + G = S + T**

Govt adds following flows to circular flow :

1) **Taxes**
2) **Transfer payments** & **subsidy payments**
3) **Govt purchases**
   - G/S from business
   - factors of prod from household, and
4) **Govt borrowing in financial markets** to **finance deficits** (if any, when G > T)

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CHAPTER 6 – NATIONAL INCOME | UNIT 2

50

Four Sector Model

- Household + Business + Govt. + Foreign Sector
- AD = C + I + G + (X - M)

(I, G & X constant)

- AS = C + S + T
- Equilibrium is achieved when -

AD = AS or C + I + G + (X – M) = C + S + T or

I + G + X = S + T + M

Foreign sector adds following flows to circular flow :

1) **exports**,
2) **imports and**
3) **net capital inflow (capital inflow - capital outflow)**

If (X > M), then NX is +ve
→ then NI incr.
If (X < M), then NX is -ve
→ then NI decr.

51

Leakage & Injection

- **Leakage-** **Outflow of income** from circular flow model. Leakages are that part of income which is **not used to purchase goods of current year** or what households **withdraws**.
- **Injection-** **Inflow of income to circular flow** → leads to **increase** in volume of income.

52

- **When AS = AD → Leakages = Injections**
  Then national income will be in equilibrium.
- **When AS > AD → Leakages > Injections**
  Stock Surplus or Deficient Demand → inventories will pile up → firms decrease production in future → lead to fall in output & income in future. (NI will fall)
- **When AS < AD → Leakages < Injections**
  Stock Shortage or Excess Demand → unexpected sales would draw down inventories (stock-out) → thus, hiring more workers & expanding production (NI will rise)

53

Deflationary Gap

Deficient Demand means,
Actual AD < Potential AD

Deficient demand → leads to '**deflationary gap**'
Occurs during **contraction**.

Leads to **unplanned inventories pile up** & thus **decrease** production & employment until **under-employment equilibrium** is reached.

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CHAPTER 6 – NATIONAL INCOME | UNIT 2

54	**Inflationary Gap** ➢ **Excess Demand means, Actual AD > Potential AD** ➢ **Excess demand → leads to 'inflationary gap'. Occurs during expansion → leads to demand pull inflation.**
55	**Investment Multiplier** **Investment Multiplier (k) explains how many times equilibrium NI increases** as result of **increase in autonomous investment**. $K = \frac{\Delta Y}{\Delta I}$ **or** $\frac{1}{1 - MPC}$ **or** $\frac{1}{MPS}$
56	**Import → M= M + mY** **Marginal propensity to import → m = Δ M / Δ Y**
57	**The more powerful leakages are - the smaller will be multiplier.** **The leakages are caused due to:** 1. **progressive rates of taxation** 2. **high liquidity preference** 3. **demand** met out of **existing stocks** or **imports** 4. **additional income spent on purchasing existing wealth** 5. **undistributed profits** of companies 6. part of income used for **payment of debts** 7. **scarcity of G/S** despite having high MPC
58	**How to solve numericals of equilibrium NI (Y) & multiplier ?** **Step 1 :** Find Disposable Income (Yd) in terms of Y = Y – T – t.Y + TR **Step 2 :** Input the above value of Yd in consumption function -> C = a + b.Yd **Step 3 :** At equilibrium -> AS = AD -> Thus, Y = C + I + G + (X-M) **Step 4 :** Input value of "C" in above equation & **find Y** (equilibrium NI). **Step 5 :** Find value of **multiplier** as per data given in question & below summary- ➢ **2 Sector -> K = 1 / (1- b)** ➢ **3 Sector** ❑ **If prop. tax (t) is not given -> K = 1 / (1- b)** ❑ **If prop. tax (t) is given -> K = 1 / 1- [b(1-t)]** ➢ **4 Sector** ❑ **If prop. tax (t) is not given -> K = 1 / (1- b + m)** ❑ **If prop. tax (t) is given -> K = 1 / 1- [b(1-t)] + m**

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Last Minute Notes

(Only Important Points)

Economics Chapter 7

Public Finance

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CHAPTER 7 – PUBLIC FINANCE | UNIT 1 – FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

1	**Macroeconomics→ study of economy as a whole.** **3 main macroeconomic goals for any nation-** **economic growth, high levels of employment & stable price levels.**
2	**Adam Smith** was a **bold advocate of free markets** & **minimal governmental activity**. As per him, govt.'s functions are- **national defense, establishing a system of justice, establishment & maintenance of public institutions**
3	**Richard Musgrave**, in his book '**The Theory of Public Finance**' (1959), gave **3 roles of government-** ➢ **Microeconomic functions** ✓ **Allocation Function** - to correct sources of inefficiency ✓ **Redistribution Function** – ensures distribution of wealth & income is fair ➢ **Macroeconomic function** ✓ **Stabilization Function**- Monetary & fiscal policies for macroeconomic stability
4	**Economic efficiency** → where all resources are **allocated in best way possible**, minimizing waste & inefficiency. If a **market** is **left to itself**, it leads to **inefficient & misallocation of society's scarce resources**. Thus, market failures provide for government's allocative function
5	**Allocation instruments which govt. can use to influence resource allocation** 1) Govt may **directly produce** an economic good 2) Govt may **influence private allocation** through- ✓ **Incentives** : Tax concessions, Subsidies ✓ **Disincentives** :Increase in Taxes, Bans 3) Govt may influence allocation through **competition policies. Eg- Competition Act 2002** 4) Govts' **regulatory activities→** licensing, min wages etc. 5) Govt sets **legal & administrative frameworks** 6) any **mixture** of above
6	**Distribution Function-** If **left to market**, **distribution of income** in society is likely to be **skewed** & thus govt. has to **intervene** to **ensure more socially optimal & egalitarian distribution.** ➢ Related to question→ **for whom should an economy produce G/S**. ➢ It also also relates to manner in which **effective demand** is **divided among individuals** of society

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7	**Examples of Redistribution function** 1) Taxation policies- **progressive taxation** of rich & provision of **subsidy to poor** **2) Proceeds from progressive taxes** used for **financing public services** that benefit poor **3) Employment reservations** to protect certain segments **4) Unemployment benefits** & **transfer payments** to deprived sector 5) Families **below poverty line -monetary aid & aid in kind** **6) Regulation** of **mfg. & sale** of certain products to ensure well-being **7) Special schemes** for **backward** & vulnerable sections
8	**Stabilization 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. **Rationale** ➢ A market economy **does not automatically** generate full employment and price stability on its own. ➢ **Recessions**, **inflation** etc.- **prolonged for longer periods** ➢ Becomes complex due to '**contagion effect**' (**increased international interdependence**)→ **instability** get **transmitted** from one country to other.

9	**Deficit budget (Exp > Rev)** - **stimulate** economic activity **Surplus budget (Rev>Exp)**- **slow down** economic activity.
10	**Fiscal federalism-** Given by **Richard Musgrave**, deals with the division of **govt functions & financial relations** among the different levels of govt. As per Musgrave, responsibility of- ➢ central (union/federal) govt → **economic stabilization & income redistribution**, and ➢ state govt → **allocation of resources**
11	India is a federation of **28 states** & **8 union territories**.
12	**Article 246** of Constitution→ demarcates powers of union & state into three lists- **1) Union list**- items where **union parliament** can legislate **2) State list-** items for **state legislative assemblies** **3) Concurrent list-** for **both**. **Conflicting legislation** in concurrent list→ **centre** prevails.
13	**Taxes levied by central (union) government** **income tax** (**other than 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

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CHAPTER 7 – PUBLIC FINANCE | UNIT 1 – FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

16	**Taxes levied by state government** **taxes on agricultural income**, lands & buildings, mineral rights, **electricity**, **vehicles**, **tolls**, professions, land revenue
17	**Property of the union** is **exempt** from **state taxation**, & vice versa. (ek dusre pe tax nahi lagate)
18	**Articles 268 to 281** of constitution→ provisions in respect of **distribution of finances among states**.
19	**Finance Commission (Article 280)-** Responsible for: ➢ evaluating **state of finances** of union & state govt, ➢ **recommending the sharing of taxes** between them ➢ **lay down principles determining distribution** of taxes among states
20	**Vertical Equity** (deciding about **share of all states** in revenue collected by centre)→ **41%** for 2021-26 **Horizontal Equity** (**allocation among states** their share of central revenue). **Criteria for distribution (horizontal equity)-** **(a)Income Distance** **(d)Demographic performance** **(b)Area** **(e)Forest** and **ecology** **(c)Population** (2011) **(f)Tax** & **fiscal efforts**
21	**GST** came on **1 July 2017**- subsumes majority of indirect tax. For any particular G/S, SGST & CGST rates are **equal**. **Integrated GST** (IGST) on **inter-state movement**
22	GST accounts for- **35%** of tax revenue of **union** & **44%** of tax revenue of **states**.
23	Supreme court verdict in **May 2022**, **Union & state** legislatures have "**equal, simultaneous and unique powers**" to make laws on GST
24	GST system **replaced old production-based** taxation system with a **consumption based** one. For **loss of revenue** of **manufacturing states**→ provide **compensation** by levying **cess on luxury goods & demerit goods** → proceeds are credited to **compensation fund**. Top five GST compensation receiving states were **Maharashtra, Karnataka, Gujarat, Tamil Nadu, & Punjab**
25	**Expenditure Decentralization** **Central govt** ✓ **defence**, ✓ **foreign affairs**, ✓ foreign trade ✓ Foreign exch mgt, ✓ money & banking, ✓ cross-state transport, ✓ communication. **State govt** ✓ **agriculture** & **industry**, ✓ **social sector services**- • health & education, • **police protection**, • **state roads** **& infrastructure**. **Local self govts -municipalities & panchayats** ➢ **public utility services** like- ✓ **water supply** ✓ **sanitation**, ✓ **local roads**, ✓ **electricity**
26	Borrowing by Govt of India & borrowing by states → **Article 292 & 293** of Constitution

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CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

1

Market failure
A situation in where **free market→ misallocation of society's scarce resources** leading to-
overproduction or underproduction of particular G/S leading to a **less than optimal outcome.**

2

Two types of market failure
a) Complete market failure- "**Missing markets**" - when market **does not supply products at all**
b) Partial market failure- occurs when **market does actually function**, but it **produces** either- **wrong quantity** or at **wrong price**.

3

Why do markets fail ? OR Reasons for market failure
I) Market Power , II) Externalities
III) Public Goods , IV) Incomplete Information

3 (a)

Market power or monopoly power→ **ability of firm** to **raise market price over its marginal cost.** (Price > MC)
Here producers **restrict output,** & keep **price high**

3 (b)

Externalities are **costs or benefits** that **do not reflect as part of market price**. They are also referred to as **'spillover effects'**, OR **'neighbourhood effects' 'third-party effects'** OR **'side-effects',**
as **originator** of externality **imposes costs or benefits on others** who are **not responsible for initiating** effect.

3 (b)

Externalities can be-

i) NPE (initiated in production confers external cost)
- Received in production

Eg- Factory **discharges untreated waste into a nearby river→ affects fish output→** less catch for **fishermen**
- **Received in consumption**

Eg- Factory **discharges untreated waste into a nearby river-** causing **health hazards** while **drinking & bathing**

ii) NCE(initiated in consumption confers external cost)
- Received in production

Eg- act of **undisciplined students talking & creating disturbance** in a class
- **Received in consumption**

Eg- smoking cigarettes in public place causing **passive smoking by others**

iii) PPE (initiated in production confers external benefit)
- **Received in production**

Eg- Firm offers training to employees - generates **+ve benefits for other firms** while they hire same workers.
- **Received in consumption**

Eg- When an **individual raises an attractive garden** & **persons walking by enjoy** the garden

iv) PCE (initiated in prod. confers external benefit)

- **Received in production**

Eg- Consumption of **services health club by employees** → **external benefit to firm**

- **Received in consumption**

Eg- If people **get immunized against contagious diseases** → **benefit to others**

4

How externalities cause inefficiency and market failure ?

- **Private cost** is **cost** incurred by producer directly involved in production → **appears in accounts**.
- **Supply curve** → shows only **private marginal costs**.
- **External costs** are borne by third parties not directly involved in transaction.

Social costs → **total costs to society** on account of **production or consumption**.

Social Cost = Private cost + External Cost

- Each **firm's cost** considers **only private cost** & do **not incorporate externalities**
- Goods having **–ve** externality → **over-produced**
- Goods having **+ve** externality → **under-produced**

5

Public Goods

- Aka. '**collective consumption good**' or social good
- Given by **Paul A. Samuelson**

Characteristics of Public Goods

1) Consumption is **collective** in nature.
2) **Non-Rivalrous** :Simultaneous consumption is possible.
3) **Non-excludable** : One individual **cannot deny other individuals'** consumption, **even if** they have **not paid** for it.
4) **Indivisibility**
5) **Additional resource cost** of another person is '**zero**'
6) **No direct payment** by the consumer is involved
7) **More vulnerable** to issues → **externalities**, **inadequate property rights**, & **free rider** problem.

Public goods will **not be produced** at all or will be **under-produced**.

6

Private goods are **scarce** & **must purchase** at a **price**.

- Do **not** face **free-rider problem**.
- **Excludable** → payment is must to access
- **Rivalrous** → Simultaneous consumption is possible.

Normally markets **efficiently allocate resources** for private goods.

Impure Public Goods- having features of **both Public & Private goods**

7	**Incomplete Information** **Perfect information** → both **buyers & sellers have complete information** Information failure leads to – **a) asymmetric information,** **b) adverse selection and** **c) moral hazard**
7.1	**a) Asymmetric Information** Means **imbalance in information**, i.e when **seller knows more than buyer or vice versa** → **distort choices** & thus market failure.
7.2	**b) Adverse Selection** Asymmetric information **generates adverse selection**. When **one party**, say X, **has some information** that other party **Y does not** → the **value** of **transaction** is **known more accurately to X** → and X may **take advantage** of Y's ignorance Eg- **Health insurers** know less about health conditions of buyers → **unable to differentiate** between **high-risk** and **low-risk** persons.
7.3	**Lemons Problem (given by George Akerlof)** Lemons- **Both** poor & good quality used cars Generally used **car on sale is 'lemon'** → **buyers' willingness to pay** will be based on '**average quality**' of used cars. **Asymmetric info leads to elimination of high-quality goods** from market. People end up either- • selecting a **sub-standard product** or • **leaving the market** altogether.
7.4	**c) Moral Hazards** It is about **informed person's taking advantage** of a **less-informed person** through an **unobserved action**. Eg- deliberately risk-taking due to comprehensive insurance cover.
	Govt Intervention to CORRECT market failure
8	**Minimize Market Power** **Establishing regulations** designed to **promote competition** & prohibit actions restraining competition.

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9

Government intervention to correct Negative Externalities

i) Direct Controls

Direct controls, (aka **command solutions**), **prohibit activities that create negative externalities** or require that negative externality be **limited** to a certain level.

ii) Market Based Policies

Market-based policies **provide economic incentives** so that **self interest** of market participants would **achieve socially optimal solution.**

Market based approaches affect market price by-

> **Setting price directly-** by pollution tax

> **Setting price indirectly-** by cap-&-trade system

10

Pollution Tax

- This tax **depends on amount of pollution** firm produces.
- Aka. **Pigouvian taxes** after A.C. Pigou
- **Making the polluter pay**→ tax **increases private cost** & thus **decreases output** of good which creates negative externality.
- **Proceeds from tax**→ used for **projects** that **protect environment**.

11

Problems in pollution tax

1) Difficult to determine → **complex & costly administrative procedures.**
2) If **demand for good** is **inelastic**→ tax have **less effect in reducing demand.**
3) Tax have **negative consequences** on **employment** & **investments** → producers shift their factories to other countries.

12

Tradable Emission Permits

- Use of **tradable permits to limit emissions** is called '**cap and trade**'.
- Tradable permit → license that allows to release a unit of pollution into environment over a period of time.
- A firm that generates emissions above what is allowed → penalized with fines.
- A firm which **produces less pollution** can **sell their permits & earn money.**
- **High polluters** have to **buy more permits**→ which increases their costs & makes them less competitive & less profitable.

13

Government intervention to correct Positive Externalities

Govt provides (Pigouvian subsidy)–

a) **corrective subsidies to producers-**to increase supply

b) **Corrective subsidies to consumers -** to increase demand

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14

Government intervention in case of merit goods

- **Merit goods** → have **positive externalities** & are **socially desirable**.
- But are **under-produced** & **under-consumed**
- **Eg-** education, health care, waste management etc
- **Govt can provide-**

1) **Regulation**→ how private activity may be conducted.
2) **Prohibit** some activities, set standards & issue mandates.
3) Use **legislation to enforce consumption**(Eg helmets)
4) **Compel individuals** to consume such good. (Eg- Right of Children to Free & Compulsory Education Act, 2009)
5) Ultimate encouragement → make the good **completely free** → leads to substantial demand.

14.1

Government intervention in case of demerit goods

- Demerit goods are **socially undesirable**. Eg- cigarettes, alcohol etc.
- Its **consumption** → imposes **negative externalities**. (over-prod. & over-cons.)
- All goods with **negative externalities are not essentially demerit goods**; e.g. **steel**.

14.2

How do governments correct market failure resulting from demerit goods ?

1) Enforce **complete ban** → but still can be **secretly driven underground** & traded in **hidden market**
2) Imposing **unusually high taxes**→ But, if **demand** is **inelastic**→ sellers can **shift tax burden to consumers**.
3) Fix **minimum price** below which **demerit good should not be sold**. (price floor)
4) Through **persuasion**, achieved by **negative advertising campaigns**
5) Through **legislations** that **prohibit advertising or promotion**
6) Strict regulations- to **limit access** to children
7) **Spatial restrictions**

15

Government intervention in case of Public goods

- Important public goods- Eg- **defence**, **establishment** & **maintenance of legal system**→ are directly provided by govt.
- **Excludable public goods**→ provided by govt & can be **financed through entry fees**.
- Some public goods are provided by **voluntary contributions** and private donations by corporate entities and NGOs.

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CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

16	**Price Intervention: Non-Market Pricing** Price intervention → **legal restrictions on price.** **a) Price Floor** (min price buyers are required to pay) or ✓ Price set **above** the equilibrium price ✓ Eg- **MSP, minimum wages, making demerit goods expensive** etc **b) Price Ceiling** (max price sellers allowed to charge) ✓ Price set **below** the equilibrium price ✓ Eg- **rent controls, black marketing, Shortages in market, problem of allocation of limited supplies among large no. of consumers etc**
17	**Correcting Information Failure** 1) Mandatory **labelling** & **content disclosures**. **2) Mandatory disclosure** of information. **3) Public dissemination of information** to improve knowledge **4) Regulation of advt** & setting of advt **standards**
18	**Equitable Distribution** **Govt can provide-** **1) progressive** income tax, **2) targeted budgetary allocations** **3) unemployment** compensation **4) transfer payments**, **subsidies**, job **reservations**, etc.
19	➢ **Government Failure** ➢ **When govt intervention to correct a market failure→** creates **inefficiency & misallocation of resources.** ➢ **Also can produce fresh & more serious problems**

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

20	➢ **Budget** is a statement that presents details of- • **'where money comes from' &** • **'where money goes to'.** ➢ **Govt budget** is a document presented for **approval & legislation** by a government and contains **estimates of proposed exp** & proposed **means of financing them.** ➢ Contains **estimates** of govt's accounts for **next fiscal year** called **budgeted estimates.**
21	**Budgetary process** is means by which **executive & legislative branches** together **formulate** a coherent set of **taxing & spending proposals**.
22	**Article 112** of constitution- '**President** shall present **to both houses** of parliament a **statement** of **estimated receipts & expenditure** of govt of India→ called as "**Annual Financial Statement**''.

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PROCESS OF BUDGET (SUMMARY)

Aug-Sep '24 → 1/4/25 → FY 25-26 → 31/3/26

Budget Prep start

National Institution for Transforming India

Budget is prepared by MoF in consultation with NITI Aayog.

1Y MoF → Budget Division →
- Schedule
- Budget Circular
  - Detailed instructions & formats for preparing estimates of exp ← Ministries, State, UTs, Autonomous Bodies

2Y Pre-Budget consultations
- Union FM → State FM, Industry Associations, Representatives from various sectors, experts from NITI Aayog & economists etc.

3Y Proposed Budget (Draft) is prepared

4Y Union FM → Prime Minister Y Budget **FREEZE**

5Y Halwa Ceremony → Marking completion & printing of budget documents.

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- **Budget Documents**

  a) Annual financial Statements (AFS) → Govt. Receipts & Expenditure ← Consolidated Fund of India, Contingency Fund of India, Public Account.

  b) Demand for Grants (DG)

  c) Finance Bill

  d) Statements mandated under FRBM Act.

     i) Macro Economic framework statement

     ii) Medium-Term fiscal Policy cum fiscal policy strategy statement.

  e) & other documents → Explanatory statements.

- Budget shows info of Rec. & Exp. of 2 years.

  FY 2024-25 ka Budget hai

  - Year Preceding CY → FY 2022-23
  - Current Year → FY 2023-24
  - Ensuing Year → FY 2024-25

  - Actual Receipts & Exp → Year Preceding the current F.Y.
  - Budgeted Estimates → • Current FY • Ensuing FY
  - Revised Estimates → • Current FY

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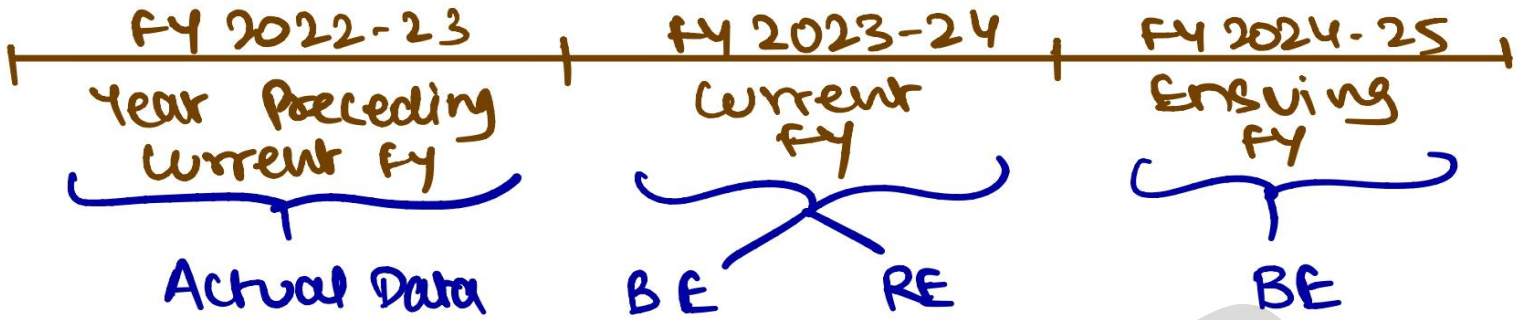

GY Budget Speech → FM → Lok Sabha.

Part A

- Current Macro Economic Situation
- Budgeted Estimates for Ensuing FY.
- Priorities of Govt.
- Total funds raised by Taxes & Borrowing.
- Proposed Allocation of Expenditure to diff. sectors [Appropriation Bill]
- Fresh schemes for Diff. sectors.

Part B

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

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Budget Presentation hone ke baad

↓

7) Budget is discussed in 2 stages in Lok Sabha

a) General Discussion → b) Demand for Grants [DG] of ministries/departments

Budget Circular → Ministries share their estimated exp of ensuing FY as per format in circular.

Ministry of Education → Estimate → ₹ 10,000 cr; Budget → ₹ 6,000 cr (Mei allocation)

Demand for Grant → Request ₹ 4,000 cr. → Voting in Lok Sabha.

On the last day of days allotted for voting on DG → Speaker will put all outstanding DGs to voting

Guillotine → Bringing debate on financial proposals to an end within specified time.

After Lok Sabha

↓

Now budget is laid in Rajya Sabha

NO voting on Demand for Grants → only General Discussion

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8) After general discussion & voting on Dfg, now Govt. introduces -

→ Appropriation Bill → Give authority to govt. → incurr exp. from Consolidated fund of India

↓ After Appr. Bill is passed

→ Finance Bill is taken up for consideration
- → Motion for leave to introduce FB cannot be opposed.
- → Parliament has to pass F.B. within 75 days

9) After Finance Bill Passed by Lok Sabha → sent to → Rajya Sabha → Has to return it with 14 days with/without recommendations

Recommendations of RS may be accepted or rejected by LS.

↓

Lastly, FB will be sent to President

↓

After assent → FB → Finance Act.

10) from FY 2017-18, Date of presentation of Budget → 1 Feb

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

But ↓

from FY 2017-18, Railway Budget is merged with General Budget

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23	**Department of Revenue** of Ministry of Finance **controls revenue matters** relating to **direct & indirect taxes** through two boards- 1. Central Board of Direct Taxes (CBDT) 2. Central Board of Indirect Taxes & Customs (CBIC)
24	**Department of Expenditure** of Ministry of Finance → nodal department for **overseeing public financial management system** of govt. It is responsible for- a) **implementation** of recommendations of **Finance Commission** & **Central Pay Commission**, b) **monitoring** of **audit comments**/observations, c) **preparation** of central government **accounts**. d) **assisting** central ministries in- ✓ **controlling costs** & **prices** of public services, ✓ **reviewing systems** & **procedures** to optimize exp.
25	One of **explanatory documents** in budget is '**Expenditure Profile**'→ consists **data of all ministries** to outline a **profile** of **general financial performance** of Govt.
26	**Central govt expenditure is classified in six broad categories :** **A. Centre's Expenditure:** ➢ **Establishment Exp** of Centre; ➢ **Central sector schemes**, and ➢ **Other** central exp → on CPSEs & Autonomous Bodies **B. Centrally Sponsored Schemes & other Transfers:** The transfers include ➢ **Centrally sponsored schemes** ➢ **Finance Commission transfers** and ➢ **Other** transfers to states
27	**Economic costs** of **unproductive public exp**: ✓ larger deficits ✓ higher levels of taxation, ✓ lower economic growth, ✓ fewer resources available for use elsewhere, and ✓ greater debt burden in the future.

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

Capital Receipts

Increase in Liabilities

Debt Capital Receipt

Market loans, Treasury Bills, 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.

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/c, Bld. etc
- **Financial Assets**
  Invt in Shares, CG giving loan & adv.

Reduction in Liabilities

- Repayment of loans & Adv. (Principal Amt)
- Payment of PF etc.

Repayment of Debt Capital Receipts is Capital Expenditure

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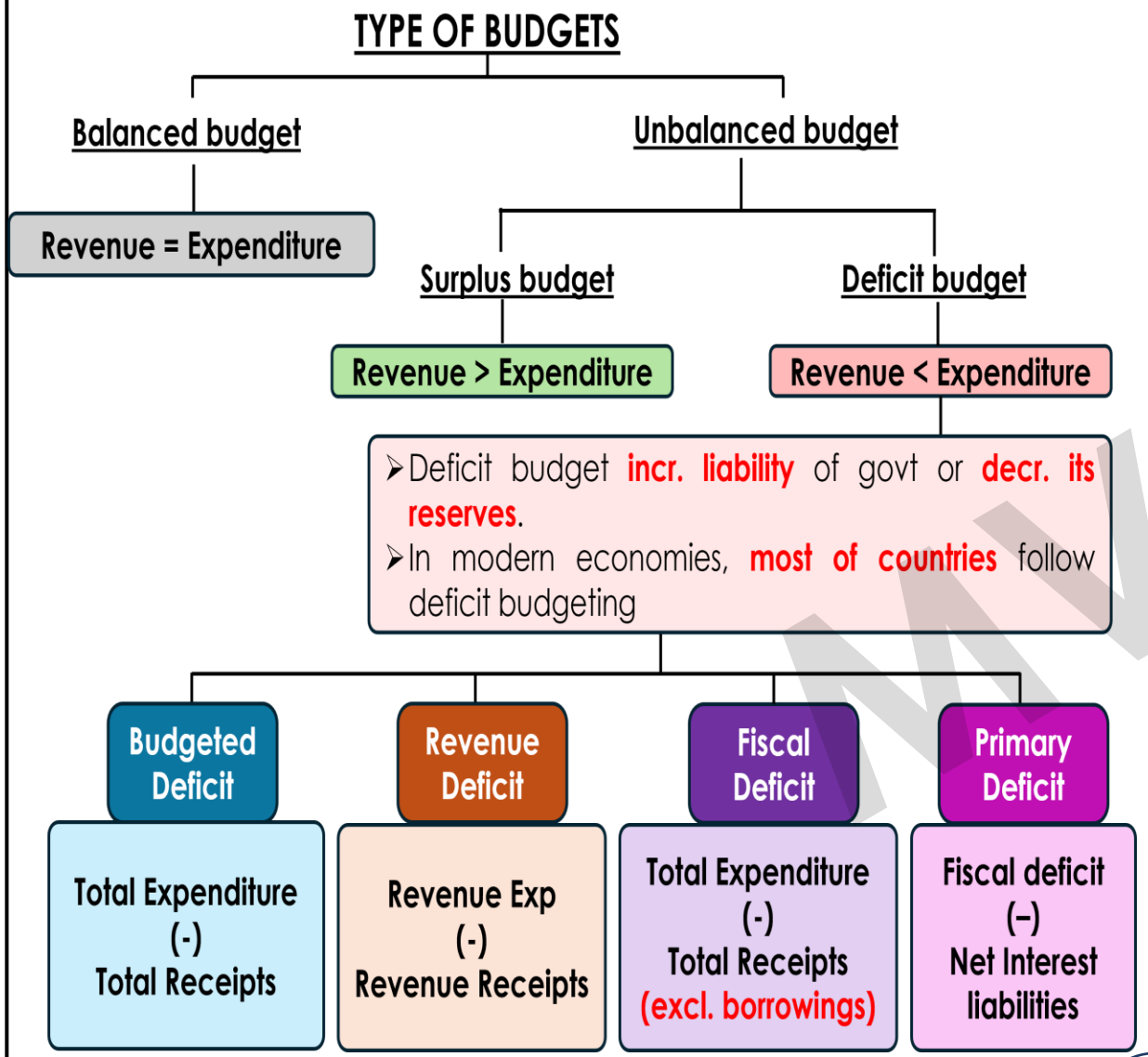

28	**Public Debt Management** ➢ **Govt** is generally **largest borrower** in any economy. ➢ Public debt - means **debt taken by govt,** which is to be **repaid at a future date** with **interest.** (debt is credited to **Consolidated Fund of India**) ➢ Debt servicing is a **continuous exercise** (not a one-time exercise)→ as a portion of debt falls due, govt simply **refinances debt**→ **sells new bonds** & uses its proceeds to **pay off old debt.**
29	➢ **Debt management strategy** is based on **3 pillars-** **1) low cost of borrowing,** **2) risk mitigation,** **3) market development.**

Institutions responsible for public debt management are	
Domestic marketable debt	**Internal Debt Management Department** (IDMD) of **RBI**
External Debt ✓ bilateral loans- (loan from one country/govt) ✓ multilateral loans (major part of external debt)– loans from multilateral agencies	**Department of Economic Affairs** in **Ministry of Finance (MOF)**

30	From 1997→ RBI provides **short-term** credit **up to 3 months** to **state govts** in form of **Ways and Means Advances (WMA).**
31	**Fiscal Responsibility & Budget Management (FRBM) (2003)**→ provides legislative framework for **reduction of fiscal deficit** & debt of govt to sustainable level. **Objectives** are: **1) inter-generational equity**, 2) long run **macroeconomic stability**, 3) better **coordination** between **fiscal** & **monetary** policy, and **4) transparency in fiscal operation** of govt.
32	**Public Debt Management Cell (PDMC)** was created in **2016** under Department of Economic Affairs.
33	**RBI Retail Direct**' facility announced by RBI on 5th Feb, 2021: ➢ improving **ease of access by retail investors** through **online access** to govt securities ➢ provide facility to **open govt securities account**
34	**Outcome budget** It establishes **direct link between budgetary allocations of schemes** & its **annual performance targets.**
	It is a **progress card** on what various ministries have done with the outlays in previous annual budget.
35	**Consolidated Fund of India** ➢ All **revenues**, **loans** & **money received** by govt are **credited** to this fund & **all exp** are **incurred from this fund**. ➢ Money can be spent from this fund → only if **approved by parliament**.
36	**Contingency Fund of India** It is placed at **disposal of President** to enable her to make advances to Govt to meet **urgent unforeseen expenditure**. (**no approval** from Parliament reqd) After spending from this fund→ amount is **recouped from Consolidated Fund of India**.
37	**Public Account** **Article 266(1)** of Constitution→ this account is used in relation to all **fund flows where govt is acting as a banker**. (**no approval** from Parliament reqd Eg- **Provident Funds** & **Small Savings**.
38	**Cut Motions** **Motions for reduction** to various **demands for grants** are made in form of cut motions.

39	**Meaning** Fiscal policy involves use of govt- **spending**, **taxation** & **borrowing** to influence both- ➢ **pattern of economic activity** & ➢ level of growth of **agg. demand, output & employment**
40	**Objectives** The most common objectives of fiscal policy are: ➢ **full employment** ➢ **price stability**, ➢ **economic development** ➢ **Equitable distribution** **Importance** & **priority** of these may **vary** from country to country- ➢ **stability & equality** → priority of **developed** nations, ➢ **economic growth, employment & equity** → priority of **developing** countries
41	**Types of Fiscal Policy** **Expansionary fiscal policy (EFP)** To **stimulate** economy during **contraction/recession-** ➢ **increasing aggregate exp**, & **decrease in taxes** It leads to **larger govt budget deficit** or smaller surplus. EFP is resorted to **close contractionary gap**.
41.1	**Contractionary fiscal policy (CFP)** To **stimulate** economy during **inflation-** ➢ **decreasing aggregate exp**, and ➢ **increase in taxes** It leads to **smaller govt budget deficit** or larger surplus. CFP is resorted to **close inflationary gap**
42	**Instruments of Fiscal Policy** 1. Govt expenditure 2. Taxes 3. Public Debt 4. Govt Budget
42.1	**Govt expenditure** 3 Types- ➢ **Current exp.** → **day-to-day running** of govt ➢ **Capital exp.** → buy **capital equipments & infrastructure**, and ➢ **Transfer payments** → govt **spending** which **does not contribute to GDP.**
42.2	**Taxes** Taxes determine **size of disposable income** → which determines **aggregate demand**.

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42.3	**Public Debt** **Public debt may be-** ➢ **Internal Debt-** Govt borrows from **its own people** in country. ➢ **External Debt-** Govt borrows from **outside sources** **Market Loans** Govt issues **treasury bills** & **securities** of which are **traded in debt markets.** ➢ For **capital projects→ long-term capital bonds** are issued ➢ For **short-term** govt expenditure→ **treasury bills** are issued. **Small Savings** These are public borrowings→ **not negotiable** & **not tradeable.** Eg- National Savings Certificate etc. **During Inflation** **Borrowing from public (new issue)→** by **sale** of securities→ **curtails aggregate demand→** Part of CFP. **During Recession** **Repayments of debt→ increase availability of money** & **increase aggregate demand→** Part of EFP.
42.4	**Government Budget** **Net effect** of budget on aggregate demand **depends on** govt's budget **balance.** ❑ **Balanced budget: (Revenue = Exp)** **No net effect** on agg. demand since leakages (taxes) = injections (exp) ❑ **Budget surplus: (Revenues > Exp)** It has **negative net effect** on agg. demand since leakages > injections It **reduces national debt** ❑ **Budget deficit: (Revenues < Exp)** It has **positive net effect** on agg. demand since injections > leakages It **adds to the national debt**
43	**Fiscal policy for long-run economic growth** **Demand-side policies unaccompanied** by policies to **stimulate aggregate supply** cannot produce long-run economic growth.

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44

Fiscal policy for reduction in inequalities of income and wealth

How **govt exp & taxes -** designed for redistribution-

- **Progressive direct tax** system
- **Indirect taxes** can be **differential-** (More tax on Luxury goods, Less tax on Necessities)

Spending programmes targeted on welfare measures-

- **Poverty alleviation** programmes
- Free or subsidized **medical care, education**
- **Infrastructure** provision on a **selective basis**
- **Subsidized production** of products of **mass** consumption
- Public production or grant of **subsidies** to ensure sufficient supply of **essential goods**
- **Strengthening human capital** for enhancing employability etc

45

Limitations of fiscal policy

1) Bad Timing

2) Difficulties in **instantaneously changing** govts' spending & tax policies

3) Practically **difficult to reduce govt spending** on some items→ **defence**, **social security,** huge **capital projects** which are **already midway**.

46

4) **Public works cannot be adjusted easily→** highways/dams have **long gestation period.**

5) Certain fiscal measures **cause disincentives**

6) **Increase is govt borrowing** creates **perpetual burden** on **future generations.**

7) Lags

i. **Recognition Lag -Lag in recognizing need** for a policy change

ii. **Decision Lag -Delays in deciding** on most appropriate policy.

iii. **Implementation Lag -** Delays in **bringing in legislation** & implementing them

iv. **Impact Lag - Outcomes** of a policy are **not visible for some time**

8) Crowding Out

- During **recession→ govt** resorts to EFP by **increasing govt exp.**
- When govt **spending exceeds tax** revenue, it borrows from market→ **raising the demand for loans** and **pushing interest rates up.**
- Higher interest rates **reduce interest-sensitive private investment.** (private sector crowds out from loan market due to govt)
- Fall in private spending **offsets** rise in govt exp.
- As a result, **fiscal policy becomes ineffective** & hurt long-term economic growth due to crowding out.

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47	**Special types of Govt Expenditure** **1) Pump Priming** Pump priming involves a **one-shot injection** of govt. expenditure into a depressed economy with aim of **boosting business confidence** & encouraging larger private investment. **2) Compensatory Spending** When govt **spending** is **deliberately carried out** with intention to **compensate for deficiency in private investment**.
48	**Non-Discretionary stabilizers Vs. Discretionary fiscal policy** **1) Non-Discretionary stabilizers Or Automatic Stabilizers** They are part of structure of economy & are '**built-in**' fiscal mechanisms that **operate automatically** to stabilize economy. **Eg-** already existing policy of tax, govt exp & unemployment benefits etc. **2) Discretionary fiscal policy** It refers to **deliberate policy actions** to **change levels of expenditure**, **taxes** to influence national output, employment & prices. **Eg- deliberating changing tax rates** when existing policy is not able to stabilize economy automatically

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Last Minute Notes

(Only Important Points)

Economics Chapter 8

Money Market

By CA Mohnish Vora (MVSIR)

Disclaimer- These notes are meant only for last-minute revision. They are not a substitute of Super Chart book. In exams, students must explain each point in more detail & should refer to chart book for complete understanding of every concept.

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CHAPTER 8 – Money Market| UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

1	**Fiat Money** • Aka. token money→ **no intrinsic value.** • Used as **medium of exchange** as govt made them **"legal tender"**
2	**Definition of Money** **For policy purposes** →set of **liquid financial assets→ variation in stock** of which→ **impact** on **agg. economic activity**. As **statistical concept**→ include **liquid liabilities** of **financial intermediaries/issuers (RBI)**
3	**Characteristics of Money** Generally **acceptable, durable**, effortlessly **recognizable**, **difficult to counterfeit**, relatively **scarce, portable**, possessing **uniformity, divisible** into smaller parts **without losing value**
4	**Functions of Money** 1) Convenient medium of exchange 2) Explicitly defined unit of value or unit of account 3) Serves as a unit or standard of deferred payment 4) Store of value
5	**Demand for money** ➢ If **people desire to hold money (in cash)**, we say there is demand for money. ➢ Demand for money is **derived demand**
6	**Theories of demand for money** **I) Classical Approach: Quantity Theory of Money** ➢ Given by **Irving Fisher** → book 'The Purchasing Power of Money' (1911). ➢ As per QTM, **money in circulation (M)** & **price level (P)** are directly **related** to each other. ➢ Aka. '**equation of exchange**' or '**transaction approach**' **MV = PT** PT = Total demand of money ; MV = Total supply of money ➢ Later, Fisher **extended above equation** to include **credit money (M')** & its **velocity (V')** **Expanded Form : MV + M'V' = PT** ➢ As per QTM→ More Transactions → More Demand of Money

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CHAPTER 8 – Money Market | UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

6.1

II) Cambridge Approach (Aka **Cash Balance Approach**)

- **Money increases utility** in **two ways-**
  1) **Split-up of sale and purchase** to two different point of time
  2) **hedge against uncertainty.** (money- a temporary store of wealth)
- **Higher income -> greater transactions -> greater demand for money.**

$$Md = k\,PY$$

Where; k = Cambridge k = proportion of nominal income (PY) that people want to **hold as cash**

7

III) Keynesian Theory of Demand for Money (Liquidity Preference Theory)

Demand for money = **Transactions Demand** (+) **Precautionary Demand** (+) **Speculative Demand**

7.1

a) Transactions motive

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

Trans. demand → **directly related** to income

$$Lr = kY$$

Where, k→ ratio of earnings kept for trans. Purposes

7.2

b) Precautionary motive

Keeping a portion of income to finance unanticipated exp→ due to unforeseen contingencies.

Prec. demand is income elastic & interest inelastic

7.3

c) Speculative motive

Money demand to **take advantage of future changes in rate of interest** or bond prices.

To **exploit attractive investment opportunity**

Return on money→ **zero**

Returns on bonds→ two types→ **interest payment** & **expected rate of capital gain**

8

Market Value of Bond inversely related to Market Rate of Interest

Current rate of interest (rn) **>** Critical rate of interest (rc)

- People **expect a fall in intt** rate **(rise** in bond prices**)**
- People will **convert their cash balances into bonds**

Current rate of interest (rn) **<** Critical rate of interest (rc)

- People **expect a rise in intt** rate **(fall** in bond prices**)**
- People would hold their wealth in the form of **liquid cash** rather than bonds

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9

Liquidity Trap

- When after a huge fall in interest rates → expectation is it cannot further fall.
- So now when in future→ interest rates will rise→ bond prices will fall
- To hold bonds at this low interest rate is to take almost certain risk of a capital loss

- Thus,
  - ❑desire to hold bonds is very low & approaches zero, and
  - ❑demand to hold money in liquid form approaches infinity.

- Speculative money demand (SMD) curve becomes perfectly elastic with respect to interest rate & becomes parallel to X axis.

- This is 'Liquidity trap' → aka. ineffective monetary policy.

- Empirical evidence of Liquidity Trap is found during "Global Financial Crisis of 2008"

10

Post-Keynesian developments in Theory of Demand for Money

IV) Inventory Approach to Transaction Balances

- Given by Baumol & Tobin
- Aka Inventory Theoretic Approach), in which money is viewed as inventory held for transaction purposes.

- People hold optimum combination of bonds & cash balance→ which minimizes opp. cost.

- Level of inventory holding (money demand)- is DIRECTLY RELATED to
  - ❑Income
  - ❑Cost of making transfer from money to bonds

& is INDIRECTLY RELATED to
- ❑Carrying cost (opp. cost)– (interest income foregone by holding money)
- ❑Number of bond transactions

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CHAPTER 8 – Money Market | UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

10.1	**V) Friedman's Restatement of Quantity Theory** Given by **Milton Friedman** → **asset price theory.** Friedman's **4 determinants** of demand for money **1) Total wealth = Permanent Income / discount rate** 2) Positively related to the **Price Level, P** 3) Rises if **opportunity costs** of money holdings decline **4) Inflation -** Positive inflation rate reduces real value of money & increases opportunity costs of money holdings
10.2	**VI) Demand for Money as Behaviour toward Risk** Given by **Tobin** in Based on principles of **Portfolio Management** People hold an **optimally structured wealth portfolio** which **comprises both** > **Bonds-** (provides return for risk) > **Money-** (No return, but also no risk) Demand for money **depends negatively** on **interest rate**.

UNIT 2 - CONCEPT OF MONEY SUPPLY

11	**Money supply = Total qty of money available with public** **'Public' is defined to include all economic units except the producers of money (i.e. Govt., & banking system- RBI & banks).**
12	Supply of money → **stock variable** Change in stock of money → **flow variable** Stock of money **available to 'public'** → **always smaller** than total stock of money in an **economy**. **Total money stock of a country = High powered money + Credit Money**
13	➢ **Supply of money' EXCLUDES** ❑ **interbank deposits** and ❑ money held by **government** and ❑ money held by **banking system**
14	**Empirical analysis** of money supply is important as it- 1) Facilitates **analysis of monetary developments** 2) Evaluate whether stock of money in economy is consistent **standards for price stability** & helps RBI in **making monetary policy**

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CHAPTER 8 – Money Market | UNIT 2 - CONCEPT OF MONEY SUPPLY

15

Measurement of money supply

Reserve money (M0) is also known as-
central bank money, base money or, high-powered money

	Currency in circulation
+	Bankers' deposits with RBI
+	Other deposits with the RBI
	Reserve Money (M0)

	Currency with Public
+	Demand deposits with banks (Current A/c & Saving A/c)
+	Other deposits with RBI
	M1 (Narrow Money)

	M1
+	Savings dep with Post Office
	M2

	M1
+	Time deposits with Banks
	M3 (Broad Money)

	M3
+	Total dep. with Post Office (excl. National Savings Cert.)
	M4

	Notes in Circulation
+	Circulation of Rupee Coin
+	Circulation of Small Coins
-	Cash on Hand with Banks
	Currency with Public

➢ **Descending order of liquidity –**
M1 (Most Liquid) &
M4 (Least Liquid)

16

Money Multiplier (m)

Money multiplier process explains **how an increase in monetary base** the **money supply to increase by a multiplied amount**.

1st Formula

$$\text{Money Multiplier (m)} = \frac{\text{Money supply (M)}}{\text{Monetary Base (MB)}}$$

2nd Formula

$$\text{Money Multiplier (m)} = \frac{1 + c}{r + e + c}$$

where,
c = currency ratio = currency / deposits
r = required reserve ratio = required reserves / deposits
e = excess reserve ratio = excess reserves / deposits

3rd Formula

If we **assume-**
1) **Banks never hold excess reserves**. (e = 0)
2) People **never hold currency** (c = 0) Then,
Money Multiplier (m) = 1 / Required Reserve Ratio = 1 / R
Above can aka.→ **Credit Multiplier or Deposit Multiplier or Deposit Expansion Multiplier**

CHAPTER 8 – Money Market

17	**Determinants of Money Supply** (By Milton Friedman & Anna Schwartz) **1) Stock of high-powered money (H)** Depends upon Behaviour of Central Bank
17.1	**2) Reserve-ratio (r) = R / D** ✓ Depends upon Behaviour of Commercial Bank If required reserve ratio **increases** - ➢ banks will decrease lending, ➢ causing a decline in deposits and hence money supply will **decline**. ✓ **Smaller** r → **larger** the money multiplier
17.2	**Excess Reserves (ER)** ER are funds that bank keeps as reserve beyond what is required → **buffer against unexpected events requiring cash**. **ER = Total reserve (TR) – Reqd. Reserve (RR)** ✓ Excess Reserves of commercial banks **do not lead to any additional loans**, and thus, do **not lead to creation of money** ✓ **Smaller** the excess reserve ratio -> **larger** will be the money multiplier ✓ When **costs to bank of holding ER** (market rate of interest) **rises** , level of **ER falls** -> **m will be larger**
17.3	**3) Currency Deposit Ratio (c) = C / D** Depends upon Behaviour of Public ✓ If public keeps **more money in their pocket** & less in bank→ **increase in currency ratio → banks create less credit money→ m falls.** ✓ **Increase** in Time deposit-demand deposit ratio TD/DD ratio → **higher the multiplier**

UNIT 3 - MONETARY POLICY

18	**Monetary Policy Defined** ➢ RBI uses monetary policy to **manage economic fluctuations** & achieve **price stability** (**inflation is low** & **stable**) ✓ When RBI **lower interest rates**, monetary policy is **easing**. ✓ When it **raises** interest rates, monetary policy is **tightening**
19	**The Monetary Policy Framework** 3 basic components- (i) **objectives** of monetary policy, (ii) **analytics** of monetary policy (transmission mechanisms) (iii) **operating procedure**

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20	**Objectives of monetary policy** Primary objective → maintaining **balance** between **price stability** & **economic growth**.
21	**Objectives of Monetary Policy in case of developing countries** 1) maintaining **economic growth** **2) adequate flow of credit to productive sectors** 3) sustaining **moderate structure of interest rates**, 4) creation of **efficient market for govt. securities**.
22	**Transmission of Monetary Policy** How changes to monetary policy **affect interest rates** & further **affect economic activity** & **inflation** **1) Saving and Investment Channel** **2) Cash-flow Channel** **3) Asset Prices and Wealth Channel** **4) Exchange Rate Channel**
23	**Instrument of Monetary Policy** **Direct Instruments** a) CRR & SLR **b) directed credit** in form of **prescribed targets** for preferred sectors **c) administered interest rates.**
	Indirect Instruments- **a) Repos** **b) Open market operations** **c) Standing facilities** **d) Market-based discount window**
24	**Operating Procedures and Instruments** Quantitative tools **1. Reserve Ratio** → Banks keep aside % **of Net Demand & Time Liabilities**. They have two types- **2. Cash Reserve Ratio (CRR)** → Banks set aside this portion in **cash with RBI**. Bank can **neither lend** it **nor can it earn any interest** on CRR **3. Statutory Liquidity Ratio (SLR)** → Banks set aside this **portion in liquid assets-** like **cash** or **gold** or **RBI approved securities** (unencumbered). Banks **are allowed to earn interest** on these securities. **4. Open Market Operations (OMO)** → To **control money supply** → RBI **buys & sells govt securities**. ✓ When RBI **sells** govt securities → **liquidity is sucked** from market (done to **control inflation**), ✓ When RBI **buys** securities → **Money Supply increases** (done during **contraction/depression**)

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25	**Qualitative tools - Selective tools that impact money supply of specific sector of economy** **1. Margin requirements →** When margin req is **raised**, customers will be able to **borrow less** 2. **Moral suasion →** By way of **persuasion**, **RBI convinces banks** to keep money in govt securities, rather than certain sectors. 3. **Selective credit control →** Controlling credit by **not lending to selective industries** or speculative businesses.
26	**Market Stabilisation Scheme (MSS)** Under MSS, **Govt** of India **borrows from RBI** & issues treasury-bills/dated securities→ done to **absorb excess liquidity** from banking system→ caused by large foreign capital inflows
27	**Policy Rates** **1. Bank Rate →** Interest rate at which **RBI lends long term funds to banks →** bank rate. Now used to prescribe **penalty** to bank if it **does not maintain** the prescribed **SLR or CRR** **2. Liquidity Adjustment Facility (LAF) →** RBI uses LAF as an instrument **to adjust liquidity & money supply**. The following types of LAF are-
	2a. Repo Rate → Repo rate is rate at which **banks borrow from RBI** on a **short-term basis** against a **repurchase agreement** **2b. Reverse Repo Rate → Rate RBI pays to banks** in order to keep additional funds in RBI. It is **linked** to repo rate: **Reverse Repo Rate = Repo Rate – 1** **3. Marginal Standing Facility (MSF) Rate → Penal rate** at which RBI lends money to banks, **over rate available** under repo policy. Banks availing MSF Rate can use **maximum of 1% of SLR securities→ MSF Rate = Repo Rate + 1**
28	**Monetary Policy Framework Agreement** ➢ **Agreement** between **Govt & RBI** on **maximum tolerable inflation rate** that RBI should target to **achieve price stability**. ➢ Announcement of an official target range for inflation is known as **inflation targeting**. ➢ **Inflation target → set by Govt** in **consultation with RBI**, **once in every five years**. Accordingly, Central Government has notified- ➢ **4 % → Consumer Price Index (CPI) → target** for **Aug 5, 2016 to Mar 31, 2021,** with the- ✓ **upper tolerance limit of 6%,** ✓ **lower tolerance limit of 2%**

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29	The RBI is mandated to publish a **Monetary Policy Report** every **six months**
30	**Monetary Policy Committee (MPC)** A **6-member committee** consisting of- ➢ **RBI Governor** (Chairperson), ➢ **RBI Deputy Governor** in charge of monetary policy, ➢ **One official** nominated by **RBI Board** and ➢ **Remaining three CG nominees**. MPC is required to **meet at least 4 times a year** MPC shall determine **policy rate** (repo rate) required to achieve inflation target.

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Last Minute Notes

(Only Important Points)

Economics Chapter 9

International Trade

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CHAPTER 9 – International Trade | UNIT 1 - THEORIES OF INTERNATIONAL TRADE

1

International trade is **exchange of G/S** & resources **between countries**.

It involves **transactions-**

- between **residents of different countries**
- involves **transactions in multiple currencies**
- **greater complexity** as it involves **heterogeneity of customers** and **currencies**, **differences in legal systems**, **business practices**, more **elaborate documentation** etc

2

Theories of international trade

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

3

Mercantilists' View of International Trade

- **Maximizing exports** (to bring more "**specie**") & **minimizing imports** through **very high tariffs**.
- Trade is ''**zero-sum game**'→ one country's **gain** is **equal** to another country's **loss**→ **net change in wealth** among the participants is **zero.**
- Mutually Gainful trade (MGT) is **not possible.**

4

The Theory of Absolute Advantage

- Given by **Adam Smith**
- Ability of a country to **produce greater qty** of a good, than competitors, using **same amount of resources.**
- Used **labor as only input.**
- Trade will happen **only if each of two countries** can **produce one good** at an **absolutely lower cost** than other country.

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

- A will produce & export wheat, while B → cloth.
- In this theory **MGT is possible.**

5

The Theory of Comparative Advantage

Ricardo→ even if one nation is **less efficient** than other nation in **production of all commodities**, there is **still scope for mutually beneficial trade** (MGT is possible)

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CHAPTER 9 – International Trade | UNIT 1 - THEORIES OF INTERNATIONAL TRADE

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, **A has absolute advantage in production of both** wheat & cloth

- Wheat [6 : 1]
- Cloth [4 : 2]

But, A has **greater absolute adv (comparative adv) → wheat**

Further, B has **lower absolute disadv (comparative adv) → cloth.**

6

The Heckscher-Ohlin Theory of Trade

Aka. **Factor-Endowment** Theory or **Modern** Theory

'**Factor endowment** → **availability** of resources- **labour & capital**.

It states that a country-

- specialize in **export** of good whose **production** requires intensive **use of its abundant resources,** &
- **imports** a commodity whose **production** requires intensive **use of its scarce resources**.

- **Capital abundant country-** Produce & export **capital-intensive goods**
- **Labour-abundant country-** Produce & export **labour-intensive goods.**

Factor-Price Equalization Theorem (Corollary to H-O Theory)- International trade **equalizes factor prices between the trading nations** → Trade in finished goods become **perfect substitutes** of trade in factors of production.

7

Theory of Comparative Adv.	Heckscher-Ohlin (Modern Theory)
Based on **labour theory of value**	Based on **money cost** - more realistic.
Considered **labour** as **sole factor** (one factor model)	Widened scope - **labour & capital → 2 factor model**
Diff in cost due to **differences in productive efficiency of workers**	Diff in cost due to **differences in factor endowments.**

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CHAPTER 9 – International Trade | UNIT 1 - THEORIES OF INTERNATIONAL TRADE

8

New Trade Theory

Nowadays countries trade in **similar products.** Eg- electronics, IT, cars etc

Market takes form of **monopolistic competition**.

2 Reasons for NTT-

a) **Economies of Scale**

b) **Network Effects-** Value of G/S is enhanced as no. of individuals using it increases→ **'bandwagon effect.'**. Eg- **WhatsApp** & **Windows**

UNIT 2 - THE INSTRUMENTS OF TRADE POLICY

1

Tariffs

- Aka. **customs duties→ taxes or duties imposed on import/export of G/S**.
- They are the **most visible** & **universally used trade measures**
- They **increase price** of G/S imported→ to **contract domestic demand** & **regulate volume of imports**
- They also **raise revenue of govt.**

2

Types of Teriff

1) **Specific Tariff - Fixed amount of money** per physical unit (qty) → Disadvantage- Its **protective value varies inversely** with **price** of the import

2) **Ad Valorem Tariff**- When duty is **levied as fixed % of value of traded commodity.** This tariff **preserves protective value** of tariff on home producer, but gives incentives to **deliberately undervalue price on invoices.**

3) **Mixed Tariffs**- Specific tariff or ad valorem → **whichever is higher**.

4) **Compound Tariff**- Adding up a **specific duty** to ad **valorem duty** (CT= $tsq + tapq$)

5) **Technical/Other Tariff-** Calculated on basis of **specific contents of imported goods**

6) **Tarrif Rate Quota- Combine two policy instruments: quotas** & **tariffs.**

7) **Variable Tariff-** A duty fixed to bring **price of an imported goods** upto level of **domestic support price.**

8) **Most-Favoured Nation Tariffs -** Tariffs between **countries which are members of WTO→** MFN rates are **highest** that **WTO members charge each other.**

9) **Preferential Tariff-** Countries promise to give another country's products **lower tariffs than their MFN rate**. These agreements are **reciprocal**.

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CHAPTER 9 – International Trade | UNIT 2 - Instruments of Trade Policy

2

10) **Bound Tariff**- A WTO member **binds** itself with **legal commitment not to raise tariff rate** above a certain level (maximum level of import duty)→ Once bound, a member can only **increase** its level **after negotiating with trading partners** & **compensating them for possible losses**.

11) **Applied Tariffs**- **Duty that is actually charged on imports** on MFN basis. Applied tariff should not be higher than bound level.

12) **Escalated Tariff**- Tariff **rates on imports of manufactured goods** are **higher than** tariff **rates on inputs & raw mat.** (is **discriminatory** in nature)

13) **Prohibitive tariff** - It is **set so high** that **no imports can enter.**

14) **Anti-dumping duty** – It is a **protectionist tariff** → when govt believes are **priced below fair market value.**
Dumping occurs when **manufacturers sell goods in foreign** country-
- ❑ **below sales prices in their domestic market** or
- ❑ **below full average cost** of product.

15) **Countervailing duties**- CVD is charged in importing country to **offset advantage that exporters get from subsidies** (from their govt.) to ensure fair pricing of imported G/S & thus **protecting domestic** firms.

Non – tariff measures (NTMs)

- Hidden or invisible measures that interfere with free trade
- **Mandatory requirements or regulations**→ legally set by govt.

Technical Measure

Product-specific properties such as **characteristics** of product, **technical specifications** & **production processes**.

Non-Technical Measures

Non-technical measures **relate to trade requirements**; for ex; **shipping requirements, custom formalities, trade rules, taxation policies, etc**

Sanitary & Phytosanitary (SPS) Measures- These are applied to **protect human, animal or plant life** from **risks arising from additives, pests**, etc. or disease-causing organisms and to **protect biodiversity**.

Ban on imports on basis of **quality** & **hygienic requirements.**

Technical Barriers to Trades (TBT)

Covers both **food & non-food products** - refer to mandatory '**Standards & Technical Regulations**' - define characteristics that product should have, like size, design, packaging, etc.

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3	**Non – tariff Barriers (NTBs)** NTBs are **discriminatory NTMs**, which are used as means to **circumvent free-trade rules** and **favour domestic industries at expense of foreign competition.** **NTBs are a subset of NTMs** that have 'protectionist or discriminatory intent'
4	**Types of Non-technical measures (IMP only)** **1) Import Quotas-** direct restriction on **quantity of good will be allowed into country**. **Types of import quota-** **a) Binding Quota-** They are **set below the free trade level of imports.** **b) Non-binding quota-** It is **set at or above the free trade level** of imports, thus having **little effect on trade**. **c) Tariff rate quotas (TRQs)→ quotas** (+) **tariffs**. **2) Price Control Measures-** **Control prices** of imported goods in order **to support domestic price of products** when **import prices are lower**. Aka. **'para-tariff' measures → increase cost** by **fixed percentage** or by a **fixed amount**. Eg: A minimum import price established for sulphur.
	4) Financial Measures- It includes measures like **advance payment requirements** & foreign exchange controls- like **denying use of foreign exchange** for certain imports. **5) Government Procurement Policies-** It involve **mandates** that whole of **specified percentage of govt purchases** should be **from domestic firms.** **6) Trade-Related Investment Measures-** **a)** Requirement to **use certain levels of locally made components** **b) restricting level of imported components**, and **c) limiting purchase or use of imported products** to an amount related to **value of local products that it exports**. **Rules of origin- Country of origin** means **country in which a good was produced→** used to **determine national source of product→ Duties & restrictions** in some cases **depend upon source of imports.** **8) Safeguard Measures-** Measures to restrict imports **temporarily** if its **domestic industry is injured →** caused by **surge in imports.** **9) Embargos- Total ban** imposed by govt **on import or export of some goods** to **particular country** for a **specified period→ most extreme form** of trade barrier.

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CHAPTER 9 – International Trade | UNIT 2 - Instruments of Trade Policy

Export-related measures

Ban on exports

Eg- during periods of **shortages**, **export of agricultural products** such as onion, wheat etc. may be **prohibited** to **make them.**

Export Taxes

Tax collected on exported goods → either **specific** or **ad valorem.**

It **raises price** of exports thus, **decreasing exports** & **increasing domestic supply** → **higher domestic consumption.**

Export Subsidies & Incentives

Govt **provide financial contribution to domestic producers** in form of **grants, loans**, duty drawback etc.

Voluntary Export Restraints

They refer to a type of informal quota administered by an exporting country **voluntarily restraining quantity of goods that can be exported out** of that country.

VER is done **to appease importing country** & **avoid the effects of possible retaliatory trade restraints**.

VERs cause **domestic prices to rise** & **loss of domestic consumer surplus**

CHAPTER 9 – International Trade | UNIT 3 - TRADE NEGOTIATIONS

1

Regional Trade Agreements (RTAs)

- RTAs → **groupings of countries**, which are formed with **objective of reducing barriers to trade**.
- As of 1 February 2021, **339 RTAs** were in force.
- **Eg- North American Free Trade Agreement (NAFTA) between Canada, Mexico, & US, → replaced by US–Mexico–Canada Agreement (USMCA)**

2

Types of RTAs

1) Unilateral trade agreements (ek tarfa)
2) Bilateral Agreements- set rules of trade **between 2 countries.** E.g. EU-South Africa FTA, ASEAN–India FTA.
3) Regional Preferential Trade Agreements- among a group of countries **reduce trade barriers on reciprocal & preferential basis** for **only members** of the group. E.g. GSTP

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4) **Free-trade area (FTA)-** group of countries that **eliminate all trade barriers.** Members **retain independence** in determining their **tariffs with non-members.** Eg- ASEAN–India FTA (AIFTA).

5) **Trading Bloc**- **group of countries** that have **FTA** between themselves & **apply a common external tariff to other countries.** Customs Union, Common Market, Economic Union are types of Trading Bloc.

6) **Customs union-** group of countries that **eliminate all tariffs** on trade among themselves but **maintain a common external tariff** with other countries.

7) **Common Market-** It involves **free flow of output & factors** of production→ by reducing or **eliminating internal tariffs** → by creating **common set of external tariffs.** There are **common barriers** against non-members (e.g- EU, ASEAN)

8) **Economic & Monetary Union-** Here members share **common currency**→ necessary to have **strong convergence in macro-economic policies.** eg, European Union

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3

- General Agreement on Tariffs and Trade (GATT) was a **multilateral trade agreement** which **provided rules of international trade** from **1948 to 1994** (47 years)
- **8th round of GATT (Uruguay Round)** of 1986-94, was **last** & culminated in **birth of WTO**.

4

GATT lost its relevance by 1980s

1) **Obsolete** to **fast-evolving world trade** due to globalisation
2) **International investments** expanded substantially
3) **Intellectualproperty rights** & **services** were **not covered**
4) **World merchandise trade increased** & was beyond its scope.
5) **Ambiguities** in **multilateral system** were heavily exploited
6) Efforts at **liberalizing agricultural trade** were **not successful**
7) **Inadequacies in institutional structure** & dispute settlement
8) It was **not a treaty**

5

Birth of WTO→ 1st July, 1995

Objectives of WTO

Principal objective→ facilitate flow of international trade smoothly, freely **& fairly**.

The WTO has **six key objectives-**

1) to set & enforce **rules** for international trade
2) to provide a **forum** for **negotiating & trade liberalization**
3) to **resolve trade disputes**
4) to **increase transparency** of **decision-making**
5) to **cooperate with other major international economic institutions**
6) to **help developing countries**

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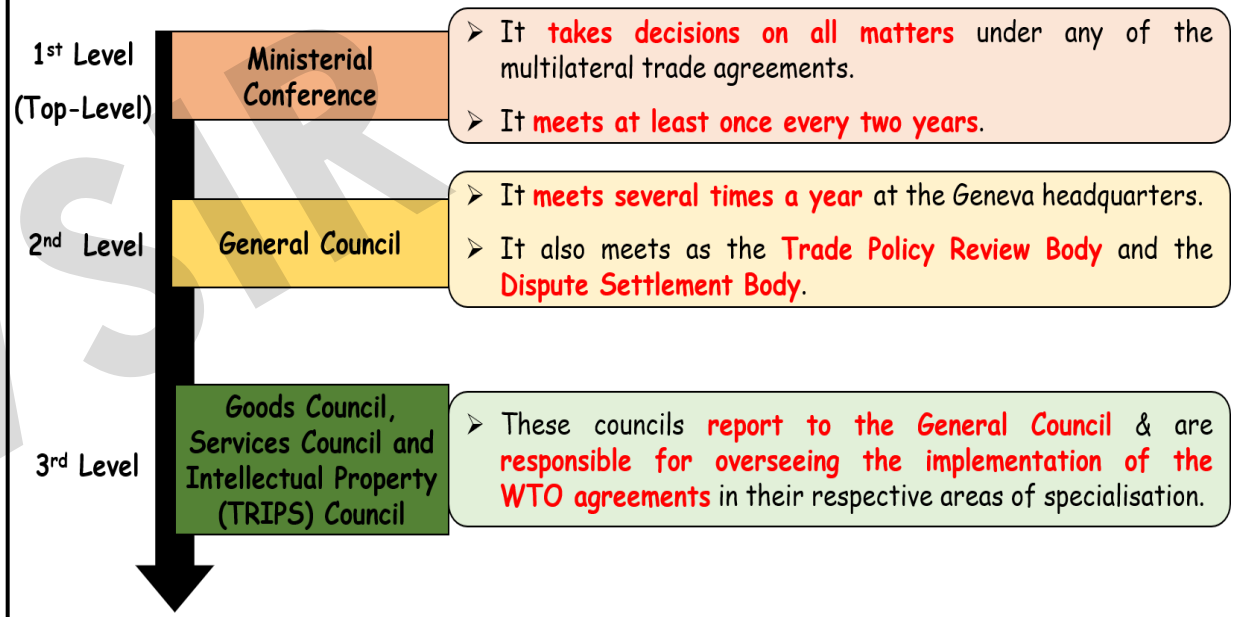
Structure of the WTO

- The WTO activities are supported by a **Secretariat** located in **Geneva**, headed by a **Director General**.
- It has a **three-tier system of decision making**



WTO has **164 members→** of which **117 are developing countries**.

The **WTO trade monitoring reports** have been prepared by the **WTO Secretariat** since 2009.

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CHAPTER 9 – International Trade | UNIT 3 - TRADE NEGOTIATIONS

6	**Guiding Principles of WTO** **1) Most-favoured-nation (MFN) – [Trade without discrimination]** Grant **someone a special favour** then you have to **do the same for all other WTO members**. **2) National treatment** Treating foreigners and locals equally → **imported** and **locally- produced goods** should be treated **equally** — at least **after foreign goods have entered domestic market**. **3) Freer trade: gradually, through negotiation** **4) Promoting fair competition** **5) Predictability: through binding and transparency** A country can **change its bindings**, **but only after negotiating** with its trading partners & **compensating them for loss** of trade. (In **agriculture**, **100% of products** now have **bound tariffs**) **6) Encouraging development and economic reform**
7	**WTO Agreements** Aka. **WTO's trade rules**→ they are "**rules-based**" **Important Agreements-** **1. Agreement on Agriculture** → focus on **3 areas** of **market access**, **domestic support** & **export subsidies**.
7	**2. Agreement on Textiles and Clothing** replaced the **Multi-Fibre Arrangement (MFA)** **3. Agreement on Trade-Related Investment Measures (TRIMs)** **4. Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)** **5. Plurilateral Trade Agreements** **Multilateral negotiations**→ involves **entire WTO contracting parties**. **Plurilateral negotiations**→ involve several countries but **do not involve all WTO countries**.
8	**The Doha Round** **Most controversial topic**→ **agriculture trade**.
9	**G20 Economies** ➢ G-20 was founded in 1990, as a forum for countries to **discuss global economic & financial issues**. ➢ **G20 members are**: Argentina; Australia; Brazil; Canada; China; European Union; France; Germany; India; Indonesia; Italy; Japan; the Republic of Korea; Mexico; the Russian Federation; Saudi Arabia; South Africa; Turkey; UK, USA.

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CHAPTER 9 – International Trade | UNIT 4 - Exchange Rates and its Economic Effects

1

Exchange rate

Aka. **foreign exchange (FX) rate**, is **price of one currency expressed in terms of units of another currency**.

Two ways to express nominal exchange rate-

1) Direct Quote (European Currency Quotation)

It is number of units of **local currency** exchangeable for one unit of a **foreign currency**

Foreign currency (USD) = base currency

Domestic currency (INR) = counter currency

Eg: USD 1 = INR 90

2) Indirect Quote (American Currency Quotation)

It is a number of units of **foreign currency** exchangeable for one unit of **local currency**

Domestic currency (INR) = base currency

foreign currency (USD) = counter currency.

Indirect Quote = 1 / Direct Quote

Eg: INR 1 = USD 0.011

2

The **rate between Y and Z** which is **derived from the given rates** of **another set of two pairs of currency** (say, X and Y, and, X and Z) is called **cross rate**

Eg- USD 1 = INR 75 ; 1 GBP = USD 1.40

Then cross rate→ **1 GBP = INR 105**

3

Exchange Rates Regimes

Exchange rate regime→ system by which a country manages its currency with respect to foreign currencies.3 Types- free, fixed, managed floating

Types of exchange rate regimes (ERR)

Basis	Free floating ERR (aka. flexible exch rate)	Fixed ERR (aka. pegged exch rate or hard peg)
Meaning	• Value is **market determined** using demand & supply • Govt or central bank **do not interfere** → self-regulating	Central bank or govt **announces** what its **currency will be worth.**
Advantages	1) **Govt can pursue own independent monetary policy**. 2) **Allows exch rate** to be **used as a policy tool** 3) **No obligation to intervene**	1) **Avoids fluctuations & eliminates risks & transaction costs** 2) **Reduced speculation** 3) **Imposes discipline** & generates **lower inflation**. 4) Stability **encourages investment**. 5) Pegging **enhances credibility**

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CHAPTER 9 – International Trade | UNIT 4 - Exchange Rates and its Economic Effects

Types of exchange rate regimes (ERR)

Basis	Free floating ERR (aka. flexible exch rate)	Fixed ERR (aka. pegged exch rate or hard peg)
Disadvantages	1) **Unpredictability** - Volatile exch rates (uncertain) 2) It **adds a risk premium**- makes international transactions **riskier**	1) **Lacks flexibility** 2) Central bank→ required to maintain **huge foreign exch reserves.**

4

Managed floating ERR

- **Aka. dirty floating** or **soft peg**

➢ Exch rates are still **free to float**, but govt. or central bank try to **influence** their values.

➢ To **prevent sudden large swings** in value.

Nominal exchange rate	Vs.	Real exchange rate
It refers to **rate** at which a person can **trade the currency** of one country for the **currency of another country.** **Eg→ 1 USD = Rs 90**		Rate at which a person can **trade G/S** of one country for **G/S of another**.

Real Exchange Rate = Nominal Exchange Rate (x) $\frac{\text{Foreign Price}}{\text{Domestic Price}}$

5

Real Effective Exchange Rate (REER)

➢ REER is **inflation adjusted NEER**

➢ An **increase in REER→ exports expensive & imports cheaper→** indicating **loss in trade competitiveness.**

6

Other Terms

1) **Vehicle Currency-** A currency that is **widely used** in international contracts→ even when it is **not national currency** of either parties. Eg- US Dollars.

2) **Arbitrage-** Making **risk-less profits** by **exploiting price differences** at **different places**. Due to **arbitrage→** at any given moment, **all markets** tend to have **same exch rate.**

	Devaluation	Depreciation
1.	**Deliberate downward adjustment** by govt or cb.	**Decrease in value** due to **market forces** of demand & supply
2.	Occurs in **fixed regime**	Occurs in **floating regime**

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CHAPTER 9 – International Trade

7	**Impacts of currency depreciation** 1) lowers price of exports→ **exports incr.** & **imports decr.**, thus **improves trade balance.** **2) increases demand** both for domestic import-competing goods & for exports, 3) leads to **output expansion**, 4) encourages **economic activity**
8	**Impacts of currency appreciation** 1) raises price of exports→ **exports decr.** & **imports incr.** **2) adversely affect competitiveness** of domestic industry, cause **larger deficits** and **3) worsens** trade balance.

UNIT 5 - International Capital Movements

1	**Foreign capital → any inflow of capital into home country from abroad.**
2	**Components of Foreign Capital Flows** 1) Foreign Aid or Assistance 2) Borrowings 3) International Investments (FDI/FPI) 4) Deposits from NRIs
3	**Foreign Direct Investment (FDI)** • When resident of one country (i.e. home country) acquires ownership of asset in another country (i.e host country) • Acquisition of **at least 10% shares→** involving **long-term relationship** & reflecting **lasting interest** & **control**
4	**3 Components of FDI** **1) Equity capital** **2) Reinvested** earnings 3) Other direct capital → **intra- company loans**
5	**The main forms of direct investments / Modes Of FDI** 1)opening of **overseas companies→** subsidiaries or branches, 2) creation of **joint ventures** 3) joint development of **natural resources** and **4) purchase of companies** in country receiving foreign capital **5) Green field** investment (**freshly starting** production) **6) Brownfield** investments (**using existing infrastructure** by merging) Eg- In India **100% FDI (automatic route)** in Brownfield Airports

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CHAPTER 9 – International Trade | UNIT 5 - International Capital Movements

6

Types of FDI

1) **Horizontal FDI-** Investor establishes **same type** of business in foreign as it operates in its home country.
Eg- cell phone service provider of India provide same service USA.

2) **Vertical FDI-** Investor establishes a business in foreign which is **different** from main business, but **supplements its major activity**.
Eg- car mfg co. acquire a foreign company that supplies tyres.

3) **Conglomerate** FDI- Investor invests in foreign business that is **unrelated** to its existing business (no previous experience).
Eg- car mfg co. acquire a foreign restaurant chain.

4) **Two-Way FDI- Reciprocal investments** between countries→ when some industries are more advanced in one nation (Eg- computer in USA), while other industries are efficient in other nations (Eg- automobile in Japan).

7

There are **two routes to for FDI** in India
1) Government Route – Prior approval of govt required
2) Automatic Route

- Where there is **no approval**→ co. can seek permission from **Foreign Investment Facilitation Portal (FIFP)**.
- Permission for FDI is **not uniform for all sectors**.

8

Sectors FDI is **prohibited** in India under all routes-

- **Atomic** Energy
- **Lottery** Business
- **Gambling** and **Betting**
- Business of **Chit Fund**
- **Nidhi** Company
- **Agricultural** & **Plantations** (**but Tea Plantation** allowed)
- **Housing** & **Real Estate**
- Trading in **TDRs**
- Manufacture of **cigars & tobacco**.

9

Foreign portfolio investment (FPI)

- FPI flow of '**financial capital**' → does **not involve ownership or control**
- Investment in **shares & bonds** etc in foreign stock market.
- Acquisition of shares in foreign co.→ **at or below 10 %**

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CHAPTER 9 – International Trade | UNIT 5 - International Capital Movements

FDI	FPI
Investment in **physical assets**	Investment in **financial assets**
Long term	**Short term**
Difficult to withdraw	**Easy** to withdraw
Not speculative	**Speculative**
Direct impact on employment of labour	**No** such impact
Involves **technology transfer**	**Does not** involve tech transfer
Interest in mgt & control	**No** such interest

10

Major reasons for FDI

i. Economies of scale → leading to more profits,
ii. Risk diversification,
iii. retention of trade patents,
iv. capture of emerging markets,
v. lower host country environmental & labour standards,
vi. bypassing of non-tariff & tariff barriers,
vii. cost–effective availability of inputs
viii. tax & investment incentives.

11

Deterrents to FDI

i. Poor macro-economic environment
ii. Unfavourable resource and labour market conditions
iii. Unfavourable legal and regulatory framework
iv. Lack of host country trade openness

12

Benefits of FDI

1) **Fosters competition** & generates a **competitive environment** in host country
2) Allows countries to finance **more investment** than supported by domestic savings.
3) Accelerate **growth** & foster **economic development**
4) **Promote political & structural reforms** important to attract foreign investors
5) Generates **direct employment** in **recipient country**.
6) Enhances **people-to-people relations** & promotes **bilateral & international relations**.
7) **Weakens market power** of domestic monopolies
8) **Better work culture** & **higher productivity standards** brought in by foreign firms

13

World Investment Report 2022→ India was ranked **8th** among the **world's major FDI recipients** in 2020.

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14

Problems of FDI

1) FDIs **concentrate on capital-intensive methods**→ so **hire few workers**.
2) FDI **moves towards regions** having more **resources** & **infrastructure**→ leads to regional disparity
3) **Slows down domestic govts** to generate more domestic savings.
4) Borrowings by foreign firms can **raise interest rates** in **host country.**
5) Due to **imported inputs** or when **profits are repatriated**→ pressure on **host country's balance of payments** & **home currency.**
6) Host country is left with **routine mgt jobs** that demand **lower skills & ability**
7) Production concentrated on items of **elite & popular consumption**
8) Foreign firm with **deep pockets** may **undercut competitive local industry** & **drive out domestic firms**
9) FDI may have **adverse impact** on host country's commodity **"terms of trade"** (defined as price of a country's exports divided by price of its imports). Huge exports→ lead to **over-supply** & thus **export prices decrease**.
10) Ruthless **exploitation of natural resources & environmental damage**.

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CA Foundation – Business Economics

Last Minute Notes

(Only Important Points)

Economics Chapter 10

Indian Economy

By CA Mohnish Vora (MVSIR)

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CHAPTER 10 – INDIAN ECONOMY

1

Between **1st & 17th century AD** → India was **largest economy of ancient & medieval world.** → controlled between **1/3rd & 1/4th of world's wealth.**
(India was **self-reliant & prosperous)**

2

- Earliest known book on **ancient Indian economic philosophy** is '**Arthashastra**' by Kautilya (Chanakya) → genre of **political philosophy**.
- Handbook for **King Chandragupta Maurya**
- The major focus of work is on means of **fruitfully maintaining and using land**.
- **True kingship** is defined as a **ruler's subordination of his own desires** & ambitions to **good of his people**

3

Period of British Rule

2 sub periods:

- **East India Company → 1757 to 1858**
- **British government → 1858 to 1947**

- **Industrial revolution in Britain** in latter half of 18th century → there **arose need of raw material** & **markets for finished goods** → led to change in nature of India's foreign trade from **exporter of manufactures** to **exporter of raw materials**
- Indian exports of finished goods → **heavy tariffs**

Indian Imports from Britain → **lower tariffs**
(Indian goods lost their competitiveness)

- **Destruction** of **Indian manufactures** → due to **hostile imperial policies** & competition from machine-made goods.

5

Stagnated Nature of Industrialisation During Colonial Era

- **Cotton mill industry → 9 million spindles** in 1930s
- **Jute mills** expanded in **Calcutta** → global demand for **ropes..**
- At **end of 19th** century, **Indian jute mill industry was largest in world** in terms ofamt of **raw jute consumed**.
- **Producer goods industries → no expansion** → because of pressure from English producers to discourage devp of industries in India.
- **Share in NDP** of **mfg sector → 7% in 1946**.

6

- **INDIAN ECONOMY: POST-INDEPENDENCE (1947-1991)**
- **At time of independence**, India had a **literacy rate of 18%** & **32 years of life expectancy in 1951.**
- **Nehruvian model** supported social & **economic redistribution** & **industrialization**
- **Rapid industrialization of economy** was **cornerstone** of **Nehru's development strategy**.
- **Planning Commission of India** was established in **1950** → to plan **development of nation** → through **five-year plans**

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CHAPTER 10 – INDIAN ECONOMY

7	**Industrial Policy Resolution** ➢ **Industrial Policy Resolution (IPR) (1948)** → expanded role of public sector & licensing to the private sector. It granted **govt. monopoly** in- **atomic energy, arms and ammunition, & railways** ➢ **IPR of 1956** → provided framework for industrial devp→ but lopsided as lead to **huge expansion of scope of public sector.** (dampening of private sector initiatives)
8	➢ **Policies** in **1950's** were guided by two **economic philosophies**: 1. **Nehru ji** → **build socialistic society** & focus on **heavy industry** 2. **Gandhi ji**→ focus on **small scale, cottage industry** and **village republics**
9	In **1950–80**→ India's avg annual GDP growth rate - '**Hindu growth rate**'- was **3.5 %**.
10	**Agriculture Issues & Green Revolution** ➢ **Agri devp** till mid 1960s → **institutional model i.e. land reforms**, **farm cooperatives** & no importance to technocratic areas like R&D , irrigation. ➢ 2 severe **droughts struck India in 1966 & 1967**. India had to **depend on USA for food** aid under **PL 480**.
11	➢ **Green Revolution'** was initiated soon by- ➢ innovative farm technologies & **HYV seed**→ focus on **wheat & rice** ➢ intensive use of **water, fertilizer and pesticides**
12	**Nationalisation of Banks** Taking of full control & mgt. from Private Sector by Govt. **Govt nationalized-** ✓ **14 banks** in **1969** and ✓ then **6 in 1980**.
13	The **economic performance** during "**1965-81**" **is the worst** in **independent India's history**.
14	MRTP Act, 1969 was aimed at **regulation of large firms** which had relatively **large market power**.
15	In **1967**, many products were **reserved** for exclusive manufacture by the **small scale sector**
16	**THE ERA OF REFORMS** ➢ The initiatives from **1981 to 1989**→ referred as '**early liberalization**' ➢ Aka. '**reforms by stealth**' → ad-hoc & not widely publicized nature. ➢ The **early reforms of 1980's** covered **three areas- industry**, **trade** and **taxation**.

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CHAPTER 10 – INDIAN ECONOMY

17

Economic Reforms of 1991

- Done under **Narsimha Rao government.**
- **Major causes for such drastic change** are
  - Large & persistent **fiscal deficit.**
  - **Foreign exchange reserves** touched **lowest point** → only **$1.2 billion** → sufficient for only two weeks of imports.
- 1991 reforms→ known as **LPG- Liberalization, Privatization** & **Globalisation,** had **two major objectives:**

1) **reorientation** of economy from centrally directed & controlled one to **market oriented economy.**
2) **macroeconomic stabilization** by reduction in fiscal deficit.

- **Globalization** indicate rapid **integration** between countries

18

The Fiscal Reforms

1) Stable & transparent tax structure,
2) Ensuring **better tax compliance,**
3) Thrust on **curbing govt exp.**
4) Reduction in **subsidies**
5) Disinvestment of **govt's equity** in PSUs &
6) Encouraging private sector participation.

19

Monetary and Financial Sector Reforms

- The focus was on-
  - **reducing burden of NPAs** on govt banks,
  - introducing & sustaining competition, and
  - **deregulating interest rates.**
- **Reduction in reserve requirements** (SLR & CRR), on recommendations of **Narasimham Committee Report, 1991.**

20

Reforms in Capital Markets

- SEBI → set up in 1988 & **statutory recognition in 1992.**
- **Independent regulator of capital (stock) market**

21

New Industrial Policy

- Announced on **24 July 1991**
- Important **reforms-**
  - Ended **'License Raj'** by **removing licensing restrictions** industries **except for** 5 industries, having **severe implications on health & environment.**
  - Public sector was limited to two items– **railway transport & atomic energy**
  - In **1990-91**→ **highest tariff rate** was **355%.**
  - Rupee was **devalued by 18%** against the dollar.

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CHAPTER 10 – INDIAN ECONOMY

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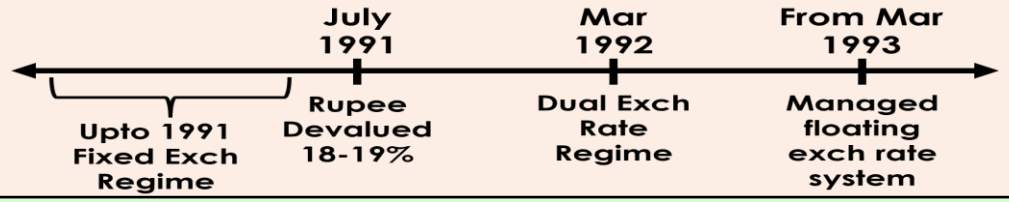
Trade Policy Reforms

- **dismantling of quantitative restrictions on imports & exports , focusing on outward oriented regime, removal of licensing on imports.**



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NITI AAYOG

- Planning Commission was abolished in 2014→ & on **1st Jan 2015** it was replaced by **National Institution for Transforming India (NITI) Aayog**.
- It is a '**Think Tank**' of govt. & a 'directional and policy dynamo'.
- **Objectives- (Only IMP points)**

1) '**spur innovative thinking** by 'experts', &
2) promote '**co-operative federalism**' by enhancing voice of states'.
3) To **evolve a shared vision** of national development priorities, sectors & strategies with active involvement of states.
4) To **foster cooperative federalism**
5) To **develop mechanisms to formulate credible plans** at the village level

24

Key initiatives of NITI Aayog

- Life (Lifestyle for Environment) → replacing prevalent **'use-and-dispose' economy**
- National Data and Analytics Platform (NDAP) → Access to Indian **government data**
- Shoonya campaign → **improve air quality** in India by accelerating the deployment of **EVs**
- E-Amrit → **one-stop destination** for all information on **EVs**
- **Methanol Economy** → aimed at **reducing India's oil import bill**, **greenhouse gas** (GHG) **emissions**, and **converting coal reserves** and municipal **solid waste into methanol**.

25

THE CURRENT STATE OF THE INDIAN ECONOMY: A BRIEF OVERVIEW

I) PRIMARY SECTOR

- Agriculture→ **largest source of livelihood** in India.
- **47%** of India's population dependent on **agriculture**.
- Contributed **18.80%** to **GDP**.
- **India has emerged as-**

✓ **world's largest producer** of **milk**, **pulses**, **jute** and **spices**.
✓ **largest area planted** under **wheat**, **rice** and **cotton**.
✓ **world's largest cattle herd** (buffaloes).

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CHAPTER 10 – INDIAN ECONOMY

26

- India is **among top 10 exporters** of **agri products** in world
- **Agricultural and Processed Food Export Development Authority (APEDA)** → responsible for export promotion of agri-products.

27

Measures by govt to improve agri. sector-

1) **100% FDI**→ marketing of food products & its E-commerce under **automatic route**
2) **Income support** to farmers through **PM KISAN**
3) Fixing of **Minimum Support Price (MSP)** at **1.50 times** the **cost of production**
4) **Pradhan Mantri Fasal Bima Yojana (PMFBY)** – **insurance scheme** → farmers **suffering crop loss/damage**
5) **Paramparagat Krishi Vikas Yojana** → promoting **organic farming**, & **improvement of soil health**.
6) Promotion of **Farmer Producer Organisations** (FPOs) to **ensure better income** for producers.
7) **Per Drop More Crop- increase water use efficiency**
8) Setting up of **E-NAM(Electronic National Agriculture Market) -a pan-India electronic trading portal** which networks existing **APMC mandis** to create **unified national market** for agri commodities.
9) **Kisan Rail**→ **improvement** in farm produce **logistics**

28

Small & fragmented landholdings, low farm productivity and subsistence farming result in very **little marketable surplus** & thus **lower income** of **agriculturists.**

29

We can say **Indian agriculture** has become **modern** since-

1) increase in use of **HYV seeds**, **fertilizers pesticides** etc.
2) positive **change in attitude** of farmers on **new techniques** of production
3) farmers using **intensive cultivation**, **multiple cropping**, **scientific water management**

30

II) SECONDARY SECTOR

- **30%** of **GVA** & employs over **12.1 crores** of people.
- In 2023→ Manufacturing Purchasing Managers' Index (PMI) in India stood at **55.4**.
- India's rank in **Global Innovation Index** (GII)→ **40th in 2022**
- **Department for Promotion of Industry and Internal Trade (DPIIT)** has a role in **formulation & implementation** of **industrial policy.**

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- Indian industry faced **retrogression & deceleration** bcoz-
  - ✓ unsatisfactory performance of agriculture
  - ✓ slackening of real investment in public sector
  - ✓ narrow market for industrial goods, especially in rural areas

32

- **Govt policies for growing secondary sector**

1) Introduction of **GST** on **1 July 2017** → **replacing** many indirect taxes.
2) **Reduction of corp. tax to domestic comp.** → at **22%**
3) '**Make in India**' is a **'Vocal for Local'** initiative launched in 2014
4) '**Ease of Doing Business**' → India ranks **63rd** in **World Bank's** annual **Doing Business Report** (DBR), 2020
5) **National Single Window System** → one-stop-shop for **investor related approvals** & **support to investors**.
6) **PM Gati Shakti National Master Plan**→ **facilitate data-based decisions** & planning of **multi-modal infrastructure**→ reducing logistics cost.
7) **National Logistics Policy (NLP)**→ aims to lower cost of logistics

33

8) **Production Linked Incentive (PLI) Scheme** was initiated for **14 key sectors** → now also extended for **white goods (air conditioners & led lights)**.
9) **FAME-India Scheme** (Faster Adoption & mfg of Hybrid & Electric Vehicles) to **promote manufacturing of electric & hybrid vehicle technology**
10) **'Udyami Bharat'** → empowerment of Enterprises MSMEs.
11) **PM Mega Integrated Textile Region and Apparel** (PM MITRA)→ for **textiles sector**.
12) **Foreign Investment Promotion Board (FIPB)** was abolished in May 2017, & replaced by **Foreign Investment Facilitation Portal (FIFP)**.
13) **Remission of Duties & Taxes on Export Products (RoDTEP) 2021 formed to the existing MEIS** (Merchandise Exports from India Scheme) to boost exports.

34

National Manufacturing Policy→ aims to **increase share of mfg in GDP to 25%** by 2025

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CHAPTER 10 – INDIAN ECONOMY

35	**Industrial sector depends on agri sector because-** ✓ Agri sector **provides food & other products** for consumption of ind. sector ✓ Agri sector **provides raw materials** for development of agro-based industries ✓ Agri sector **provides market** for industrial products
36	**III) SERVICE SECTOR** ➢ India has unique experience of **by-passing secondary sector** in growth trajectory by a **shift from agriculture to services sector.**
37	➢ **Service sector** refers to **industry producing intangible goods** (services) ➢ Its **largest sector of India** & is **55% of GVA**. ➢ It is **fastest growing sector** in India & has **highest labour productivity**. ➢ **India** is among **top 10** WTO members in **service exports and imports**. ➢ Services sector is **largest recipient of FDI inflows**. ➢ **100% foreign participation** in **telecommunication services** through Automatic Route. ➢ **FDI ceiling in insurance cos.** was raised to **74%**.
38	**Conclusion** **India Development Update (IDU)** of **World Bank** published in Nov 2022 → **India's** is relatively **more insulated from global spillovers** than other emerging markets

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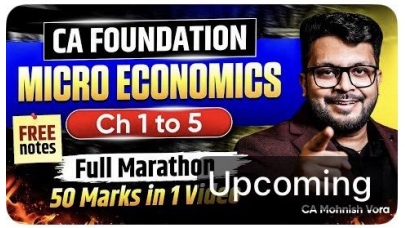

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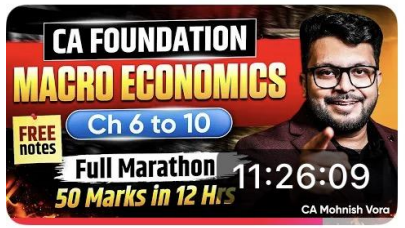

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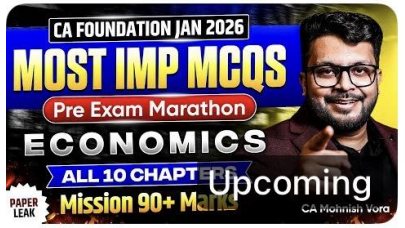

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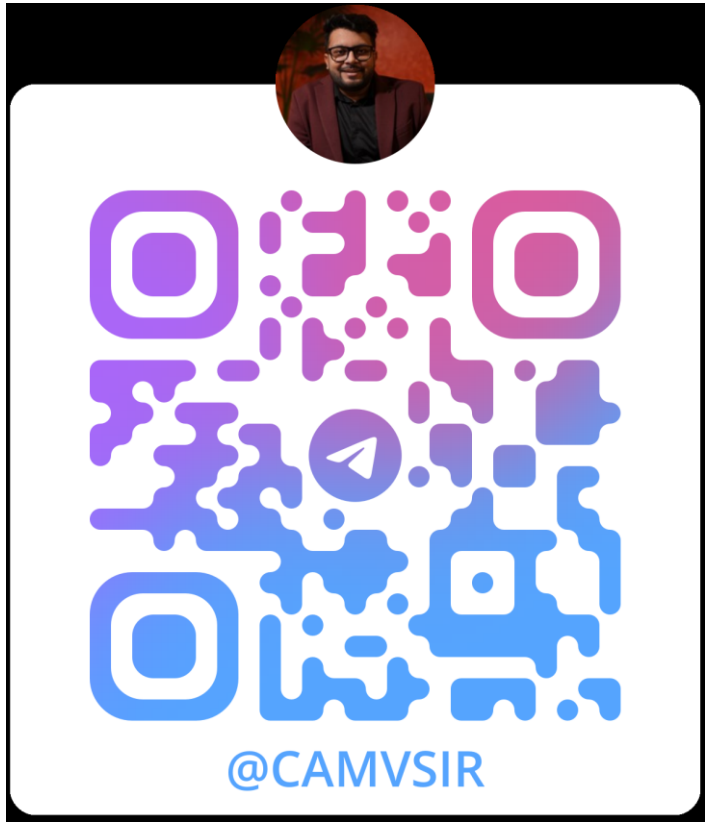

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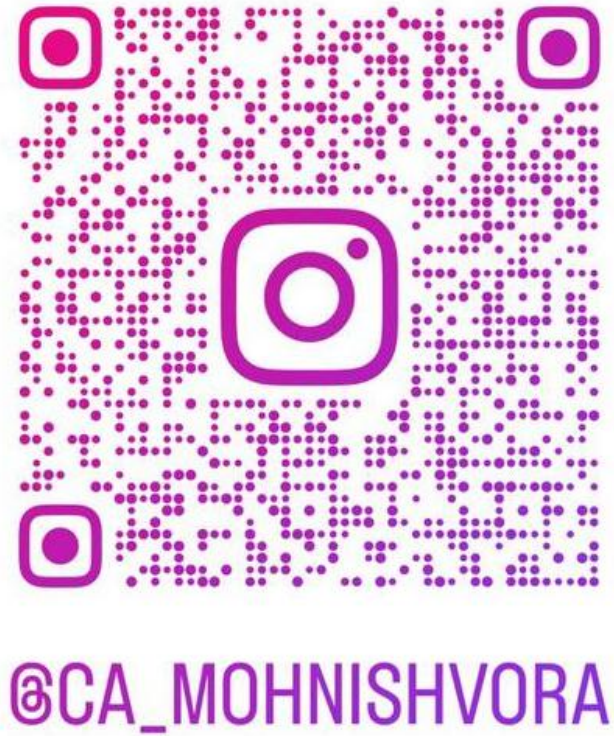

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