

CBSE Class–12 Economics
NCERT Solutions
Chapter-01 (Microeconomics)
Introduction

Question 1: Discuss the central problems of an economy.

Solution: An economy is a system of organizations and institutions that either facilitate or play a role in the production and distribution of goods and services in a society. We know that resources are limited as against unlimited wants, hence it is important to economise their use and utilize them in the most efficient manner.

Every economy faces three central problems due to multiplicity of wants, scarce availability of resources and problems of choice. This scarcity challenges the best possible usage of these available resources to fulfil the unlimited demands. The three central problems of an economy are as follows:

- (a) Problems of allocation of resources.
- (b) Problems of fuller and efficient utilisation of resources
- (c) Problems of growth of resources.

(a) **Problems of allocation of resources:** Every economy has limited resources which can alternatively be used for producing different goods and services. Every economy has to face three problems which we call allocation of resources. It is more elaborated in below mentioned points:

- **What to produce and in what quantities?** It is the problem of choosing the different items of goods and the quantities to produce with the available resources.

The very first problem encountered by any economy is to decide what goods are to be produced and in what quantities or amount with the limited resources. There is a lot to be decided; whether to produce consumer goods or capital goods; agricultural goods or investment goods; whether to cater education and healthcare sector or to strengthen country's military. An appropriate example was set by the Latin American nation Costa Rica; they dismantled their military in 1949 and invested the money, which earlier was spent on the maintenance of their army, on education and healthcare.

Once it is decided, what to produce, the next decision is to estimate the amount or quantity of the production. For e.g. if an economy decides to produce more of wheat

and cloth within a given period of time, then it will have to produce less of machines due to the limited resources available.

So the economy constantly struggles to choose what to produce and in what quantities.

- **How to produce?** This problem relates to the choice of technique i.e. labour intensive or capital intensive. For example production of cloth is possible either by handloom or by the use of modern machines. In labour intensive technique, proportion of labour is more (eg: production by handloom) and capital is less. With this technique, more employment can be generated.

In capital intensive technique, proportion of capital (eg production by machinery) is more and labour is less. It produces goods on large scale using high technology.

An economy should adopt that technique which gives **efficient production** at **minimum cost** and **best use of scarce resources**. Developed countries use capital intensive techniques whereas developing countries use more of labour intensive techniques.

- **For whom to produce?**

This problem refers to selection of category of people who will ultimately consume the goods i.e., the distribution of final goods and services.

It is the problem of deciding whether to produce for low income group or high-income group. It depends on the level and distribution of income and wealth. The objective behind selecting such mechanism is to reduce inequality of income, to reduce poverty and to add to the social welfare and standard of living of people.

This problem can be categorised under two main heads:

(a) **Personal Distribution:** It means how national income of an economy is distributed among different groups of people.

(b) **Functional Distribution:** It involves deciding the share of different factors of production in the total national product of the country.

(b) **Problem of efficient and fuller utilisation of resources:** Next problem with the economy is how to use its limited resources i.e., land, labour, capital and other resources so that maximum production at least cost can be produced.

If the resources are fully utilised, it will mean unemployment or underemployment of resources i.e., wastage of natural and human resources.

(c) **Problem of growth of resources:** Growth of resources has become a basic problem as the resources are scarce and they will have possibility of being exhausted after a continuous use. This objective can be achieved

by technological advancement. Under developed countries remain poor of poor growth of resources. Beside fuller utilisation, these countries should try to raise their productive capacities by exploring further availability of resources and discovering better techniques for their use.

Question 2: What do you mean by the production possibilities of an economy?

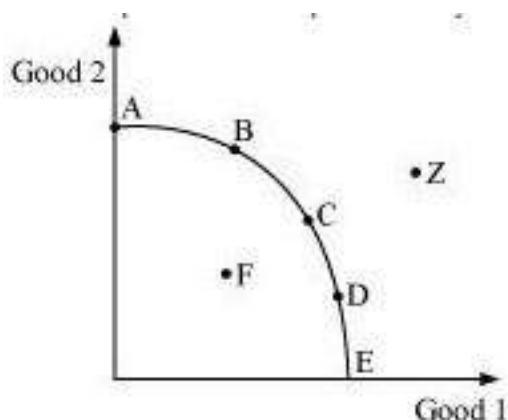
Solution: Production possibilities of an economy imply those numerous alternative combinations of goods and services, which a particular economy can produce, with the given technology/stock of technical knowledge and employing the available resources fully and efficiently. In other words, it refers to various feasible bundles of goods and services that can be produced together by efficiently utilizing the given technology and available resources.

Question 3: What is a production possibility frontier?

Solution: The production possibility frontier (PPF) refers to a curve that shows the various combinations of two goods that an economy can produce with the available technology and given resources which are fully and efficiently employed. It is also called production possibility curve (PPC) because it shows the limit of what is possible to produce with present resources.

Assumptions:

- (a) Productive resources are given in an economy.
- (b) All the resources are fully employed and efficiently utilised.
- (c) Techniques of production are given and do not change.
- (d) The resources are not equally efficient in production of all products.



All the points lying on the PPC, that is curve AE, are associated with different quantities of good 1 and good 2 produced, by employing the available resources fully and in an efficient manner. While any point lying under the curve, like F, depicts inefficiency or under utilisation of available resources. Whereas any point lying outside the curve, like Z, depicts over utilisation of the available endowment of resources and technology;

making it non- feasible.

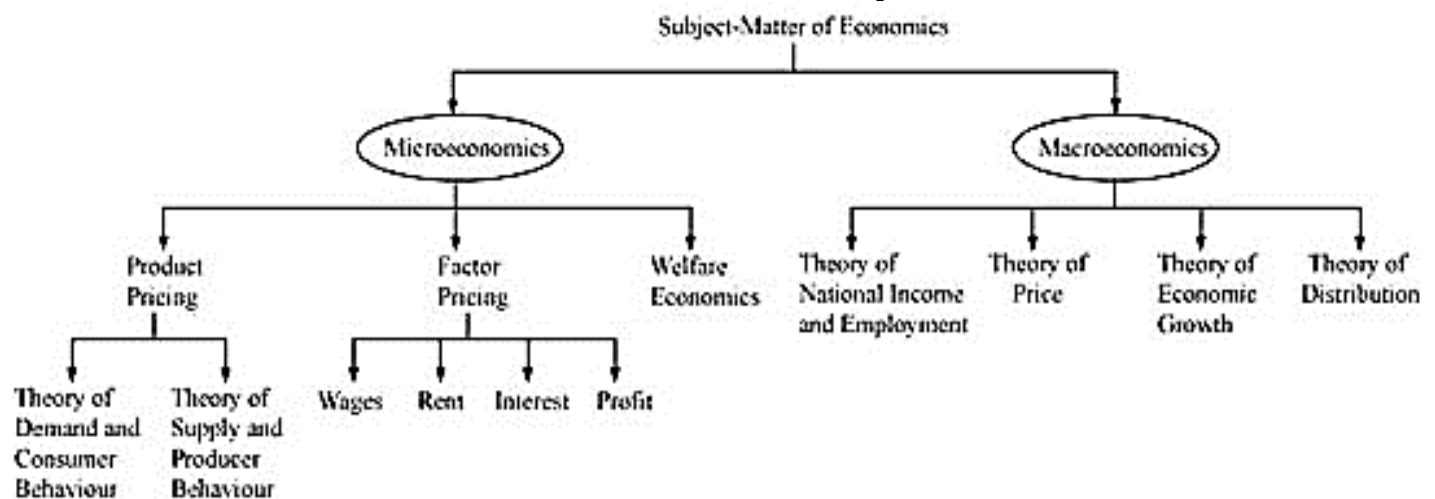
This graph shows as we increase the production of Good 1, the production of Good 2 falls as there are limited resources in the economy. It means resources are transferred to the production of Good 1 by withdrawing them from Good 2 i.e., one commodity is transformed into the other, not physically but by transferring resources. Therefore, it is also called 'transformation curve'.

Thus, PPF or PPC refers to a graphical representation of all the possible combinations of two products that can be produced with the given resources and technology.

Question 4: Discuss the subject matter of economics.

Solution: The subject matter of economics is sub-divided into two core branches, Micro Economics and Macro Economics. This division came into existence only after the year 1930 as per the suggestion by Ragnar Frisch.

The domains of interest of these two branches of economics can be presented as



Microeconomics is the study of individual economic units, i.e. the behaviour of consumers and firms. The study of how they utilise the given resources in the best possible manner in order to maximise their rational objectives falls under the domain of microeconomics.

It is also the study of demand and supply and how their interaction determines prices of various goods and services. Microeconomics helps in solving the three central problems of an economy.

It is also called the Price theory as it primarily focuses on how prices are determined both in commodity and factor markets. Here demand and supply are main tools of analysis. Its main tools are individual income, individual expenditure.

It is also termed as Factor theory or micro theory of distribution as it includes the determination of wages,

rent, interest and profit.

In Macroeconomics we study how the economy as a whole operates. It focuses on the determination of the aggregate measures, like aggregate demand, aggregate supply and overall price level and how they change over time. It is also known as the Theory of Income and Employment as its main focus is on how income and employment levels are determined. Macroeconomics helps in understanding and solving problems like inflation, unemployment, Balance of Payments (BOP) disequilibrium, poverty, etc. Aggregate Demand and Aggregate supply are the main tools of analysis.

Question 5: Distinguish between a centrally planned economy and a market economy.

Solution:

	Points of Difference	Centrally Planned Economy	Market Economy
1.	Meaning	In centrally planned economy, things are controlled by central authority with the objective of achieving definite targets.	In market economy, things are controlled by capitalists who aims at maximising profits.
2.	Ownership of factors of production	Here Factors/ all means of production are publicly owned; i.e., public ownership.	Here Factors (land, labour, capital and enterprise) of production are privately owned.
3.	Production motive	The motive of production is social welfare.	The main motive is profit making.
4.	Governing factor	The production is governed by planning mechanism; i.e. according to the government plans.	The production is governed by price mechanism; i.e., by demand and supply.
5.	Income distribution	The degree of inequality of income is low.	There exists unequal distribution of income.

6.	Government's role	The main role is played by the government from production to distribution.	The main role is played by private players. They decide what to produce, while the role of a government is limited to maintaining law and order in the nation.
7.	Alternative name	It is also known as controlled economy.	It is known as free economy.

Question 6: What do you understand by positive economic analysis?

Solution: Positive economic analysis refers to the analysis in which we study what is or how an economic problem is solved by analyzing various positive statements and mechanisms. In other words, it is also called cause and effect relationship. It states 'what is'

These are factual statements and describe what was, what is and what would be. These statements can be tested, proven or disproven and do not involve personal value judgments. For example, if someone says that it is raining outside, then the truth of this statement can be verified. It deals with actual or realistic situations. Economists like Lionel Robbins considers economics as pure science. Other examples can be taken as India is overpopulated country, India has mixed economy, etc

Question 7: What do you understand by normative economic analysis?

Solution: Normative economic analysis refers to the analysis in which we study whether a particular mechanism is desirable or not. In this analysis, we study 'what ought to be' the desired situation or in what ways the economic problems should be solved. It suggests aims and objectives for the economy and points out what ought to be done to achieve these aims and objectives. In normative economic analysis, we come across normative statements that cannot be tested as they involve personal value judgments. It deals with idealistic situations and is based on ethics. An example of a normative statement could be, 'Central government should not stop providing minimum support price to the farmers'. Other example can be Government should encourage private companies to accelerate pace of industrialization. Economists like Marshall, Pigou etc. regard economics as a normative science.

Question 8: Distinguish between microeconomics and macroeconomics.

Solution:

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

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