Unit II: "Determination of Income and Employment"

📘 Solved Textual Q&A – Chapter: Determination of Income and Employment

A. 1-Mark Very Short Answers

Q No.	Question	Answer
1	Define aggregate demand (AD) in a two-sector economy.	AD = Consumption (C) + Investment (I)
2	What is marginal propensity to consume (MPC)?	MPC = ΔC / ΔY; change in consumption divided by change in income
3	How is marginal propensity to save (MPS) related to MPC?	MPC + MPS = 1
4	Define effective demand.	Effective demand is the level where aggregate demand equals aggregate supply—the intersection point
5	What is the 'paradox of thrift'?	When individuals save more, aggregate consumption falls, reducing income and savings at the macro level

B. Short Answer (2–3 Marks)

1. **Difference between ex-ante and ex-post investment.**
   – *Ex-ante* is planned investment; *ex-post* is actually realized investment during the period.

2. **Explain consumption function.**
   – C = a + bYd, where ‘a’ = autonomous consumption and ‘b’ = MPC × disposable income (Yd).
3. **Define investment multiplier.**
   – K = 1 / MPS; it shows how initial change in investment leads to greater change in income.
4. **What is full employment?**
   – The level of employment where every person willing and able to work at prevailing wage rates can find employment.
5. **Define deficiency of demand.**
   – When aggregate demand is lower than aggregate supply; leads to unemployment and idle capacity.

C. Long Answer (4–6 Marks)

1. **Explain aggregate demand and aggregate supply in the two-sector model.**
   – Aggregate Demand = C + I; Aggregate Supply = Output produced by firms equals national income. Equilibrium occurs when AD = AS.
2. **Describe how equilibrium income is determined using the AD-AS approach.**
   – Equilibrium at point where AD and AS intersect. If AD < AS, inventory rises, firms cut production; if AD > AS, firms expand output.
3. **What is the consumption function? Explain with an equation and diagram.**
   – C = a + bY; slope = MPC. The function shows relationship between consumption and income. An upward shift indicates increase in autonomous consumption.

4. **Elaborate on the working of the investment multiplier.**
   – A rise in autonomous investment causes income to rise repeatedly through successive rounds of spending: $\Delta Y = k \times \Delta I$, where $k = 1/MPS$.
5. **Explain the paradox of thrift and its macro implications.**
   – When everyone saves more, overall consumption falls, reducing AD, income, and saving—negating the intended gain.

✍️ 20 Additional Model Questions & Answers

🔹 Short Answer (2–3 Marks)

1. **Find APC + APS when APC = 0.8.**
   – APS = 0.2; APC + APS = 1
2. **If autonomous consumption = ₹200, MPC = 0.6, and Y = ₹1000, find consumption (C).**
   – C = 200 + 0.6 × 1000 = ₹ 800
3. **Explain ex-cess demand and its effect on employment.**
   – AD > AS: firms produce more, reduce unemployment, but may lead to inflation.
4. **Define involuntary unemployment.**
   – People willing to work at the prevailing wage rate yet unable to find jobs.
5. **Why is price level assumed constant in this model?**
   – To isolate real output and income effects; prices don’t change, so demand shifts affect output, not inflation.
6. **What happens when MPS is 0.25 and investment rises by ₹100?**
   – Multiplier K = 1/0.25 = 4; income rises by ₹400.

7. **What is short-period equilibrium output?**
   – Output level where planned AD equals AS for that period with fixed factors.

8. **How does a parametric shift impact the AD curve?**
   – A change in autonomous variables (consumption, investment) shifts AD curve upward or downward.

9. **Which component of AD is autonomous?**
   – Consumption when income = 0 (autonomous consumption) and investment (assumed autonomous).

10. **Why are government spending and taxes excluded in this two-sector model?**
    – Because model includes only households and firms; government sector is excluded for simplicity.

- **Long Answer (4–6 Marks)**

11. **Derive equilibrium income when C = 100 + 0.75Y and I = ₹1000.**
    – Y = C + I → Y = 100 + 0.75Y + 1000 → 0.25Y = 1100 → Y = ₹4400; C = 100 + 0.75×4400 = ₹3400

12. **Discuss the role of MPC in determining the size of multiplier.**
    – A higher MPC (lower MPS) → higher multiplier and bigger impact of investment expenditure on income.

13. **Explain equilibrium and disequilibrium with graphs.**
    – Show AD and AS curves. Equilibrium at intersection. If AD > AS, points above equilibrium show under-supply. If AD < AS, points below equilibrium show over-supply.

14. **Compare voluntary vs involuntary unemployment.**
    – Voluntary: choosing not to work at prevailing wages. Involuntary: willing but cannot find employment.

15. **How can the economy correct deficiency of demand?**
– Increase government spending, reduce taxes, or expand money supply to boost AD and employment.

16. **What policy measures address excess demand?**
– Reduce aggregate demand with tax hikes, lower government spending, or restrict money supply.

17. **Explain the concept of full employment in context of Keynesian model.**
– Level of output at which effective demand equals full employment output—no cyclical unemployment.

18. **State the assumptions of the two-sector Keynesian model.**
– No government, closed economy, constant price level, fixed interest rate, full-capacity firms adjust output.

19. **Analyze how an increase in investment shifts equilibrium.**
– AD curve shifts upward; income rises by multiplier times investment; employment increases accordingly.

20. **Summarize limitations of the model in real economies.**
– Ignores taxes, government and foreign trade sector, assumes constant prices and interest rate, doesn't account for supply constraints or inflation.