Chapter-1 : Nature & Rationale of Economics

Topic-1: Defination & Subject Matter of Economics

Definition of Economics

The term "Economics" was originally derived from the two Greek word "Oikos" which means household and "Nemein" which means management. Thus, it refers to managing of a household using the limited funds.

Main Definitions of Economics

Wealth Definition	Welfare Definition	Scarcity Definition	Growth Definition
Economics is the science that studies production and consumption of wealth	Economics studies those economic activities of a social man which are concerned with attainment and use of material requisites of well-being	Economics is the study of human behaviour as a relationship between ends and scarce means having their alternative uses.	Economics is a Science that suggests the ways and means of how the scarce means to be used to accelerate the rate of economic development and to attain higher living standard.

Wealth or classical Definition of economics

In this category, the definitions of economics as given by Adam Smith (1723-99) and his followers are included. Adam Smith, the father of modern economics, in his book 'An Enquiry into the Nature and Causes of Wealth of Nations' (1776) defined economics as the Science of Wealth.

"Economics is the science which treats of wealth." **J.B. Say**

"Economics investigates the nature of wealth and the laws of its production and distribution." **J.S. Mill**

Following are the main features of wealth definition:

Study of Wealth
Study of Material Goods Only
Study of Causes of Wealth
Study of Tangible goods only
Much Emphasis on Wealth

Wealth definition has been criticized on the following grounds –

Too Much Stress on Wealth
Only Material Goods.
Neglect of Human Welfare
Concept of Economic Man
Neglect of Means

Welfare or Neo classical Definition of economics

Prof. Marshall (1842 – 1924), in his book 'Principles of Economics' which was published in 1890, gave a material welfare definition of economics. In this definition, he gave more importance to human welfare in comparison to wealth

"The range of our enquiry becomes restricted to that part of social welfare that can be brought directly or indirectly into relation with measuring rod of money." **Prof. Pigou**

According to **Prof. Cannon,** the aim of political economy is the explanation of the general causes on which the material welfare of human beings depends."

Features – The main features of material welfare definitions are as follows-

1. Study of mankind
2. Study of Ordinary Business of Life Material Requisites Study of Real Man

Material welfare definitions deal with economics both as a science and an art. Economics is a science because it makes a systematic study of human activities relating to material welfare. It is an art because it tells us how to achieve the welfare of man and society.

Criticism of Welfare Definition

1. Study of All Types of Economic Activity and Men
2. Restricts the Scope of Economics.
3. Difficult to Measure Welfare
4. Economics is a Pure Science
5. Impracticable

Scarcity Definition or Science of choice making

Prof. Robbins not only criticized Marshall's definition but also gave his own definition which is known as scarcity definition. He gave this definition in his book 'an Essay on the Nature and Significance of Economic Science' which was published in 1932. According to his definition, economics studies those activities of human beings which they perform to obtain scarce means having alternative uses in order to satisfy their unlimited wants. Thus, economics studies human behavior as relationship between unlimited wants and scarce means which are capable of being alternatively used. Scarcity of means, in relation to unlimited wants, leads to the problem of making a choice, i.e., economic problem. Hence, economic problem is the central idea in Robins' definitions.

Many economists like Stigler, Samuelson, Macifie, Oscar Lange, Sciovosky, have supported Robbins' definition of economics –

1. "Economics is fundamentally a study of scarcity and the problems which scarcity rise to." **-Stonier and Hagur**
2. "Economic is a science concerned with the administration of scarce resources." **-Scitovosky**

Features

Following are the main features of Robbins' definition –

1. Economics is a Science
2. Human Behaviour
3. Unlimited Ends
4. Scarce Means
5. Alternative Uses of Means
6. Science of choice (or Science of Scarcity)

Criticisms of scarcity defination

Though the definition given by Robbins is logical and scientific yet it has been criticized by several economists on the following grounds:

1. Prof. Robbins has contradicted himself by giving two different views. On the one hand, he regards economics as neutral between ends while, on the other, he considers economics as a science of choice.
2. If we accept neutrality of economics towards ends, then the study of economics will be of no use. We are interested only in that science which can help to solve our economic problems.
3. According to Robbins, economics is the study of all human activities which are related to the problem of choice. The problem of choice as such is faced not only by the social beings but also by the non-social beings like saints and smugglers. Their inclusion makes the scope of economics too wide to be explained.
4. Economic problems also originate from factors other than scarcity which Robbins as not brought to the surface. The great depression of 1929-33 has proved that economic problems may also arise due to abundance.
5. It is not applicable to rich countries where economic problems may be due to high incomes rather than scarcity.
6. According to Prof. Maurice Dobb, Robbins definition of economics is not applicable to socialist countries (like that of China) where economic activities are subject to government control and regulation

Growth Definition

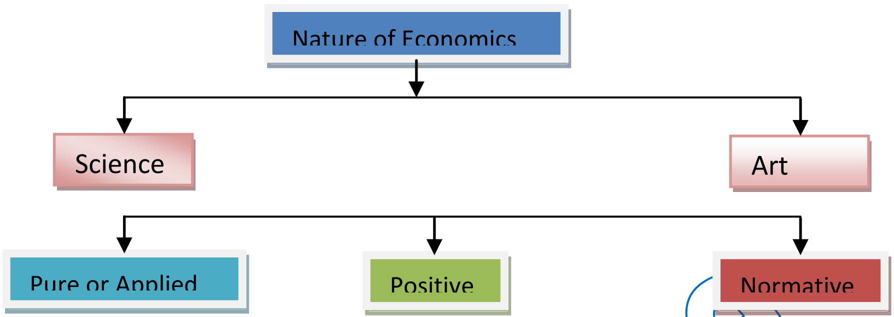
According to Prof. Samuelson, "Economics is the study of how man and society choose, with or without the use of money, to employ scarce productive resources, which could have alternative uses, to produce various commodities over time and distribute them for consumption now and in the future among various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

The main features of this definition are as follows –

1. Samuelson has emphasized the need of choice which arises due to unlimited wants and scarcity of resources.
2. Growth definition not only lays stress on the allocation of resources but also on their proper utilization n so that more wants could be satisfied.
3. According to Samuelson, available resources should not only be used properly, but efforts should also be made to increase them as to satisfy ever increasing wants.
4. Economics is not only concerned with the identification of economic problems but it should also suggest ways and means to solve them.
5. It is a growth oriented definition which says that economics is concerned with determining the pattern of employment of scarce resources to produce goods over tome. Thus, growth definition studies the problem of an economy not at a point of time but over a period of time. Thus, economics is not only concerned with the present pattern of consumption but also with future consumption.

In short, Samuelson's definition of economics is the most comprehensive of all earlier definitions. It includes all the issues which were highlighted in the earlier definitions on the one hand, and the issues of economic development on the other.

Nature of Economics



Marshall has rightly observed that –
"Economics is therefore a science pure and applied rather than a Science and an Art".

Economics as a Science

1) In simple words, a science is commonly defined as a systematic body of knowledge about a particular branch of the universe. This implies that a science is a study of a branch of learning and not of the whole universe.
2) In the opinion of Poincare who says – "A science is built upon facts as a house is built of stones."
3) Applying this is to our subject, we find economics is built upon facts, examined and systematized by economists. Further, economics like other science deduce conclusion or generalizations after observing, collecting and examining facts. Thus, it deals with (i) observation of facts. (ii) Measurement (iii) Explanation (iv) Verification. In short, it formulates economic laws about human behaviour. In this way economics has developed into a science of making and possessing laws for itself
4) Science economics satisfies all the tests of a science, economics is regarded as a full-fledged, science. In short, it is no way less than other sciences.

The economics as a science can be divided into two parts i.e. (a) Positive Science and (b) Normative Science.

I. **Economics as a Positive Science –** A positive science establishes a relation between cause and effect. It tells us that if we do a certain thing, same result will follow –
In the words of Prof. J.M. Keynes –
"A positive science may be defined as a body of systematized knowledge concerning what is a normative science or regulative science relating to the criteria of what it ought to be."
II. **Economics as A Normative Science –** Marshall, Pigou and historical school puts the arguments that economics is normative science.
According to Marshall –
"Economics is a normative science because it has a norm viz; welfare."

In the opinion of Keynes,
"A normative science or regulative science is a body of systematized knowledge concerning with the criterion of 'what ought to be' and concerned with the deal distinguished from the factual."

Therefore, a normative science describes what should be done and what should not be done.
From the above noted discussion, we can say that economics is both positive and normative science as at present, it deals with 'what is' and 'what ought to be'. Therefore, it not only focuses why certain things happen, it also conveys whether it is the right thing to happen.

Economics as an art

Art is completely different from science.

1) In the words of Cossa – "A science teaches us to know; an art teaches up to do. In other words, science explains and expounds; art directs, art imposes precepts or proposes rules."In other words, science is theoretical but an art is political.
2) What is an Art? As J.M. Keynes has put it: "An art is a system of rules for the attainment of a given end".The object of an art is the formulation of precepts applicable to policy. This implies that art is practical. Applying this definition of art, we can say it is an art. Its several branches like I consumption, production and public finance provide practical guidance to solve economic problems. Again for example the theory of consumption guides the consumer to obtain maximum satisfaction with his given income (means). In this sense, economics can be considered as an art in the wider sense of the term art i.e. in the sense of practical science. It means creation or practical application of knowledge. It is for this reason; we treat economics as an art.

In the words of Pigou –

"Economics has given us light (i.e., knowledge) and also fruit it is light bearing (as such, it is a Science) and also fruit bearing (as such, it is an Art). Economics is not a science only or a art only, but it is both a science and an art."

Economics, Both a Science and an Art

1) Many economists do not consider Economics as an Art. They believe that its function is to merely investigate, explore and explain the various interrelated aspects and has to do nothing in solving the practical problems.
2) But the careful study shows that Economics does help in solving practical problems in several cases, and so has the practical utility also. Thus, it can rightly be said that Economics is a science as well as an art.

In a nutshell, we can conclude the discussion that economics is both science and art.

<u>Microeconomics v/s Macroeconomics</u>

S.No.	Points	Microeconomics	Macroeconomics
1	**Study**	It studies individual unit	It studies aggregate or group of individual units.
2	**Assumption**	At micro level full employment is assumed which is never found in an economy. Hence this is an unreal assumption	At macro level, full employment is not assumed. Instead equilibrium employment is assumed which is a real assumption.
3	**Subject Matter**	We study demand supply, consumer behavior production, types of market, theory of cost & revenue etc.	We study national income, theory of wage, interest & employment. Theory of money, theory of international trade etc.
4	**Applicability**	It is useful in analysis of an individual unit like cost of an individual good, demand of a single good, price of a single good.	It is useful in analysis of aggregate units such as aggregate demand, aggregate prices or inflation-deflation, aggregate or national income etc.
5	**Usefulness to Govt.**	It is less useful to Govt. in formulating economic policies.	It is more useful to Govt. in formulating economic policies.

Interdependence between Micro and Macro Economics

1) Actually micro and macro economics are interdependent. There is a two way relationships between the two. Macro economics is some spheres depends on micro economics. In fact, in recent years, micro foundations of macro economics have been greatly highlighted. On the other hand, micro economics too is dependent on macro economics in some crucial respects.

2) **Dependence of Macro economics on Micro economics.** The theories regarding the behaviour of some macroeconomic aggregates are derived from theories of individual behaviour. For instance, the theory of investment, which is a part and parcel of the macro economics theory, is derived from the behaviour of individual entrepreneur.

3) Micro economics theory contributes to macro economic theory in another way also. The theory of relative prices of products and factors is essential for explanation of the determination of general price level

4) **Dependence of Micro economics on Macro economics**. Not only does macro economics depend upon to some extent on micro economics, microeconomics also depends upon to some extent on macro economics. The determination of the rate of profit and the rate of interest are well known micro economics topics, but they greatly depend upon the macro economics aggregates.

5) It follows that through micro economics and macro economics deal with different subjects, there is great interdependence between them. In the explanation of many economic phenomena, both micro and macroeconomic tools and concepts have to be applied.

Topic-2: Concentration of Economic Power

Meaning of Concentration

- **The term "concentration of economic power" means the economic position which enables a concern to command control over production or market, exchange or employment in respect of any goods of services.**

- **C.N. Vakil has defined the term concentration of economic power as "the capacity to influence economic decision affecting the lives of large numbers of people, which is wielded by one pr more persons, who have somehow obtained such capacity. For example, a dictator who has complete political power over his country has also the capacity to take decisions influencing the economic life of the people over whom he rules.**

- **Economic power may also be concentrated in the hands of a few persons who, because of their control of the production of certain goods are in a position to decide their prices irrespective of the interests of the consumer. Economic power is also concentrated in modern times in the hands of larger, well-organized trade unions or employers, either Government or private in their own interest by joint action and coercion which usually results in deadlock of economic activity".**

Types of Concentration

According to the report of the Monopolies Enquiry Commission, under the chairmanship of K.G. Dasgupta in 1964, there are two types of concentration:

1. **Country- Wise Concentration –** It is a situation where a large number of concerns engaged in the production or distribution of different commodities are in the controlling hands of one individual or family or business group.
2. **Product- Wise Concentration –** It is a situation where the production and distribution of a commodity or service is controlled by a single concern or by a comparatively limited number of concerns which are, in their turn, controlled by a single family or a few families.

Forms-According to MRTP Act

1. **Considerable Share of Productive Capacity –** If an undertakings, either by itself or together with its inter-connected undertaking, has a licensed capacity for the production of any goods which is equivalent to not less then one-fourth of-the total installed capacity in India for the production of such goods, the undertaking wm be deemed to be a dominant undertaking.
2. **Control Over Market** – If an undertaking, either by itself or together with its inter-connected undertakings, controls not less than one fourth of the total supply of distribution of any service in India, it wm be regarded as a dominant undertaking.
3. **Considerable Share of Employment** – The percentage of the total number of workers in the industry employed by a concern is sometimes taken to decide the extent of its economic dominance. For example, prior to the amendment of 1982, the number of workers employed was one of the criteria used by the MRTP Act to describe an undertaking as a dominant undertaking or as a monopolistic undertaking.
4. **Large Assets** – The value of the assets of a concern gives some indication of the economic power it wields. It has been said that, in India, there is a tendency to equate the size of assets with monopoly.

Causes of Concentration

The Monopolies Inquiry Commission (MIC) bas mention the following cases of concentration of economic power:

1. **Growth of Joint Stock Companies & Technological Advances-** The development of the joint stock form of business and the economies of scale arising out of technological advances are among the main causes of the growth of the concentration of economic power.
2. **Inter-Connections** – Inter-company investments, interlocking of directors, mergers. Amalgamation, etc. have contributed to the concentration of economic power.
3. **Inherent Opportunities** – In India, after independence, the very forces which were harnessed to accelerate the pace of industrialization of the country, worked, at the same time, to concentrate power in industry in a few individuals or families who were already wealthy and powerful.
4. **Assistance From Financial Institutions** – the advantage of big business over small business in obtaining assistance from banks and other financial institutions has also contributed to concentration of economic power. Some big businesses had representatives on the Board of Directors of some of the banks.

The operation of the economic system, with its criterion of credit-worthiness and security lending, supported the large and established enterprises against the small and struggling enterprises.

5. **Controls** – the system of industrial licensing, import restrictions, exchange controls, etc. has helped big business by restricting the freedom of entry. Big business groups were in a comparative advantageous position as the licensing authority preferred men of proven business ability. Big business house attempted to pre-empt capacity by obtaining multiple licenses for the same product. The ability of big businessmen to secure foreign collaboration was a reason for their success in setting new licenses.
6. **Managing Agency** – Supplying managerial skill in different from and diverse was the managing agency system has proved a fruitful source of concentration of economic power.

Remedial Measures (How to Control concentration of Economic power?)

1. Regulation of Private Business

(i) **The MRTP Act –** It has been designed with the main objective of the prevention of concentration of economic power to the common detriment, and the control of monopolistic and restrictive trade practices that are prejudicial to public interest. It provides that mergers, amalgamation, take-overs, and substantial expansion by dominant and large undertakings can only be effected with the prior approval of the Government.

(ii) **The Companies Act –** It empowers the Government to regulate the formation of managerial, administrative and financial integration and inter company investments.

(iii) **The Industries (Development and Regulation) Act (IDRA) –** It empowers the Government to regulate the establishment of new undertakings, substantial expansion of the manufacture of a new article, etc and to regulate or restrict the role of different categories of undertakings-private, joint and cooperative, and small and large. It empowers the Government to exercise control over the management or to take over the management of any undertaking in the public interest.

(iv) **The Essential Commodities Act –** It empowers the Government to regulate the quality and quantity of output, price and distribution of any commodities that may be notified by it. The nomination of Government representatives or of those of financial institutions on the management board of industrial undertakings and the power of financial institutions to exercise the convertibility option have also been designed to regulate the functioning of the large private sector undertakings.

(v) **The Capital Issues (Control) Act and Securities Contracts (Regulation) Act –** It empowers the Government to regulate the financing and capital structure of private cooperate enterprises and to influence the ownership pattern of the share capital. The new guidelines for listings securities, announced in November 1982, aim at preventing undue concentration of shares in a limited number of hands.

2. Encouragement of Small & New Entrepreneurs – To encourage small and new entrepreneurs and to restrict the role of the large industrial houses, the Licensing Policy announced in 1970 made it clear that the role of the large industrial houses would be restricted mostly to the core and heavy investment sectors. The role of the large-scale sector was further restricted by reserving a large number of items for exclusive manufacture in the small-scale sector.

3. Expansion of Public, Co-operative & Joint Sectors – The major objectives of the public sector include control of the commanding heights of the economy and effective competition to the private sector. According to the Industrial Policy Resolution, the future development of the most important 17 industries has been the exclusive right of the state; and in 12 other industries, the state is to play an active role. Further, the state has the right to enter any other industry. Thus, the public sector has been assigned a dominate role. This role has been expanding in the distribution of essential goods. It is demanded that the public sector should enter the consumer goods sector in big way. The growth of co-operative sector will reduce the concentration of economic power.

4. Ceiling on Property – Ceiling on income and property also prevent concentration. It may, however, discourage hard work, investment and growth.

5. Progressive Taxation – Progressive taxation can also check the concentration of economic power, though high ratio of tax may become a disincentive for investment and encourage tax evasion.

6. Other Measures

(i) Liberalization of Imports;
(ii) Non acceptance of financial and other assistance by political parties from business houses;
(iii) Consumer association to protect the right of consumers, and
(iv) Abolition of corruption from administrative machinery.

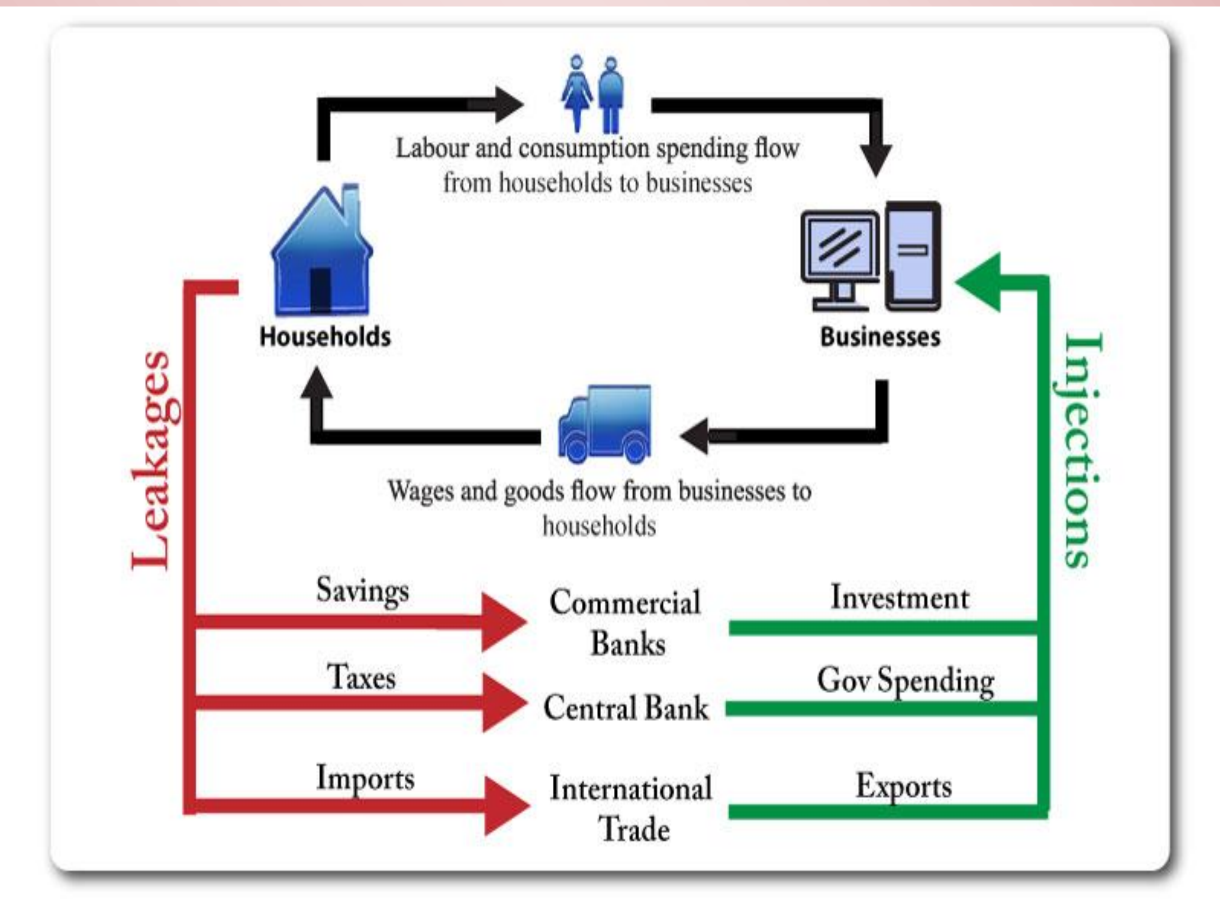
Topic-3: Economic Systems,Socialist,Capitalist & Mixed.

Meaning of an Economy

An economy is a man-made organization for the satisfaction of human wants. According to A.J. Brown, "An economy is a system by which people get living". The way man attempts to get a living differs in major respects from time to time and from place to place. In primitive times 'get a living' was simple but with growth of civilization it has become much more complex. Here it is important to note that the way person earns his/her living must be legal and fair. Unfair and illegal means such as robbery, smuggling may earn income for oneself but should not be taken into consideration as gainful economic activity or a system of 'get a living'. **It will therefore be appropriate to call that economy is a framework where all economic activities are carried out**

Circular Flow of Goods and Money in an Economic System

Every economy is a system in which the production of many goods is organized to satisfy many wants of human beings. In an economic system, the two economic units namely households and enterprises are linked by a circular pattern of economic activities as illustrated in Figure The choices and decisions of these two main units are the deriving forces of economic activity



Types of Economic System

- Capitalist Economy
- Socialist Economy
- Mixed Economy

Capitalist Economy

The capitalist or free enterprise economy is the oldest form of economy. Earlier economists supported the policy of 'laissez fair' meaning leave free. They advocated minimum government intervention in the economic activities.

The following are the main features of a capitalist economy;

1) Private property

- In a capitalism system all the individuals have the right to own property. An individual can acquire property and use it for the benefit of his own family.

- There is no restriction on the ownership of land, machines, mines, factories and to earn profit and accumulate wealth. After the death of a person the property or wealth is transferred to the legal heirs.
- Thus the institution of private property is sustained over time by the right of inheritance.

2) **Freedom of enterprise**

- Freedom of enterprise implies that business firms are free to acquire resources and use them in the production of any good or service. The firms are also free to sell their product in the markets of their choice.

- In a capitalist economy the government does not coordinate production decisions of the citizens. Individuals are free to choose any occupation.

- A worker is free to choose his/her employer. Government or any other agency does not impose restrictions/obstacles in the way of workers to enter or leave a particular industry. A worker chooses that occupation where his income
- is maximum.

3) Consumer's Sovereignty

- In a capitalist economy consumers are like a king. They have the full freedom to spend their income on goods and services that give them maximum satisfaction. In capitalist system production is guided by consumer's choices. This freedom of consumers is called consumer's sovereignty

4) Profit Motive

- Self-interest is the guiding principle in capitalism. Entrepreneurs know that they will own the profit or loss after the payment to all other factors of production.

- Therefore they are always motivated to maximize their residual profit by minimizing cost and maximizing revenue. This makes the capitalist economy an efficient and self-regulated economy.

5) Competition

- There are no restrictions on the entry and exit of firms in a capitalism system. The large number of producers are available to supply a particular good or service and therefore no firm can earn more than normal profit.

- Competition is the fundamental feature of capitalist economy and essential to safeguard against consumer's exploitation. Although due to large-size and product distinction monopolistic tendencies have grown these days still the competition can be seen among a large number of firms.

6) Importance of markets and prices

- The important features of capitalism like private property, freedom of choice, profit motive and competition make a room for free and efficient functioning of price mechanism.

- Capitalism is essentially a market economy where every commodity has a price. The forces of demand and supply in an industry determine this price. Firms which are able to adjust at a given price earn normal profit and those who fail to do so often quit the industry. A producer will produce those goods, which give him more profit.

7) Absence of government interference

In a free enterprise or capitalist economy the price system plays an important role of coordinating agent. Government intervention and support is not required. The role of government is to help in free and efficient functioning of the markets.

8) Capitalism in today's world

Pure capitalism is not seen in the world now-a-days. The economies of USA, UK, France, Netherland, Spain, Portugal, Australia ect. are known as capitalistic countries with active role of their respective government in economic development.

Socialist- Economy

In the socialist or centrally planned economies all the productive resources are owned and controlled by the government in the overall interest of the society. A central planning authority takes the decisions.

1) Collective Ownership of means of Production

- In a Socialist economy means of production are owned by the government on behalf of the people.
- The institution of private property is abolished and no individual is allowed to own any production unit and accumulate wealth and transfer it to their heirs.
- However, people may own some durable consumer goods for their personal use

2) Social Welfare Objective

- The decisions are taken by the government at macro level with the objective of maximization of social welfare in mind rather than maximization of individual profit.
- The forces of demand and supply do not play any important role. Careful decisions are taken with the welfare objectives in mind.

3) Central Planning

Economic planning is an essential feature of a socialist economy.. Government takes all economic decisions regarding production, consumption and investment keeping in mind the present and future needs.

The Central Planning Authority keeping the national priorities and availability of resources in mind allocates resources The planning authorities fix targets for various sectors and ensure efficient utilization of resources.

4) Reduction in Inequalities

- The institutions of private property and inheritance are at the root of inequalities of income and wealth in a capitalist economy. By abolishing these twin institutions a socialist economic system is able to reduce the inequalities of incomes.

5) No class conflict

- In capitalist economy the interests of the workers and management are different. Both of them want to maximize their own individual profit or earnings. This results in class conflict in capitalist economy.
- In socialism there is no competition among classes. Every person is a worker so there is no class conflict. All are co-workers.

6) Socialism in today's world

- Countries such as Russia, China and many eastern European countries are said to be socialist countries. But they are changing now and encouraging liberalisation in their countries for their economic development.

Socialist- Economy

A mixed economy combines the best features of capitalism and socialism. Thus mixed economy has some elements of both free enterprise or capitalist economy as well as a government controlled socialist economy. The public and private sectors co-exist in mixed economies.

The main characteristics of a mixed economy are as follows:

1) Co-existence of public and private sectors.

- The private sector consists of production units that are owned privately and work on the basis of profit motive. The public sector consists of production units owned by the government and works on the basis of social welfare.

- The areas of economic activities of each sector are generally demarcated. Government uses its various policies e.g. licensing policy, taxation policy, price policy, monetary policy and fiscal policy to control and regulate the private sector.

2) Individual Freedom with some government restrictions

- Individuals take up economic activities to maximize their personal income. They are free to choose any occupation and consume as per their choice. But producers are not given the freedom to exploit consumers and labourers. Government puts some restrictions keeping in mind the welfare of the people.

- For instance, government may put restrictions on the production and consumption of harmful goods. But within rules, regulations and restrictions imposed by the government, for the welfare of the society the private sector enjoys complete freedom.

3) Economic Planning

The government prepares long-term plans and decides the roles to be played by the private and public sectors in the development of the economy. The public sector is under direct control of the government as such production targets and plans are formulated for them directly. The private sector is provided encouragement, incentives, support and subsidies to work as per national priorities.

4) Price Mechanism

- Prices play a significant role in the allocation of resources. For some sectors the policy of administered prices is adopted.

- Government also provides price subsidies to help the target group. The aim of the government is to maximize the welfare of the masses. For those who can not afford to purchase the goods at market prices, government makes the goods available either free of cost or at below market (subsidized) prices.

- Thus in a mixed economy people at large enjoy individual freedom and government support to protect the interests of weaker sections of the society.

- Indian economy is considered a mixed economy as it has well defined areas for functioning of public and private sectors and economic planning. Even countries such as USA, UK, etc. which were known as capitalistic countries are also called mixed economies now because of active role of their government in economic development

Topic-4:Pigou's Social Welfare & Welfare Economics

Introduction to A.C Pigou & his work

- Arthur Cecil Pigou (1877-1959) was among the last in the long line of classical economists associated with the Cambridge School.
- The numerous works by Pigou cover various fields of economic thought. Pigou's marked interest in 'how government policy could increase national well-being?'
- Furthermore, his notable contribution, Economics of Welfare (1932) occupies a unique position in the history of economic thought and has earned him recognition as the father of modern welfare economics

Meaning of Welfare Economics

- According to Pigou, welfare resides in a man's state of mind or consciousness which is made up satisfactions or utilities. The basis of welfare hence is necessarily the extent to which an individual's desires are met.

- Social welfare is regarded as the summation of all individual welfares of society. Since general welfare is a very wide complicated and impracticable notion, Pigou delimits the range of his study to economic welfare. He therefore, defines economic welfare as:

"That part of social welfare that can be brought directly or indirectly into relation with the measuring rod of money."

- Thus economic welfare, in the Pigovian sense, implies the satisfaction of utility derived by an individual from the use of exchangeable goods and services.

Pigovian Welfare Conditions

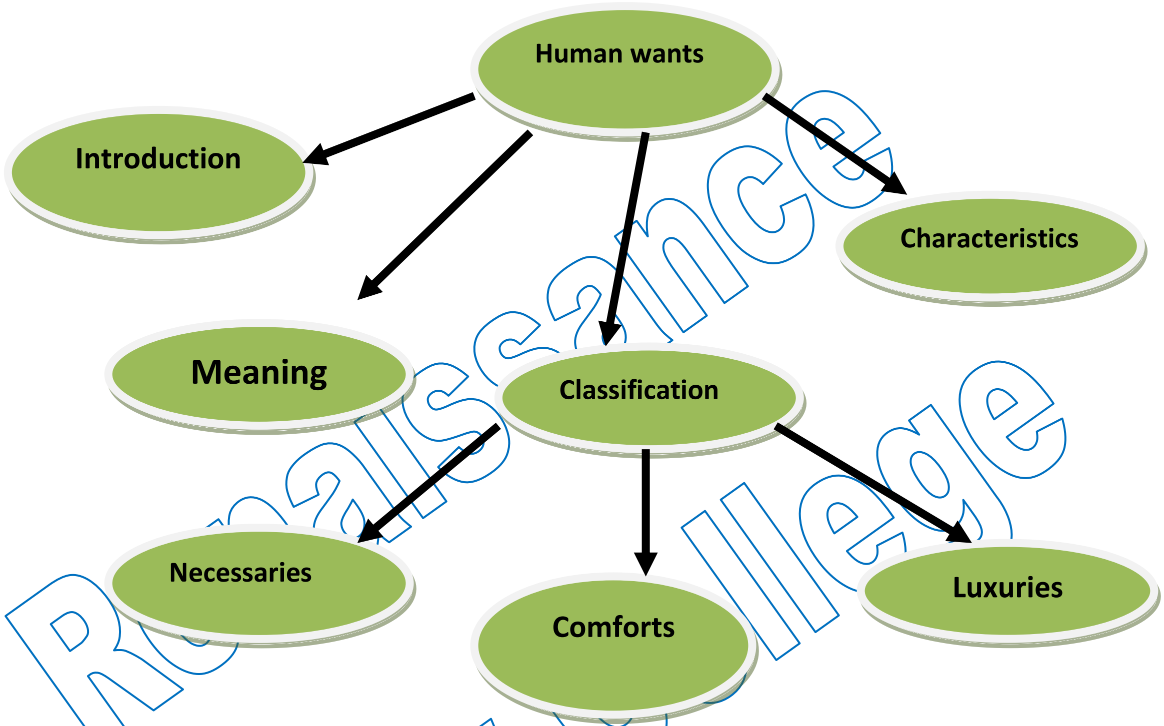
1. **First condition for welfare - Increase in National Income :** The first condition states that welfare is said to increase when national income increases. Given the same tastes and income distribution, an increase in the national income represents an increase in welfare. Pigou contends that in most cases the national income would increase even though the disutility of work also increases.
2. **Second condition for welfare Maximisation-Equitable distribution of national income** the distribution of the national income is equally important. It national income remains constant, transfers of income from the rich to the poor would improve welfare. According to Pigou such transfers mean less to the wealthy than to poor, as a result the economic position of the latter is

raised. This welfare condition is based on the dual Pigovian postulates of 'equal capacity for satisfaction and diminishing marginal utility of income.'

Pigou argues that different people derive the same satisfaction out the same real income and that "People now rich are different kinds from the people now poor having in their fundamental nature greater capacities for enjoyment."

CHAPTER-2 : BASIC CONCEPTS & PRINCIPLES OF ECONOMICS

Topic 1 : Human wants, comforts and luxuries



Introduction:

Economics has defined want very scientific way . Wants include all human's desire which he desires to get because he is social animal and when he see other people with these material . He thinks that he wants same thing . In other world we can want to money or any other thing which attracts our mind and brain .

Human Wants: meaning

- Man is a bundle of desires. His wants are infinite in variety and number. Some wants are natural, for example foods, air, clothing and shelter without which existence of man's life is not possible. Similarly wants vary from individual to individual and they multiply with civilization.

- Every desire cannot be a want. If a poor person desires to have a car, his desire cannot be called a want. A desire can become a want only when a consumer has the means (i.e. money) to purchase the thing and he is also ready to spend the means (money). For a desire to become a want, the following four elements must be present

1. The desire for a thing.
2. Efforts to satisfy the desire.
3. The means (i.e. money) to purchase the thing.
4. Readiness to spend the means (i.e. money) to satisfy the desire.

Characteristics of Human Wants:

1. **Human wants are unlimited:** Man's mind is so made that he never completely satisfied and hence there is no end to human wants. One want is satisfied another want will crop up to take its place and thus it is never ending cycle of want.
2. **Any particular want is satiable:** Though the wants are unlimited, but it is possible to satisfy a particular want, provided has the means (resource).
3. **Wants are complementary:** It is a common experience that we want things in groups. A single article out of group can not satisfy human wants by itself. It needs other things to complete its use e.g. a motor-car needs petrol and mobile oil it starts working. Thus the relationship between motor-car and petrol is complementary.
4. **Wants are competitive:** Some wants competes to other. We all have a limited amount of money at our disposal; therefore we must choose some things and reject the other. E.g. sugar and jaggery, tea and coffee.
5. **Some Wants are both complimentary and competitive:** When use of machinery is done the use of labour needs to be reduced. This indicates competitive nature. But to run the machinery the labour is also required and as such it indicates complimentary relationship.
6. **Wants are alternative:** There are several ways of satisfying a particular want. If we feel thirsty, we can have water, lassi, in summer while coffee, tea in winter. The final choice depends upon availability of money and the relative prices.
7. **Wants vary with time place and person:** Wants are not always the same. It varies with individual to individual. People want different things at different times and in different places.
8. **Wants vary in Urgency and Intensity:** All wants are not equally urgent and in tense. Some wants are urgent while some are less urgent.
9. **Wants multiply with civilization:** With the advancement the wants multiply. Therefore the wants of people living in urban area are more than the villagers. With civilization the demand for radio, T.V, motor-car etc, are increasing.
10. **Wants are recur:** Some wants are recurring in nature, e.g. food we require again and again.
11. **Wants change into habits:** If a particular want is regularly satisfied a person becomes used to it and it grows into habit e.g. smoking of cigarate and use of drugs.
12. **Wants are influenced by income, salesmanship and advertisement:** It income is higher more wants can be satisfied. Many things we buy of particular brands due to salesmanship or advertisement.
13. **Wants are the result of custom or convention:** As a part of custom and convention we buy many thins. Really they are not required but unlikely we have to purchase it e.g. expenses on social ceremonies.
14. **Present wants are more important then future wants:** Future is uncertain and hence man

Classification of Wants:

The wants can be classified as under.

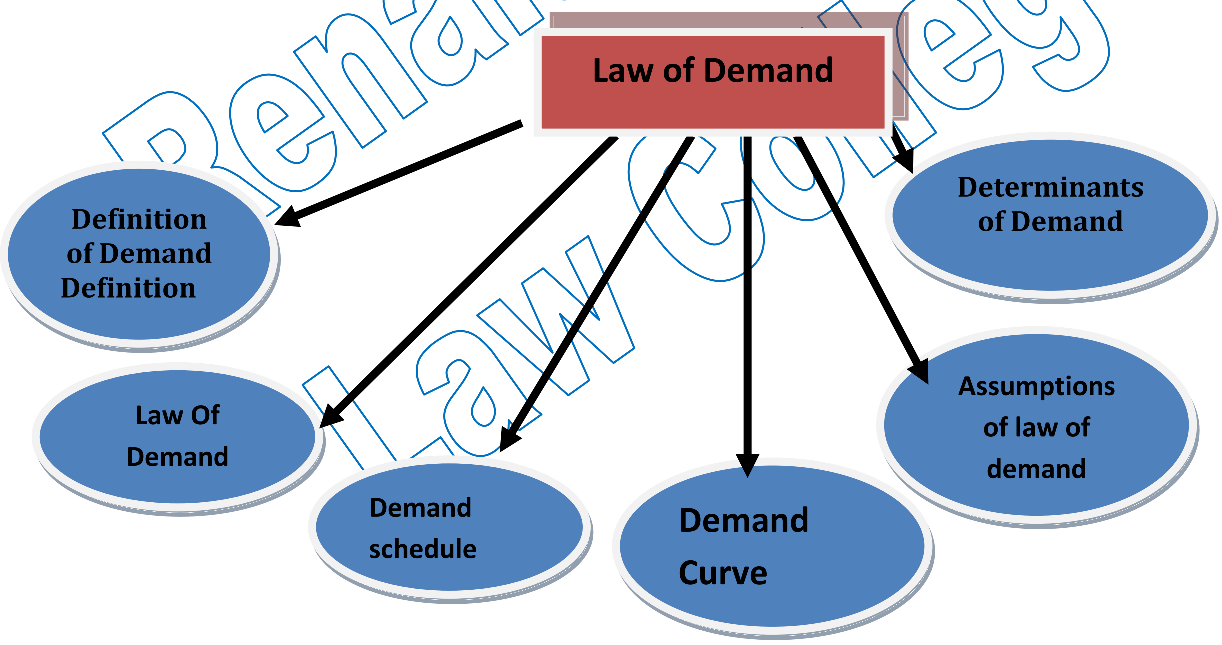
A. **Necessaries**: All wants which are very necessary to live in this earth , that wants are called Necessities . In necessities we can include air , water , food , clothes and house . We need water and food for drinking and eating , we need cloths to wear , we need house to live . If we do not get or receive all these things , we cannot live in this earth These can be sub divided as

- Necessaries of existence: The things without which we can not exist e.g. water, food, clothing, shelter.
- Conventional necessaries: The things which we are forced to use by social custom.

B. **Comforts**: After satisfying our necessaries we desire to have some comforts. Comforts are also the want of human being . But without this we can live the life . But if we get comforts , we can live better life . Cooler, fans , Scooter and computer are all our main comforts . Because with these comforts , person becomes more efficient .
For example table and chair for a student help to increase the efficiency. But cushioned costly chair is not a comfort, it becomes luxury.

C. **Luxuries:** In economics, luxuries are those wants which crops up when a man or woman become richest in this world . After this he or she dreams of AC rooms , eating only in five or seven star hotels . He or she baths only high paid bathing pools . He or she wants to travel only in top costly ac cars . He or she wants to live only in high cost building . These all desires and wants are called luxuries . It decreases human efficiency .e.g. gold and silver, costly furniture, etc.

Topic 2 Law of Demand- Elasticity of Demand



Understanding Demand - Definition of Demand

In economic terminology the term demand conveys a wider and definite meaning than in the ordinary usage. Ordinarily demand means a desire, whereas in economic sense it is something more than a mere desire. It is interpreted as a want backed up by the - purchasing power. Further demand is per unit of time such as per day, per week etc. moreover it is meaningless to mention demand without reference to price. Considering all these aspects the term demand can be defined in the following words,
"Demand for anything means the quantity of that commodity, which is bought, at a given price, per unit of time."

Law Of Demand - Demand Price Relationship

This law explains the functional relationship between price of a commodity and the quantity demanded of the same. It is observed that the price and the demand are inversely related which means that the two move in the opposite direction. An increase in the price leads to a fall in the demand and vice versa. This relationship can be stated as
“Other things being equal, the demand for a commodity varies inversely as the price”
or
“The demand for a commodity at a given price is more than what it would be at a higher price and less than what it would be at a lower price”

Demand Schedule or Demand Table

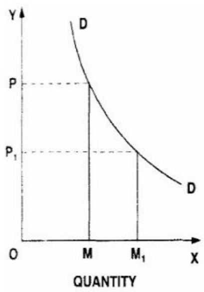
These are the two devices to present the law. The demand schedule is a schedule or a table which contains various possible prices of a commodity and different quantities demanded at them. It can be an individual demand schedule representing the demand of an individual consumer or can be the market demand schedule showing the total demand of all the consumers taken together, this is indicated in the following table.

Price per Liter in Rs.	Individual Demand Schedule (Quantity in liter Demand by Different Individuals) (Daily Demand)				Market Demand Schedule (Daily Demand
24	1.00	0.75	0.50	0.00	75
22	1.25	1.00	0.75	0.50	100
20	1.5	1.25	1.00	0.75	125
18	1.75	1.5	1.25	1.00	150

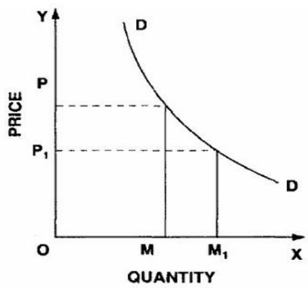
It can be observed that with a fall in price every individual consumer buys a larger quantity than before as a result of which the total market demand also rises. In case of an increase in price the situation will be reserved. Thus the demand schedule reveals the inverse price-demand relationship, i.e. the Law of Demand.

Demand Curve DD

It is a geometrical device to express the inverse price-demand relationship, i.e. the law of demand. A demand curve can be obtained by plotting a demand schedule on a graph and joining the points so obtained, like the demand schedule we can derive an individual demand curve as well as a market demand curve. The former shows the demand curve of an individual buyer while the latter shows the sum total of all the individual curves i.e. a market or a total demand curve. The following diagram shows the two types of demand curves.



(A)



(B)

In the above diagram, figure (A) shows an individual demand curve of any individual consumer while figure (B) indicates the total market demand. It can be noticed that both the curves are negatively sloping or downwards sloping from left to right. Such a curve shows the inverse relationship between the two variables. In this case the two variable are price on Y axis and the quantity demanded on X axis. It may be noted that at a higher price OP the quantity demanded is OM while at a lower price say OP1, the quantity demanded rises to OM1 thus a demand curve diagrammatically explains the law of demand.

Assumptions of the 'Law of Demand'

The law of demand in order to establish the price-demand relationship makes a number of assumptions as follows:

1. Income of the consumer is given and constant.
2. No change in tastes, preference, habits etc.
3. Constancy of the price of other goods.
4. No change in the size and composition of population.

These Assumptions are expressed in the phrase "other things remaining equal".

<u>Determinants (Factors Affecting) of Demand</u>

1) **Income**: The relationship between income and the demand is a direct one. It means the demand changes in the same direction as the income. An increase in income leads to rise in demand and vice versa.

2) **Population**: The size of population also affects the demand. The relationship is a direct one. The higher the size of population, the higher is the demand and vice versa.

3) **Tastes and Habits**: The tastes, habits, likes, dislikes, prejudices and preference etc. of the consumer have a profound effect on the demand for a commodity. If a consumers dislikes a commodity, he will not buy it despite a fall in price. On the other hand a very high price also may not stop him from buying a good if he likes it very much.

4) **Other Prices**: This is another important determinant of demand for a commodity. The effects depends upon the relationship between the commodities in question. If the price of a complimentary commodity rises, the demand for the commodity in reference falls. E.g. the demand for petrol will decline due to rise in the price of cars and the consequent decline in their demand. Opposite effect will be experienced incase of substitutes.

5) **Advertisement**: This factor has gained tremendous importance in the modern days. When a product is aggressively advertised through all the possible media, the consumers buy the advertised commodity even at a high price and many times even if they don't need it.

6) **Fashions**: Hardly anyone has the courage and the desire to go against the prevailing fashions as well as social customs and the traditions. This factor has a great impact on the demand.

7) **Imitation**: This tendency is commonly experienced everywhere. This is known as the demonstration effects, due to which the low income groups imitate the consumption patterns of the rich ones. This operates even at international levels when the poor countries try to copy the consumption patterns of rich countries.

Exceptions of the 'Law of Demand'

In case of major bulk of the commodities the validity of the law is experienced. However there are certain situations and commodities which do not follow the law. These are termed as the exceptions to the law; these can be expressed as follows:

1. Continuous changes in the price lead to the exceptional behavior. If the price shows a rising trend a buyer is likely to buy more at a high price for protecting himself against a further rise. As against it when the price starts falling continuously, a consumer buys less at a low price and awaits a further in price.
2. Giffens's Paradox describes a peculiar experience in case of inferior goods. When the price of an inferior commodity declines, the consumer, instead of purchasing more, buys less of that commodity and switches on to a superior commodity. Hence the exception.
3. Conspicuous Consumption refers to the consumption of those commodities which are bought as a matter of prestige. Naturally with a fall in the price of such goods, there is no distinction in buying the same. As a result the demand declines with a fall in the price of such prestige goods.
4. Ignorance Effect implies a situation in which a consumer buys more of a commodity at a higher price only due to ignorance.

In the exceptional situations quoted above, the demand curve becomes an upwards rising one as shown in the alongside diagram. In the alongside figure, the demand curve is positively sloping one due to which more is demanded at a high price and less at a low price.

Variation & Changes In Demand

The law of demand explains the effect of only-one factor viz., price, on the demand for a commodity, under the assumption of constancy of other determinants. In practice, other factors such as, income, population etc. cause the rise or fall in demand without any change in the price. These effects are different from the law of demand. They are termed as changes in demand in contrast to variations in demand which occur due to changes in the price of a commodity. In economic theory a distinction is made between

(a) Variations i.e. extension and contraction in demand due to price

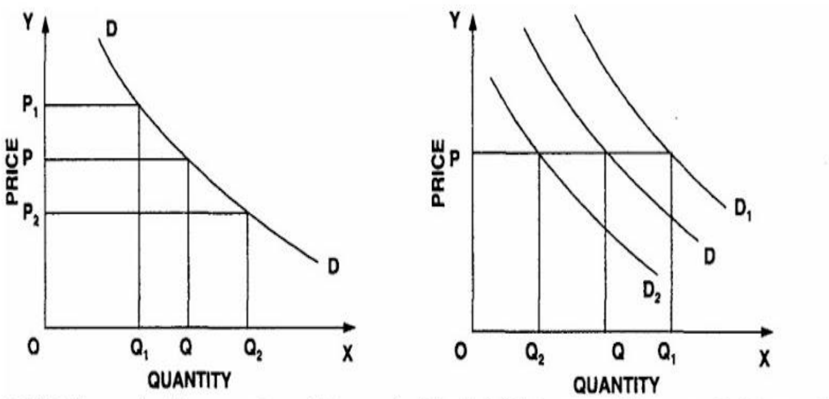
(b) Changes i.e. increase and decrease in demand due to other factors.

(a) Variations in demand refer to those which occur due to changes in the price of a commodity.
These are two types.

1. **Extension of Demand**: This refers to rise in demand due to a fall in price of the commodity. It is shown by a downwards movement on a given demand curve.
2. **Contraction of Demand**: This means fall in demand due to increase in price and can be shown by an upwards movement on a given demand curve.

(b) Changes in demand imply the rise and fall due to factors other than price.
It means they occur without any change in price. They are of two types.

1. **Increase in Demand**: This refers to higher demand at the same price and results from rise in income, population etc., this is shown on a new demand curve lying above the original one.
2. **Decrease in demand**: It means less quantity demanded at the same price. This is the result of factors like fall in income, population etc. this is shown on a new demand lying below the original one.



2.3 (A) Extension/Contraction of Demand *Fig. 2.3 (B) Increase/Decrease in Demand*

Fig (A) Extension/Contraction of Demand Fig (B) Increase/Decrease in Demand

In figure A, the original price is OP and the Quantity demanded is OQ. With a rise in price from OP to OP1 the demand contracts from OQ to OQ1 and as a result of fall in price from OP to OP2, the demand extends from OQ to OQ2.

In figure, B an increase in demand is shown by a new demand curve, D1 while the decrease in demand is expressed by the new demand curve D2, lying above and below the original demand curve D respectively. On D1 more is demand (OQ1) at the same price while on D2 less is demanded (OQ2) at the same price OP.

Elasticity of Demand

1) The concept of the elasticity of demand has great significance as it explains the degree of responsiveness of demand to a change in price. It thus elaborates the price-demand relationship. The elasticity of demand thus means the sensitiveness or responsiveness of demand to a change in price.

2) According to Marshall, "the elasticity (or responsiveness) of demand in a market is great or small accordingly as the demand changes (rises or falls) much or little for a given change (rise or fall) in price."

3) Different commodities react to a change in price in the same direction; the degree of their response differs. Demand for some commodities is more sensitive or responsive to a change in price, while it is less responsive for some others. Elasticity of demand is a measure of relative changes in the amount demanded in response to a small change in price. Certain goods are said to have an elastic demand while others have an inelastic demand. The demand is said to be elastic when a small change in price brings about considerable change in demand. On the other hand, the demand for a good is said to be inelastic when a change in price fails to bring about significant change in demand.

4) The concept of elasticity can be expressed in the form of an equation as:

Ep = [Percentage change in quantity demanded / Percentage change in the price

Types of Price Elasticity

The concept of price elasticity reveals that the degree of responsiveness of demand to the change in price differs from commodity to commodity. Demand for some commodities is more elastic while that for certain others is less elastic. Using the formula of elasticity, it possible to mention following different types of price elasticity:

Types of Price Elasticity

- Perfectly inelastic demand (ep = 0)
- Inelastic (less elastic) demand (e < 1)
- Unitary elasticity (e = 1)
- Elastic (more elastic) demand (e > 1)
- Perfectly elastic demand (e = ∞)

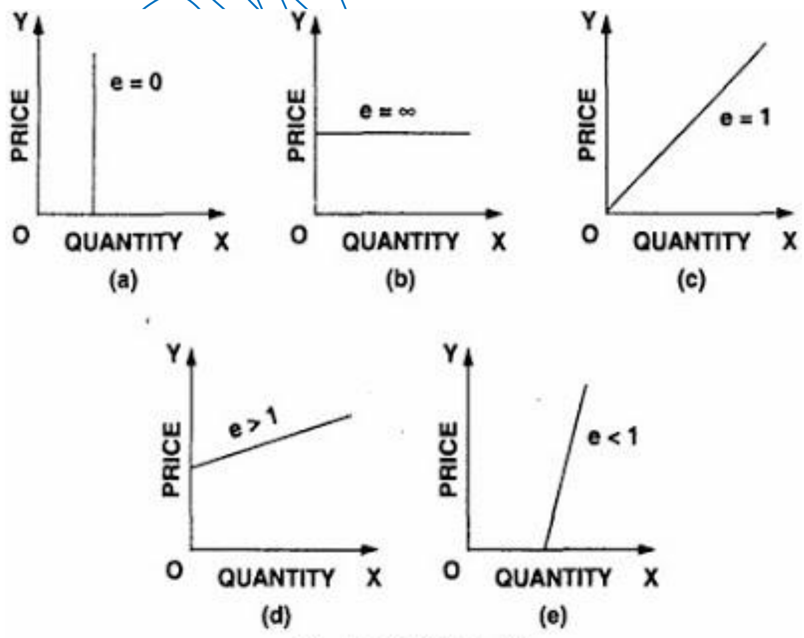


Fig. 2.14 (a) to (e)

1. **Perfectly inelastic demand (ep = 0)**
This describes a situation in which demand shows no response to a change in price. In other words, whatever be the price the quantity demanded remains the same. It can be depicted by means of the alongside diagram.
The vertical straight line demand curve as shown alongside reveals that with a change in price (from OP to Op1) the demand remains same at OQ. Thus, demand does not at all respond to a change in price. Thus ep = O. Hence, perfectly inelastic demand. Fig a
2. **Inelastic (less elastic) demand (e < 1)**
In this case the proportionate change in demand is smaller than in price. The alongside figure shows this type.
In the alongside figure percentage change in demand is smaller than that in price. It means the demand is relatively c less responsive to the change in price. This is referred to as an inelastic demand. Fig e
3. **Unitary elasticity demand (e = 1)**
When the percentage change in price produces equivalent percentage change in demand, we have a case of unit elasticity. The rectangular hyperbola as shown in the figure demonstrates this type of elasticity. In this case percentage change in demand is equal to percentage change in price, hence e = 1. Fig c
4. **Elastic (more elastic) demand (e > 1)**
In case of certain commodities the demand is relatively more responsive to the change in price. It means a small change in price induces a significant change in, demand. This can be understood by means of the alongside figure.
It can be noticed that in the above example the percentage change in demand is greater than that in price. Hence, the elastic demand (e>1) Fig d
5. **Perfectly elastic demand (e = ∞)**
This is experienced when the demand is extremely sensitive to the changes in price. In this case an insignificant change in price produces tremendous change in demand. The demand curve showing perfectly elastic demand is a horizontal straight line. Fig b
It can be noticed that at a given price an infinite quantity is demanded. A small change in price produces infinite change in demand. A perfectly competitive firm faces this type of demand.

From the above analysis it can be concluded that theoretically five different types of price elasticity can be mentioned. In practice, however two extreme cases i.e. perfectly elastic and perfectly inelastic demand, are rarely experienced. What we really have is more elastic (e > 1) or less elastic (e < 1) demand. The unitary elasticity is a dividing line between these two cases.

Determinants of Elasticity

1. **Nature of the Commodity**: Humans wants, i.e. the commodities satisfying them can be classified broadly into necessaries on the one hand and comforts and luxuries on the other hand. The nature of demand for a commodity depends upon this classification. The demand for necessities is inelastic and for comforts and luxuries it is elastic.
2. **Number of Substitutes Available**: The availability of substitutes is a major determinant of the elasticity of demand. The large the number of substitutes, the higher is the elastic. It means if a commodity has many substitutes, the demand will be elastic. As against this in the absence of substitutes, the demand becomes relatively inelastic because the consumers have no other alternative but to buy the same product irrespective of whether the price rises or falls.
3. **Number Of Uses**: If a commodity can be put to a variety of uses, the demand will be more elastic. When the price of such commodity rises, its consumption will be restricted only to more important uses and when the price falls the consumption may be extended to less urgent uses, e.g. coal electricity, water etc.
4. **Possibility of Postponement of Consumption**: This factor also greatly influences the nature of demand for a commodity. If the consumption of a commodity can be postponed, the demand will be elastic.

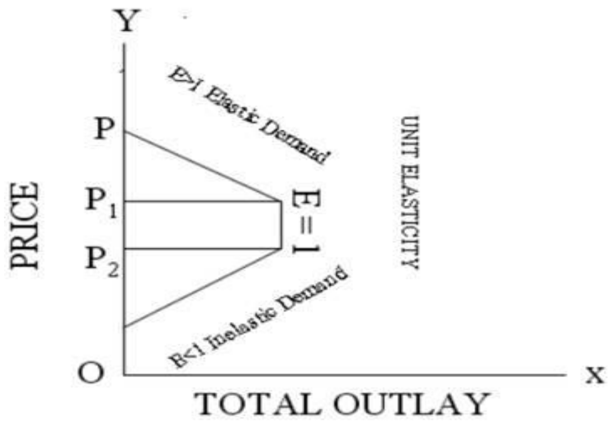
5. **Range of prices**: The demand for very low-priced as well as very high-price commodity is generally inelastic. When the price is very high, the commodity is consumed only by the rich people. A rise or fall in the price will not have significant effect in the demand. Similarly, when the price is so low that the commodity can be brought by all those who wish to buy, a change, i.e., a rise or fall in the price, will hardly have any effect on the demand.
6. **Proportion of Income Spent**: Income of the consumer significantly influences the nature of demand. If only a small fraction of income is being spent on a particular commodity, say newspaper, the demand will tend to be inelastic.
7. According to Taussig, unequal distribution of income and wealth makes the demand in general, elastic.
8. In addition, it is observed that demand for durable goods, is usually elastic.
9. The nature of demand for a commodity is also influenced by the complementarities of goods.

From the above analysis of the determinants of elasticity of demand, it is clear that no precise conclusion about the nature of demand for any specific commodity can be drawn. It depends upon the range of price, and the psychology of the consumers. The conclusion regarding the nature of demand should, therefore be restricted to small changes in prices during short period. By doing so, the influence of changes in habits, tastes, likes customs etc., can be ignored.

Measurement of Elasticity

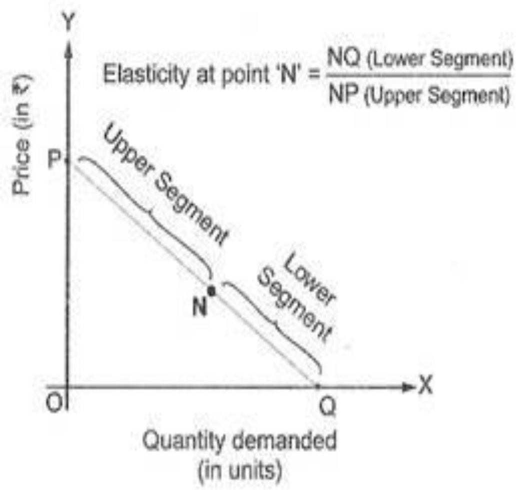
For practical purposes, it is essential to measure the exact elasticity of demand. By measuring the elasticity we can know the extent to which the demand is elastic or inelastic. Different methods are used for measuring the elasticity of demand.

1. **Percentage Method**: In this method, the percentage change in demand and percentage change in price are compared.
   ep = [Percentage change in demand / Percentage change in price]
   In this method, three values of 'ep' can be obtained. Viz., ep = 1, ep > 1, ep > 1.
   - If 5% change in price leads to exactly 5% change in demand, i.e. percentage change in demand is equal to percentage change in price , e = 1, it is a case of unit elasticity.
   - If percentage change in demand is greater than percentage change in price, e > 1, it means the demand is elastic.
   - If percentage change in demand is less than that in price, e > 1, meaning thereby the demand is inelastic.
2. **Total Outlay Method:** The elasticity of demand can be measured by considering the changes in price and the consequent changes in demand causing changes in the total amount spent on the goods. The change in price changes the demand for a commodity which in turn changes the total expenditure of the consumer or total revenue of the seller.
   - If a given change in price fails to bring about any change in the total outlay, it is the case of unit elasticity. It means if the total revenue (price x Quantity bought) remains the same in spite of a change in price, 'ep' is said to be equal to 1
   - If price and total revenue are inversely related, i.e., if total revenue falls with rise in price or rises with fall in price, demand is said to be elastic or e > 1.
   - When price and total revenue are directly related, i.e. if total revenue rises with a rise in price and falls with a fall in price, the demand is said to be inelastic pr e < 1.



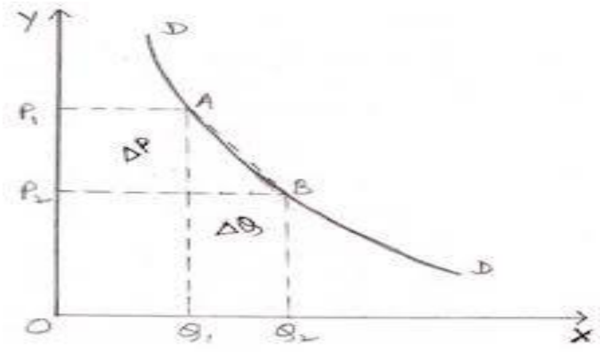
3. **Geometric method** :Another suggested by Marshall is to measure elasticity at a point on a straight line is called Point Method or geometric method

Geometric method was suggested by Prof. Marshall and is used to measure the elasticity at a point on the demand curve. When there are infinitely small changes in price and demand, then the 'Geometric Method' is used. This method is also known as 'Graphic Method' or 'Point Method' or 'Arc Method'. Elasticity of demand (E_d) is different at different points on the same straight line demand curve.
In order to measure E_d at any particular point, lower portion of the curve from that point is divided by the upper portion of the curve from the same point.
Elasticity of Demand (E_d) = Lower segment of demand curve (LS) / Upper segment of demand curve (US)
As seen in Fig. , elasticity at a particular point 'N' is calculated as NQ/NP.



4. **Arc Method**

$$Ep = \frac{\dfrac{\text{original quantity - new quantity}}{\text{original quantity + new quantity}}}{\dfrac{\text{original price - new price}}{\text{original price + new price}}} \qquad \frac{\dfrac{Q2 - Q1}{(Q1 + Q2)/2}}{\dfrac{P2 - P1}{(P1 + P2)/2}}$$



Income Elasticity of Demand

The discussion of price elasticity of demand reveals that extent of change in demand as a result of change in price. However, as already explained, price is not the only determinant of demand. Demand for a commodity changes in response to a change in income of the consumer. In fact, income effect is a constituent of the price effect. The income effect suggests the effect of change in income on demand. The income elasticity of demand explains the extent of change in demand as a result of change in income. In other words, income elasticity of demand means the responsiveness of demand to changes in income. Thus, income elasticity of demand can be expressed as:

$$EDy = \frac{((Q\ current - Q\ previous) / (Q\ previous))}{((Y\ current - Y\ previous) / Y\ previous))}$$

ED = Elasticity of Demand
Q = Quantity
Y = Income
EDy = Income Elasticity of Demand

The following types of income elasticity can be observed:

1. **Income Elasticity of Demand Greater than One:** When the percentage change in demand is greater than the percentage change in income, a greater portion of income is being spent on a commodity with an increase in income- income elasticity is said to be greater than one.
2. **Income Elasticity is unitary:** When the proportion of income spent on a commodity remains the same or when the percentage change in income is equal to the percentage change in demand, EY = 1 or the income elasticity is unitary.
3. **Income Elasticity Less Than One (EY< 1):** This occurs when the percentage change in demand is less than the percentage change in income.
4. **Zero Income Elasticity of Demand (EY=o):** This is the case when change in income of the consumer does not bring about any change in the demand for a commodity.
5. **Negative Income Elasticity of Demand (EY< o):** It is well known that income effect for most of the commodities is positive. But in case of inferior goods, the income effect beyond a certain level of income becomes negative. This implies that as the income increases the consumer, instead of buying more of a commodity, buys less and switches on to a superior commodity. The income elasticity of demand in such cases will be negative.

Cross Elasticity of Demand

While discussing the determinants of demand for a commodity, we have observed that demand for a commodity depends not only on the price of that commodity but also on the prices of other related goods. Thus, the demand for a commodity X depends not only on the price of X but also on the prices of other commodities Y, Z….N etc. The concept of cross elasticity explains the degree of change in demand for X as, a result of change in price of Y. This can be expressed as:

Cross Price Elasticity

$$E_{xy} = \frac{\dfrac{Q_{x2} - Q_{x1}}{\left(\dfrac{Q_{x2} + Q_{x1}}{2}\right)}}{\dfrac{P_{y2} - P_{y1}}{\left(\dfrac{P_{y2} + P_{y1}}{2}\right)}} = \frac{\%\Delta Q_x}{\%\Delta P_y}$$

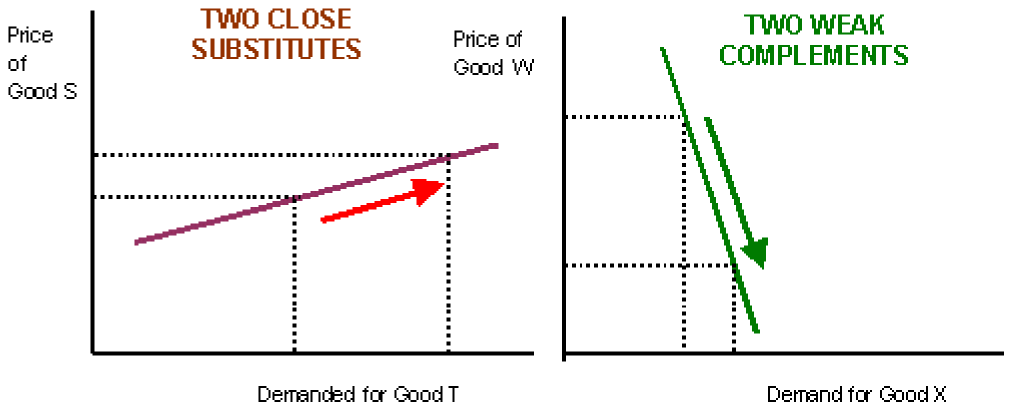
- $E_{xy} > 0$ Substitutes (+/+ or -/-)
- $E_{xy} < 0$ Complements (+/- or -/+)
- $E_{xy} = 0$ Unrelated goods (0/+ or 0/-)

The relationship between any two goods is of two types. The goods X and Y can be complementary goods (such as pen and ink) or substitutes (such as pen and ball pen). In case of complementary commodities, the cross elasticity will be negative. This means that fall in price of X (pen) leads to rise in its demand so also rise in t) demand for Y (ink) On the other hand, the cross elasticity for substitutes is positive which means a fall in price of X (pen) results in rise in demand for X and fall in demand for Y (ball pen). If two commodities, say X and Y, are unrelated there will be no change i. Demand for X as a result of change in price of Y. Cross elasticity in cad of such unrelated goods will then be zero.

In short, cross elasticity will be of three types:

1. Negative cross elasticity – Complementary commodities.
2. Positive cross elasticity – Substitutes.
3. Zero cross elasticity – Unrelated goods.

Value of coefficient	Description	Type of good(s)
Cross-elasticity:		
Positive ($E_{AB} > 0$)	Quantity demanded A changes in the same direction as change in price B	Substitutes
Negative ($E_{AB} < 0$)	Quantity demaded A changes in the opposite direction from change in price B	Complementary
Income elasticity:		
Positive ($E_i > 0$)	Quantity demanded of the product changes in the same direction as changes the income	Normal or Superior
Negative ($E_i < 0$)	Quantity demanded of the product changes in the opposite direction as does the income	Inferior



Importance of Elasticity

The concept of elasticity is of great importance both in economic theory and in practice.

1. Theoretically, its importance lies in the fact that it deeply analyses the price-demand relationship. The law of demand merely explains the qualitative relationship while the concept of elasticity of demand analyses the quantitative price-demand relationship.
2. The Pricing policy of the producer is greatly influenced by the nature of demand for his product. If the demand is inelastic, he will be benefited by charging a high price. If on the other hand, the demand is elastic, low price will be advantageous to the producer. The concept of elasticity helps the monopolist while practicing the price discrimination.
3. The price of joint products can be fixed on the basis of elasticity of demand. In case of such joint products, such as wool and mutton, cotton and cotton seeds, separate costs of production are not known. High price is charged for a product having inelastic demand (say cotton) and low price for its joint product having elastic demand (say cotton seeds).
4. The concept of elasticity of demand is helpful to the Government in fixing the prices of public utilities.
5. The Elasticity of demand is important not only in pricing the commodities but also in fixing the price of labour viz., wages.
6. The concept of elasticity of demand is useful to Government in formulation of economic policy in various fields such as taxation, international trade etc. (a) The concept of elasticity of demand guides the finance minister in imposing the commodity taxes. He should tax such commodities which have inelastic demand so that the Government can raise handsome revenue.(b) The concept of elasticity of demand helps the Government in formulating commercial policy. Protection and subsidy is granted to the industries which face an elastic demand.
7. The concept of elasticity of demand is very important in the field international trade. It helps in solving some of the problems of international trade such as gains from trade, balance of payments etc. policy of tariff also depends upon the nature of demand for a commodity.
8.

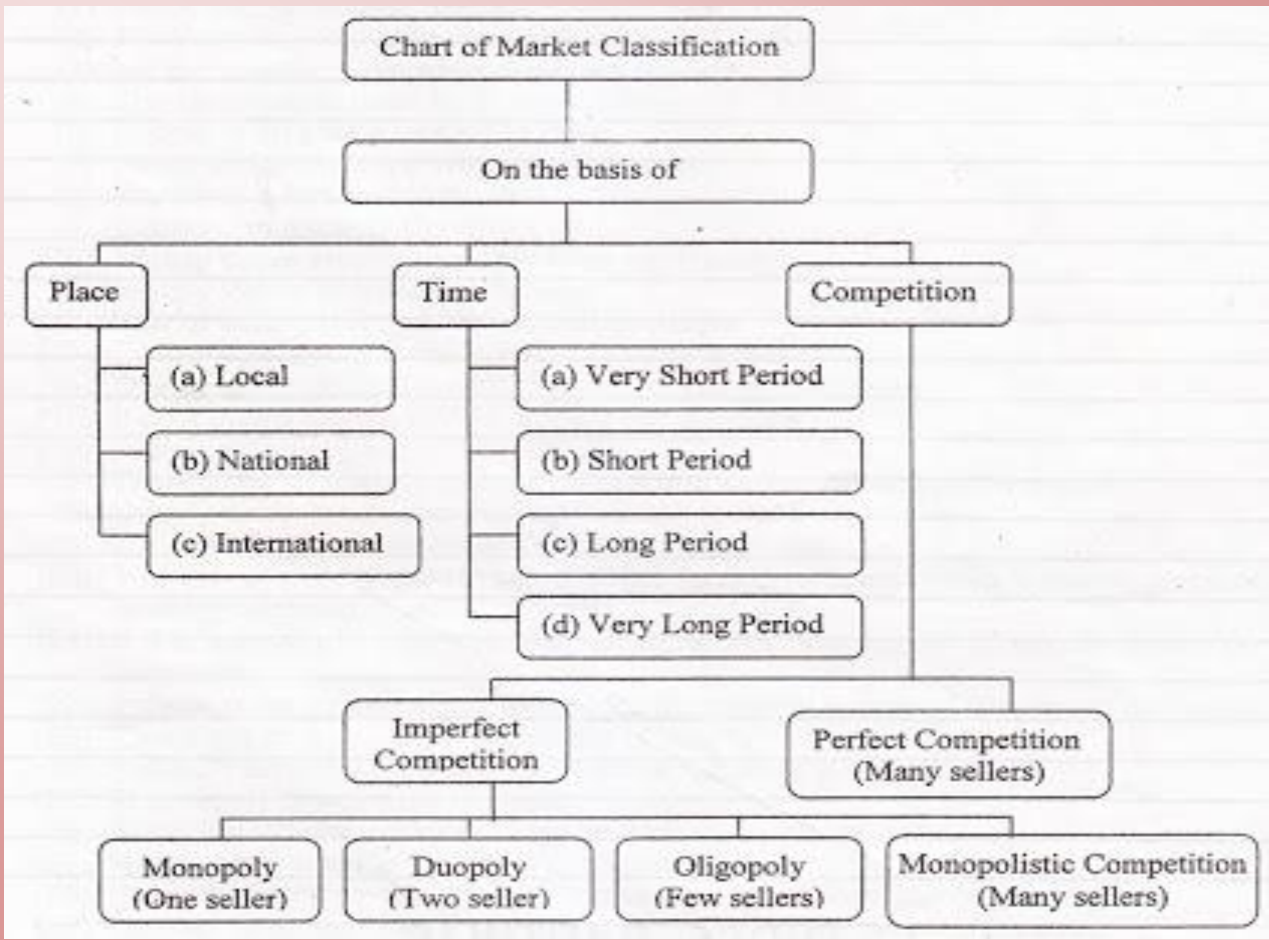
<u>Topic- 3- Market: Meaning and types</u>

Meaning of market

"Market refers to an arrangement, whereby buyers and sellers come in contact with each other directly or indirectly, to buy or sell goods."

Thus, above statement indicates that face to face contact of buyer and seller is not necessary for market. E.g. In stock or share market, the buyer and seller can carry on their transactions through internet. So internet, here forms an arrangement and such arrangement also is included in the market.

Classification or Types of Market



What is Perfect Competition?

1) Perfect Competition is a market structure where there is a perfect degree of competition and single price prevails.
2) The concept of Perfect Competition was introduced by Dr. Alfred Marshall.
3) Nothing is 100% perfect in this world. So, this states that perfect competition is only a theoretical possibility and it does not exist in reality.

Main Features of Perfect Competition

1. **Many Sellers -** In this market, there are many sellers who form total of market supply. Individually, seller is a firm and collectively, it is an industry. In perfect competition, price of commodity is decided by market forces of demand and supply. i.e. by buyers and sellers collectively. Here, no individual seller is in a position to change the price by controlling supply.

2. **Many Buyers -** Individual buyer cannot control the price by changing or controlling the demand. Because individual buyer's individual demand is a very small part of total demand or market demand. Every buyer has to accept the price decided by market forces of demand and supply. In this way, all buyers are price takers and not price makers. This also ensures existence of single price in market.

3. **Homogenous Product -** In this case, all sellers produce homogeneous i.e. perfectly identical products. All products are perfectly same in terms of size, shape, taste, colour, ingredients, quality, trade marks etc. This ensures the existence of single price in the market.

4. **Zero Advertisement Cost -** Since all products are identical in features like quality, taste, design etc., there is no scope for product differentiation. So advertisement cost is nil.

5. **Free Entry and Exit -** There are no restrictions on entry and exit of firms. This feature ensures existence of normal profit in perfect competition. When profit is more, new firms enter the market and this leads to competition. Entry of new firms competing with each other results into increase in supply and fall in price. So, this reduces profit from abnormal to normal level. When profit is low (below normal level), some firms may exit the market. This leads to fall in supply. So remaining firms raise their prices and their profits go up. So again this ensures normal level of profit.

6. **Perfect Knowledge -** On the front of both, buyers and sellers, perfect knowledge regarding market and pricing conditions is expected. So, no buyer will pay price higher than market price and no seller will charge lower price than market price.

7. **Perfect Mobility of Factors -** This feature is essential to keep supply at par with demand. If all factors are easily mobile (moveable) from one line of production to another, then it becomes easy to adjust supply as per demand.Whenever demand is more additional factors should be moved into industry to increase supply and vice versa. In this way, with the help of stable demand and supply, we can maintain single price in the Market.

8. **No Government Intervention -** Since market has been controlled by the forces of demand and supply, there is no government intervention in the form of taxes, subsidies, licensing policy, control over the supply of raw materials, etc.

9. **No Transport Cost -** It is assumed that buyers and sellers are close to market, so there is no transport cost. This ensures existence of single price in market.

What is Monopoly?

1. The term monopoly is derived from Greek words 'mono' which means single and 'poly' which means seller. So, monopoly is a market structure, where there only a single seller producing a product having no close substitutes.
2. This single seller may be in the form of an individual owner or a single partnership or a Joint Stock Company. Such a single firm in market is called monopolist. Monopolist is price maker and has a control over the market supply of goods. But it does not mean that he can set both price and output level. A monopolist can do either of the two things i.e. price or output. It means he can fix either price or output but not both at a time.

Characteristics / Features of Monopoly

1. A single seller has complete control over the supply of the commodity.
2. There are no close substitutes for the product.
3. There is no free entry and exit because of some restrictions.
4. There is a complete negation of competition.
5. Monopolist is a price maker.
6. Since there is a single firm, the firm and industry are one and same i.e. firm coincides the industry.
7. Monopoly firm faces downward sloping demand curve. It means he can sell more at lower price and vice versa. Therefore, elasticity of demand factor is very important for him.

Monopolistic Competition

1. Pure monopoly and perfect competition are two extreme cases of market structure. In reality, there are markets having large number of producers competing with each other in order to sell their product in the market. Thus, there is monopoly on one hand and perfect competition on other hand. Such a mixture of monopoly and perfect competition is called as monopolistic competition. It is a case of imperfect competition.
2. Monopolistic competition has been introduced by American economist Prof. Edward Chamberlin, in his book 'Theory of Monopolistic Competition' published in 1933.

Features of Monopolistic Competition

1. **Large Number of Sellers -** There are large number of sellers producing differentiated products. So, competition among them is very keen. Since number of sellers is large, each seller produces a very small part of market supply. So no seller is in a position to control price of product. Every firm is limited in its size.
2. **Product Differentiation -** It is one of the most important features of monopolistic competition. In perfect competition, products are homogeneous in nature. On the contrary, here, every producer tries to keep his product dissimilar than his rival's product in order to maintain his separate identity. This boosts up the competition in market. So, every firm acquires some monopoly power
3. **Freedom of Entry and Exit -** This feature leads to stiff competition in market. Free entry into the market enables new firms to come with close substitutes. Free entry or exit maintains normal profit in the market for a longer span of time.
4. **Selling Cost -** It is a unique feature of monopolistic competition. In such type of market, due to product differentiation, every firm has to incur some additional expenditure in the form of selling cost. This cost includes sales promotion expenses, advertisement expenses, salaries of marketing staff, etc.
5. **Absence of Interdependence -** Large numbers of firms are different in their size. Each firm has its own production and marketing policy. So no firm is influenced by other firm. All are independent.

What is Oligopoly?

The term oligopoly is derived from two Greek words: 'oligi' means few and 'polein' means to sell. Oligopoly is a market structure in which there are only a few sellers (but more than two) of the homogeneous or differentiated products. So, oligopoly lies in between monopolistic competition and monopoly.

Example of Oligopoly:

In India, markets for automobiles, cement, steel, aluminium, etc, are the examples of oligopolistic market. In all these markets, there are few firms for each particular product.
DUOPOLY is a special case of oligopoly, in which there are exactly two sellers. Under duopoly, it is assumed that the product sold by the two firms is homogeneous and there is no substitute for it. Examples where two companies control a large proportion of a market are: (i) Pepsi and Coca-Cola in the soft drink market; (ii) Airbus and Boeing in the commercial large jet aircraft market; (iii) Intel and AMD in the consumer desktop computer microprocessor market.

Features of Oligopoly:

1. Few firms: Under oligopoly, there are few large firms. The exact number of firms is not defined. Each firm produces a significant portion of the total output. There exists severe competition among different firms and each firm try to manipulate both prices and volume of production to outsmart each other.

2. Interdependence: Firms under oligopoly are interdependent. Interdependence means that actions of one firm affect the actions of other firms. A firm considers the action and reaction of the rival firms while determining its price and output levels. A change in output or price by one firm evokes reaction from other firms operating in the market.

3. Non-Price Competition: Under oligopoly, firms are in a position to influence the prices. However, they try to avoid price competition for the fear of price war. They follow the policy of price rigidity. Price rigidity refers to a situation in which price tends to stay fixed irrespective of changes in demand and supply conditions. Firms use other methods like advertising, better services to customers, etc. to compete with each other.***If a firm tries to reduce the price, the rivals will also react by reducing their prices. However, if it tries to raise the price, other firms might not do so. It will lead to loss of customers for the firm, which intended to raise the price. So, firms prefer non- price competition instead of price competition.***

4. Barriers to Entry of Firms: The main reason for few firms under oligopoly is the barriers, which prevent entry of new firms into the industry. Patents, requirement of large capital, control over crucial raw materials, etc, are some of the reasons, which prevent new firms from entering into industry. Only those firms enter into the industry which is able to cross these barriers. As a result, firms can earn abnormal profits in the long run.

5. Role of Selling Costs: Due to severe competition 'and interdependence of the firms, various sales promotion techniques are used to promote sales of the product. Advertisement is in full swing under oligopoly, and many a times advertisement can become a matter of life-and-death. A firm under oligopoly relies more on non-price competition.***Selling costs are more important under oligopoly than under monopolistic competition.***

6. Group Behaviour: Under oligopoly, there is complete interdependence among different firms. So, price and output decisions of a particular firm directly influence the competing firms. Instead of independent price and output strategy, oligopoly firms prefer group decisions that will protect the interest of all the firms. Group Behaviour means that firms tend to behave as if they were a single firm even though individually they retain their independence.

7. Nature of the Product: The firms under oligopoly may produce homogeneous or differentiated product.

i. If the firms produce a homogeneous product, like cement or steel, the industry is called a pure or perfect oligopoly.

ii. If the firms produce a differentiated product, like automobiles, the industry is called differentiated or imperfect oligopoly.

8. Indeterminate Demand Curve: Under oligopoly, the exact behaviour pattern of a producer cannot be determined with certainty. So, demand curve faced by an oligopolist is indeterminate (uncertain). As firms are inter-dependent, a firm cannot ignore the reaction of the rival firms. Any change in price by one firm may lead to change in prices by the competing firms. So, demand curve keeps on shifting and it is not definite, rather it is indeterminate.

Price determination in Perfect Competition

1. In prefect competition, price is determined by the market forces of demand and supply. All buyers and sellers are price takers and not price makers. Buyer represents demand side in the market. Every rational buyer aims at maximising his satisfaction by purchasing more at lower price and lower at higher price. This is called demand behaviour of buyer i.e. Law of Demand.
2. Seller represents supply side in the market. Every rational seller aims at maximizing his profits by selling more at higher price and lesser at lower price. This is called supply behaviour of seller i.e. Law of supply. But at a common price, buyer is ready to demand a particular quantity of goods and seller is also ready to supply exactly the same quantity of goods to buyer, such common price is called 'Equilibrium Price' and such quantity is called 'Equilibrium Quantity'.

"Equilibrium Price is a price which equates both demand and supply".

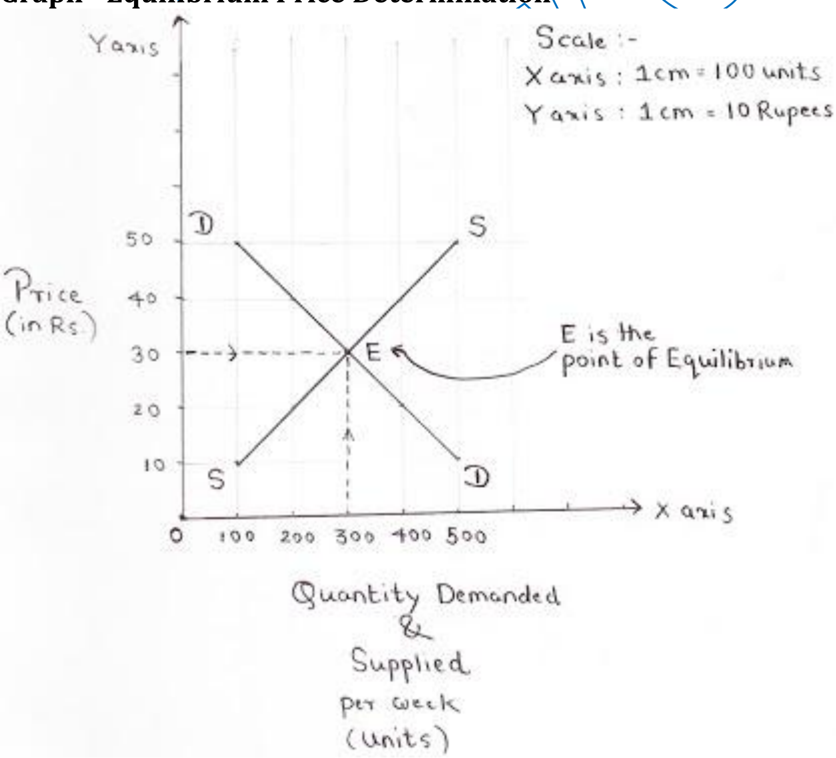
Table - Sample Demand and Supply Schedules

Demand and Supply Schedules

Price per unit of commodity	Quantity demanded per week	Quantity Supplied per week
(Rs.)	(Units)	(Units)
50	100	500
40	200	400
30	300	300
20	400	200
10	500	100

It is the price at which total demand is exactly equal to total supply. Graphically it is the point where DD curve and SS curve intersect each other.

Graph - Equilibrium Price Determination



In the above graphical diagram, the following points have been observed :-

1. On X axis, quantity demand and supplied per week has been given and on Y axis, price has been given.
2. Buyers are purchasing more at lower price and vice versa. This negative relationship is shown by downward sloping DD curve.
3. Sellers are selling more at higher price and vice versa. This positive relationship is shown by upward sloping SS curve.
4. Rs. 30 is that price at which demand equates supply (300 units). So, Rs. 30 is an equilibrium price and 300 units is an equilibrium quantity.
5. Suppose, price fails to Rs. 20/-, So this results into increase in demand (as per Law of Demand) and decrease in supply (as per Law of Supply). Since DD > SS, i.e. because of low supply, sellers will be dominant and competition will be among buyers, this leads to rise in price level. (i.e. from Rs. 20 to Rs. 30) Again price will come back at original level i.e. equilibrium price (Rs. 30).
6. Suppose, supply exceeds demand (DD < SS) now buyers become dominant and competition will be among sellers. This leads to downfall in price. (i.e. from Rs. 40 to Rs.30). Again price will come back to original level. i.e. equilibrium price (Rs. 30).
7. Such automatic adjustment by demand and supply forces will keep single price in market.

Topic 5- control of Monopolies

What is Monopoly

1) In the sixties, the problem of growth of monopoly power drew particular attention. The Government appointed the Monopolies Inquiry Commission in May, 1964, under the chairmanship of Justice K. C. Dasgupta. Its task was to enquire into the existence and effect of concentration of economic power in the organized private sector. It excluded the public sector and agriculture from the purview of its study. It investigated cases of 'product -wise concentration' and inter-industry concentration. Planning in India is fundamentally opposed to concentration of economic power.

2) But curiously with the progress of planning in India, it was realised, that there was growing concentration of wealth and economic power in fewer hands. The benefits of economic growth did not percolate to the poor. In the agricultural sector it was cornered by the big landlords. In the industrial sector also it were the big industrialists who benefited. We thus failed to achieve economic growth with justice, so enthusiastically enshrined in the Directive Principles of the Indian Constitution.Economic power gets concentrated through the monopolistic and restrictive trade practices.

3) "Monopolistic practice includes every practice whether it is by action or understanding or agreement, formal or informal, to which persons enjoying monopoly power resort in exercise of the same to reap the benefits of that power and every action, understanding or agreement tending to or calculated to preserve, increase or consolidate such power.
4) Restrictive practice refers to "practices other than those pursued by monopolists which abstract the free play of competitive forces, impede the free flow of capital or resources into the stream of production or of the finished goods in the stream of distribution at any point before they reach the hands of the ultimate consumers."
5) According to the commission, (a) controls and licenses have played a major part in the creation and growth of monopolies, (b) Big business has advantages over the smaller businesses in securing financial accommodation. It enjoys many economies of scale- "Big business by its very bigness sometimes succeeds in keeping out competition." (c) Intercorporate investment of funds and interlocking of directors was-another factor, (d) Foreign collaboration also helped big business rather than small business.

Evils of Monopoly in India :

The growth of monopoly power has the following evils :
(a) It was disadvantageous to the weaker sections.
(b) As development proceeds, the initial monopolies have more of an absorbing than spread effects.
(c) Economic disparity which arises due to undue concentration of economic power "affects economic growth itself in the long; run and inhibits it, for such growth is not sufficiently widespread to be self-generating'.
(d) Monopoly leads to the growth of inequalities.
(e) It has the power to corrupt.
(f) It can influence economic decisions of the government. Since big business controls the press, it can influence the public world opinion as well to its favour.
(g) Monopoly is also responsible for misdirection of resources.

The Monopoly Inquiry Commission, however, failed to comprehend the nature of the concentration problem in its proper perspective. While commenting on the economic consequence of concentration, it held that such concentration fostered economic growth. It led to increased capital formation. It was also responsible for the development of managerial skill. Big business has also succeeded in attracting foreign collaboration. "Thus monopolies have become the engines as well as consequences of growth."

Government Measures to Control Monopoly in India :

The M.I.C. pointed out that there is a circular relationship between monopoly and development, each appearing as a cause and effect of the other. Thus a vicious circle is being formed. It is a circle without an opening. It is a growing circle. If left to itself it has a cumulative effect. The state therefore has taken a number of measures to control the growth and exercise of monopoly power in India

1. The Monopolies Restrictive Trade Practices (MRTP) Act :

On the basis of the recommendations of the Monopoly Inquiry Commission the MRTP Act was passed which came into force from June, 1970.

The provisions of the Act came to be divided in three groups, namely:

(a) Provisions relating to concentration of economic power,
(b) Those relating to monopolistic trade practices and
(c) Those relating to restrictive trade practices.

- The Act provided for the establishment of a permanent statutory Monopolies and Restrictive Trade Practices Commission, which started functioning since 1970.
- The Act provides for strict surveillance of the large business houses. They most seek government's permission for expansion, for merger, amalgamation or for starting a new undertakings.
- The Act also requires all collective and bilateral agreements relating to restrictive trade practices to be registered with the Registrar of Restrictive Trade Agreements.
- In foreign countries like France, Canada, West Germany, etc, public sector bodies come under the purview of restrictive trade practices. But in India public sector bodies are outside the regulatory provisions.
- The MRTP Amendment Bill 1983 seeks to protect consumer not only from restrictive trade practices but also from unfair or unethical practices like misleading advertisements.

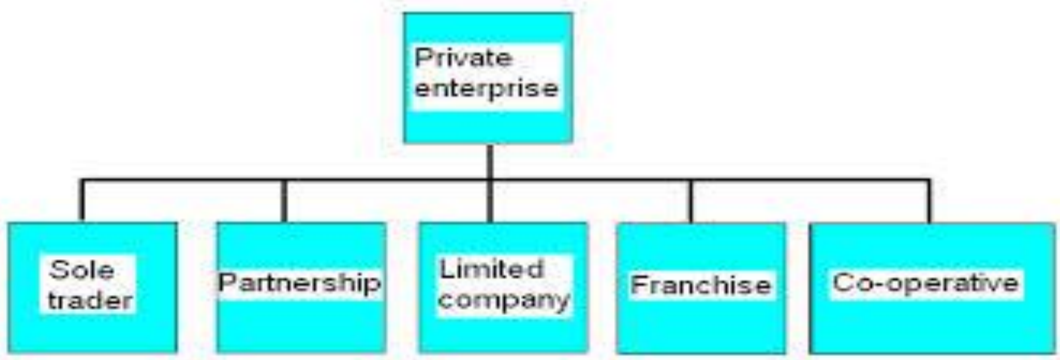
Other measures to curb the growth of monopoly power in India are the following :

1. Enactment of Foreign Exchange Regulation Act (FERA) 1973.
2. The expansion of the public sector particularly in infrastructure and in basic and heavy industries.
3. Vigorous promotion of village and small industries.
4. Regulation of flow of financial resources to the private sector from the public financial institutions.
6. Development of the co-operative sector.

Conclusion:

- Sometimes it is argued that the top 20 monopoly houses should be nationalized, if we desire a cure for the monopoly problem permanently.
- Here we should remember that an important feature of planning in India is the acceptance of the concept of mixed economy. In a mixed economy the public and private sectors coexist and contribute to the fulfillment of the planned objectives.
- The Industrial Policy allows the private sector to develop in relation with the targets and objectives of national plans and policies.
- At present there are innumerable instruments with the Government to regulate and control the activities of the private sector, so as to prevent the growth of monopolistic tendencies. The Government therefore has rightly declared that it has no intention of nationalizing the top 20 monopoly houses.
- But then, the various instruments available with the Government for controlling monopoly should be sincerely and effectively utilised.
- As pointed out by Dr. Subramaniam Swami this requires "a courage of conviction and a will to experiment" which are lacking.

Topic-6 Types of Business organizations



Sole Trader/ Sole Proprietorship

1) **Single ownership:** Any single entrepreneur known as sole proprietor can start this type of business. Even though his family members may help him or few people employed by him to manage the business, the ownership lies with one person. Since the sole proprietor is the only owner, the entire amount of capital is invested by him either from his own savings or partly through borrowing.
2) **No separate entity:** Law does not confer any separate entity to the business. The business and the proprietor are one and the same in the eyes of law.
3) **No separation of ownership from management:** There is no separation of ownership and management. The entrepreneur himself manages the business and enjoys absolute control over the affairs of the business. He is the owner, manager, seller, purchaser and everything.
4) **Unlimited liability:** The liability of the sole proprietor is unlimited. Thus, the private property of the owner is at risk as it is liable for business obligation in the event of business losses. There will be hardly any difference between personal property and business property of the entrepreneur.
5) **Individual risk:** The entire risk of the business is borne by the entrepreneur himself as he is the only owner of the business. All the risk and gain are the sole responsibility of the owner. This undivided risk will keep the entrepreneur vigilant and cautious for the business.
6) **No profit sharing:** The entrepreneur enjoys the entire profit earned in this form of business as there are no other persons to share the profit. Being the owner, he enjoys all the benefits.
7) **Least legal formalities:** There are no legal formalities required for setting up sole proprietorship business. There is no need of registration of the business. But in some cases a license is to be obtained for starting the business. For example, an individual cannot set up a bank or an insurance company. License is needed for starting a restaurant or selling drugs, crackers etc.
8) **Secrecy:** Since all the decisions are usually, to be taken by the entrepreneur himself, he can maintain utmost secrecy for the same.

Partnership

1) **Agreement**: There must be agreement between the parties concerned. This is the most important characteristics of partnership. Without agreement partnership cannot be formed. "No agreement no partnership." But only competent persons are entitled to make a contract.
   There are some provisions contained in the partnership agreement. These are determined clearly before the commencement of business. But it differs from business to business. This documents may be written or oral. But it must be written so that disputes may be settled according to the provisions of agreement.
2) **Number of Partnership**: There should be more than one person to form a partnership. But there is restriction for the maximum number of partners. In case of ordinary business, the partners must not exceed 20 and in case of banking must not exceed 10 (before nationalization).
3) **Business:** The object of the formation of partnership is to carryon any type of business. It may be manufacturing or merchandise type small or large scale business. But it should not be illegal business in the country concerned.
4) **Profit motive** :The basic motive of the formation of partnership is to earn profit. This profit is distributed among the partners according to agreed proportion. If there is loss it will be sustained by all partners except the minor.
5) **Conduct of Business**: The business of partnership is conducated by all the partners or any or them acting for all. But each partner is allowed to participate in the management by law.
6) **Entity**: It has no separate entity apart from its members. It is not independent of the partners. Law has not granted it any legal entity.
7) **Unlimited liability** :This is the prominent feature of partnership that the liability of each partner is not limited to the amount invested but his private property is also liable to pay the business obligations.
8) **Investment**: Each partner contributes his share in the capital according to the agreement. Some persons become partners without investing any capital to the business. But they devote their time, energy and ability to their business instead of capital and receive profit.

9. **Transferability of share** :There is restriction to transfer the share from one partner to another person without the consent of existing partners. So the investment in the partnership remains confined into few hands.
10. **Position** :One partner is an agent as well as principal to other partner. He can bind the other person by his act. In the position of an agent he can make contract with another person or parties on behalf of his concerned firm.
11. **Mutual Confidence** :The business of the partnership cannot be conducted successfully without the element of mutual confidence and cooperation of partners. So the members must have trust and confidence in each other.
12. **Free Operation** :There are no strict rules and regulations to control the partnership activities in our country i.e. no restriction for the audit of accounts, submission of various reports and other copies to any government authority. So this organization may operate freely without any interference.

Limited Company or Joint Stock Company:

1. Association of persons: A company is a voluntary association of persons established for profit motive. A private company must have at least two persons and the public limited company must have at least seven persons to get it registered. The maximum number of persons required for the registration in case of private company is fifty and in case of public company there is no maximum limit.

2. Artificial person: A company is an artificial person. It is created by law. Like that of the natural person, it can own property, incur debts, file suits, enter into contracts with others under its own name. It can be sued and fined but cannot be imprisoned.

3. Separate legal entity: A company being created under law has a separate entity from its members. Any of its members can enter into contracts with others. A member cannot bind a company by his acts or dealings with the third parties. The company can file a suit against its members and its shareholders can also sue the company. Further, a shareholder is not liable for the acts of the company even though he may be holding all the shares of that company.

4. Limited liability: The liability of the members or shareholders is limited to the extent of the value of shares held or the amount guaranteed by them. The shareholders are not personally liable for the debts of a company beyond that limit.

5. Transferability of shares: The shares of a public limited company are freely transferable and can be purchased and sold through the stock exchanges. A shareholder of a public limited company can transfer his shares without the consent of other shareholders. But there are certain restrictions on transferability of shares in case of private limited company.

6. Common seal: Since a company is an artificial person, it cannot put its signature on any document. Therefore, it is statutory for every company to have a seal on which the name of the company is engraved. Affixing of seal on any document signifies the signature of the company. Of course two directors have to sign as witnesses in such .cases.

7. Separation of ownership from management: The shareholders are the owners of the company. They are heterogeneous group of people who are widely scattered throughout the country and abroad. The shareholders elect their representatives called directors to manage the company. Thus, the company is managed by directors rather than the shareholders. This results in separation of ownership from management.
8. Perpetual succession: The company enjoys a continuous existence. Its existence is not affected by death, lunacy or insolvency of its shareholders or directors as the case in partnership or sole proprietorship. The company can only be dissolved by the operation of law.
9. Investment facilities: A joint stock company raises its funds through issue of shares to general public. Due to the small denomination of the shares, the company provides investment opportunities to all sections of people who want to put their surplus money in the company's share.
10. Accountability: A joint stock company has to function as per the provisions of the Companies Act. The accounts are to be audited by qualified auditors. Such accounts and exports are published for the information of all stakeholders. Regular and timely reports are to be submitted to the Government.

11. Restricted action: A company cannot go beyond the powers mentioned in the abject clause of the Memorandum of Association. Therefore, its action is limited.

Cooperative Societies
The Indian Cooperative Societies Act, 1912 - Section 4 of this Act definies cooperatives "as a society which has its objectives the promotion of economic interest, its members in accordance with cooperative principles."

Characteristics of Cooperative Soceity:
Based on the above definitions, we can derive the following characteristics of cooperative organisations.
1. Voluntary association: Everybody having a common interest is free to join cooperative society. There is no restriction on the basis of caste, creed, religion, colour, etc. Anybody can also leave it at any time after giving due notice to the society. That is specialty of any cooperative society. There should be minimum of 10 members to for cooperative society but there is no maximum limit for the membership.
2. Separate legal entity:A cooperative society after registration is recognised as separate legal entity by law. It acquires an identity quite distinct and independent of its member can purchase, dispose its own assets, can sue and also can be sued. The income of cooperative society is legally taxable as per the Income Tax Act, 1961.
3. Democratic management: Equalities is the essence of cooperative enterprises, governed by democratic principles. Every member has got equal right over the function management of that society. As such each member has only single voting right irrespective of the number of shares held or capital contributed by them. In case of cooperative society, no member detects the terms and conditions of the functioning because "one man one vote" is the thumb rule.
4. Service motive: The main objective being formation of any cooperative society is for mutual benefit through self-help and collective effort. Profit is not at all in the agenda of the cooperative society. But if members so like, they can take up any activities of their choice to generate surplus in order to meet the day-to-day expenses.
5. Utilisation of surplus: The surplus arising from the operation of business is partly kept in a separate reserve and partly distributed as dividend among the members. According to Indian Cooperative Societies Act - 1912, each society must transfer at least one-fourth of its profits to general reserve. It may distribute maximum upto 90 per cent of its surplus as dividend to its members and can spent another 10 per cent for the welfare of the members.
6. Cash trading: One exception in the cooperative society is that like other business if never go for credit sales. It sells the goods on the basis of cash only. Hence, the cooperative society hardly come across with the financial hardship because of non-collection of sales dues. Members can only purchase on the basis of credit, which is an exception to the present rule.

7. Fixed rate of return: All members are supposed to contribute capital for the formation of a cooperative society or at the time of joining as a member of the cooperative ^society. In return to the capital invested, the members are assured of a fixed rate of return maximum to the extent of 9 per cent per annum on the sum deployed by them. This amount is being paid from the surplus generated by the society on that year. This is an incentive extended by the society to its members.

8. Government control: All the cooperative societies of the country are regulated by the Government through its different rules and regulations framed from time to time. Cooperative societies of the country are required to register themselves as per the Indian Cooperative Societies Act, 1912. Sometimes different State Governments also frame laws regarding the registration and functioning of cooperative societies for their states.

9. Capital: The capital of the society is raised from its members by way of share capital. However, the major part of finance is raised by the society through taking loan from the Government or by accepting grants and assistance from the Central or State Government or from the apex cooperative institutions like state and central cooper

Franchising

The term "franchising" can describe some very different business arrangements. It is important to understand exactly what you're being offered.

Business format franchise

- This is the most common form of franchising. A true business format franchise occurs when the owner of a business (the franchisor) grants a licence to another person or business (the franchisee) to use their business idea - often in a specific geographical area.
- The franchisee sells the franchisor's product or services, trades under the franchisor's trade mark or trade name and benefits from the franchisor's help and support.
- In return, the franchisee usually pays an initial fee to the franchisor and then a percentage of the sales revenue.
- The franchisee owns the outlet they run. But the franchisor keeps control over how products are marketed and sold and how their business idea is used.
- Well-known businesses that offer franchises of this kind include Prontaprint, Dyno-Rod, McDonald's and Coffee Republic.
- Other types of arrangement

Different types of sales relationships are also sometimes referred to as franchises. For example:

- **Distributorship and dealership** - you sell the product but don't usually trade under the franchise name. You have more freedom over how you run the business.
- **Agency** - you sell goods or services on behalf of the supplier.
- **Licensee** - you have a license giving you the right to make and sell the licensor's product. There are usually no extra restrictions on how you run your business.

Chapter-3 : Means of Production & respective concepts

TOPIC 1 : FACTORS OF PRODUCTION

Meaning of Production Function

The relationship between the physical inputs and the physical outputs of a firm is generally referred to as the production function.

The production function can also be expressed in the form of mathematical equations in which output is the dependent variable and inputs are the independent variables. In general terms this relationship can be stated as :

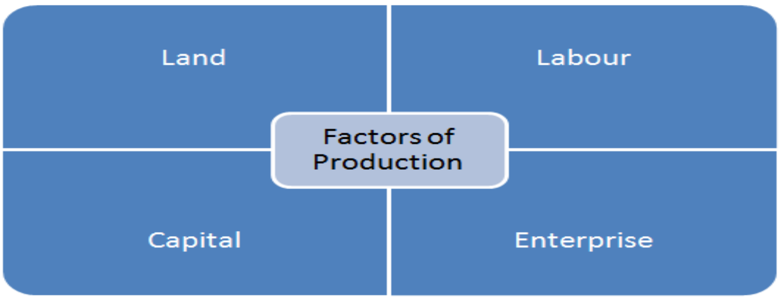
P: (a, b, c, ……. n)

Where P is the rate of output of a given commodity and a, b, c, …….n are the various factor services used per unit of the time

Assumption of the production function.

The production function is based on the following assumptions.

i) It is related to a specified period of time.
ii) It is assumed that the state of technical knowledge does not change during the period of time.
iii) It is assumed that the firm in question will use the best and the most efficient technique available in production.
iv) The factors of production are divisible into viable units.



LAND –

The term 'Land' in economics is often used in a wider sense. It does not mean only the surface of the soil, but it also includes all those natural resources which are the free gifts of nature.

It, therefore, means all the free gifts of nature. These natural gifts include: (i) rivers, forests, mountains and oceans; (ii) heat of sun, light, climate, weather, rainfall, etc. which are above the surface of land; (iii) minerals under the surface of the earth such as iron, coal, copper, water, etc. According to Marshall, "By land is meant… materials and forces which nature gives freely for man's aid in land, water, air, light and heat." Therefore, land is a stock of free gifts of nature

Characteristics of Land

1. Free Gift of Nature
2. Fixed Quantity
3. Land is Permanent
4. Land is a Primary Factor of Production
5. Land is a Passive Factor of Production
6. Land is Immovable
7. Land has some Original Indestructible Powers
8. Land Differs in Fertility
9. Supply of Land is Inelastic
10. Land has Many Uses

ORGANIZATION AND ENTERPRISE (ENTREPRENEURSHIP)

Features of Entrepreneurship

The entrepreneur as an organizer of the process of production is the fore-runner of economic development of a country.

1. Scare human resource
2. Heterogeneous factor
3. Indispensable factor
4. Intangible factor
5. Highly mobile
6. Cannot be Bought & Sold
7. Residual reward

TOPIC -2 : LABOUR & ITS PRODUCTIVITY

What is labour

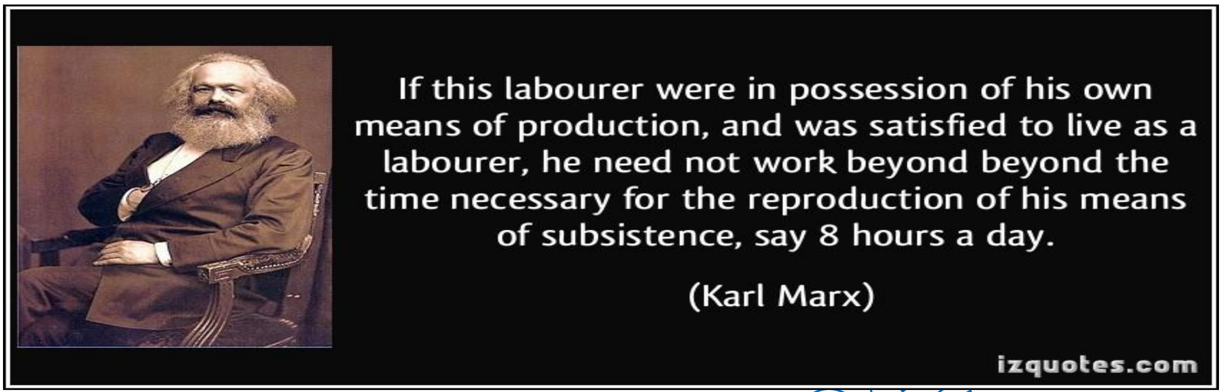
Labour includes both physical and mental work undertaken for some monetary reward. In this way, workers working in factories, services of doctors, advocates, ministers, officers and teachers are all included in labour. Any physical or mental work which is not undertaken for getting income, but simply to attain pleasure or happiness, is not labour.

For example, the work of a gardener in the garden is called labour, because he gets income for it. But if the same work is done by him in his home garden, it will not be called labour, as he is not paid for that work. So, if a mother brings up her children, a teacher teaches his son and a doctor treats his wife, these activities are not considered 'labour' in economics. It is so because these are not done to earn income.

Characteristics of Labour

Labour has the following peculiarities which are explained as under:

1. Labour is Perishable:
2. Labour cannot be separated from the Labourer:
3. Less Mobility of Labour:
4. Weak Bargaining Power of Labour:
5. Inelastic Supply of labour:
6. Labourer is a Human being and not a Machine:
7. A Labourer sells his Labour and not Himself:
8. Increase in Wages may reduce the Supply of Labour:
9. Labour is both the Beginning and the End of Production:
10. Differences in the Efficiency of Labour:
11. Indirect Demand for Labour:
12. Difficult to find out the Cost of Production of Labour:
13. Labour creates Capital:
14. Labour is an Active Factor of Production



DEFINITION of 'Labor Productivity'

A measurement of economic growth of a country. Labor productivity measures the amount of goods and services produced by one hour of labor. More specifically, labor productivity measures the amount of real GDP produced by an hour of labor. Growing labor productivity depends on three main factors: investment and saving in physical capital, new technology and human capital.

The eight main factors that affect productivity are:

1. Technical factors
2. Production factors
3. Organizational factor
4. Personnel factors
5. Finance factors
6. Management factors
7. Government factors
8. Location factors

TOPIC 3: WAGES

Wage

A **wage** is monetary compensation (or remuneration) paid by an employer to an employee in exchange for work done. Payment may be calculated as a fixed amount for each task completed (a task **wage** or piece rate), or at an hourly or daily rate, or based on an easily measured quantity of work done.

Nominal and Real Wages

Nominal Wage:

By nominal wage is meant the total amount of money earned by a person during a certain period. For instance one employs a servant and pays him Rs. 2600 per month for the services he renders to him. The amount which is paid in terms of money only is named as normal wages.

Real Wages:

Real wages refer to the total amount of satisfaction which a worker receives in the form of necessities, comforts and luxuries in return for the services. Real wages generally include money wages and other facilities like free clothing, free housing, free accommodation, free electricity etc. If we are to judge the standard of living of the masses it can be estimated not from the nominal wages of the workers but from the real wages. In other words of Adam Smith, the labour is rich or poor, is well or ill rewarded in proportion to the real not nominal wages of the labour.

Factors Determining Real Wages

(i) Purchasing Power of Money: The purchasing power of money does not remain the same. It continues fluctuating from time to time. When the prices of the commodities go up, the purchasing power of money falls and when the prices fall, the purchasing power of money rises. The real wages of a labour depend upon the purchasing power of money. If the nominal wages are quite high and prices are low, then we can say that the real wages of labour are high but in case the cost of living is high, then the real wages will be low. Thus we conclude that other things remaining the same, the higher the cost of living, the lower the real wages and vice versa.

(ii) Opportunity of Extra Earning: If a person has an opportunity of earning extra income in a certain occupation, than his real wages will be higher then the one who does not have. For instance a Professor can increase his income by writing books, contributing articles of journals, newspapers etc but a superintendent working in are office does not have opportunity for supplementing his income. So his real wages will be low as compared to professor's income even if both are getting the same salary.

(iii) Nature of Work: In computing real wages, we have to take into consideration the nature of work also. If the work is pleasant and agreeable then real wages will be high, even if the nominal wages are low. For instance Rashid is working as a pilot in the PAF and is getting Rs. 50,000 per month. Another man Humid is magistrate and is receiving Rs. 20,000 monthly. There is no doubt that Rashid's nominal wage is higher but his duty is of such a nature that his life is always in danger. On the other hand the duty of the magistrate is pleasant and has a social status. So we can say that the real wage of the magistrate is high because his work is pleasant while that of the pilot is low because his work is risky

(iv) Hours of Work: When we are to measure the real wages of two different persons earning the same amount, the number of working hours should also be taken into account. For instance if a worker receives Rs. 5000 monthly by working four hours a day and the other 8 hours a day. The real wage of the former will be higher than the later.

(v) Tenure of Service: Employments are of two types; permanent and seasonal. If a person is engaged in a work which is regular and permanent then the other things remaining the same, his real wages will be higher than the one who is working in a seasonal occupation.

(vi) Form of Payment: While determining the real wages of a labour, the form of payment should also be taken into consideration. If a labour is receiving Rs. 6000 monthly and there is no extra payment in kind such as clothing, food, shelter etc then his real wages will be lower than the one who earns Rs. 5000 monthly and also receives additional facilities in kind.

(vii) Expenses of Trainings: Expenses of training are also one of the very important elements in determining the real wages of a labour. For instance the nominal wages of two labourers are the same but their period and the cost of training differ. One labour has spent 16 years of his life in getting education and has spent Rs. 10 lacs. The cost and the period of training of the other labour is Rs. 40,000 and two years only. It is quite evident that the real wages of the later are higher than that of the former.

(viii) Social Status: Real wages also depend upon social status. The money wages of magistrate and a professor may be equal but the former's position is held in great social esteem in this country. So we can say that real wages of the magistrate are higher than the professor's.

TOPIC 4: SYSTEM OF WAGE PAYMENT

The wage payment systems can be divided into two main systems as follows.
1. Piece rate system
2. Time rate system

Importance of Wage Payment System

* Wage payment system facilitates the preparation of wage plan for future.
* Wage payment system helps to determine the cost of production and the profitability of the organization.
* Wage payment system determines the amount of earning of the workers and their living standards.
* Wage payment system affects the interest and attitude of the workers.
* Wage payment system determines the level of satisfaction of the workers and affects the rate of labor turnover.
* Wage payment system helps in recruiting skilled, experienced and trained workers.
* Wage payment system helps to increase the productivity and goodwill of the organization.

Essential Characteristics of A Good Wage Payment System

* Wage payment system should be fair and justifiable to the workers and organization.
* Wage payment system should help in maximizing workers' satisfaction and minimizing labor turnover.
* Wage payment system should assure minimum guaranteed wages to all workers.
* Wage payment system should assure equal pay for equal work.
* Wage payment system should provide more wages to efficient and skilled workers.
* Wage payment system should follow government policy and trade union's norms.
* Wage payment system should be simple and understandable to all the workers.
* Wage payment system should help in improving performance and productivity of the workers.
* Wage payment system should be flexible enough to suit the needs of the organization

1. Time Wage System or Time Rate System :

Under this system, laborers get wage on the basis of time which is utilized in organization. This wages may be charged on per hour, per day, per month or per year basis. There is no relation or quantity of output and wages in this method. In India's industry, this method is most popular. Its other name is day wages system or time wok system.

We can calculate wages with following formula

Total Wages = Time taken X Rate

For Example

A worker produced 10000 articles in 7600 hours. His hourly wage rate is Rs. 2 /- . Calculate the wage of the worker when he is paid on the basis of time.

Solution :

Applying the formula, we get :
Wage = T.T. X R
= 7600 X 2 = Rs. 15200

2. Piece Wage System or Work Rate System:
Under this method or system, laborers can get the wages on the basis of their work done. No time element will be used for calculation of wages. Rate is also on the basis of quantity or unit produced. Under this, method, laborer tries to best for producing the products fastly for getting more wages. This method is also called payment by result.

Formula
Total Wages = Unit Produced X Rate per unit

For Example:
2500 units were produced by a worker in 1200 hrs. Rate of production is Rs. 3 /- per unit. Calculate the wage of the worker if he is paid according piece rate method.

Solution:
By applying formula, we get:
Wages = units produced X rate per unit
= 2500 X 3 = Rs. 7500

1. ***Meaning*** - Piece rate system is a method of wage payment to workers based on the quantity of output they have produced. Time rate system is a method of wage payment to workers based on time spent by them for the production of output.
2. ***Nature of Payment*** - Piece rate system pays the workers according to the units of output produced. Time rate system pays the workers according to the time spent in the factory.
3. ***Emphasis*** - Piece rate system gives emphasis on larger quantity of output. Time rate system emphasis on better quality of output.
4. ***Discrimination*** - Piece rate system discriminates the workers and pays more wages to efficient and skilled workers. Time rate system does not discriminate the workers and pays the same wages to efficient and inefficient workers.
5. ***Supervision***- Piece rate system requires strict supervision to get the required quality output. Time rate system requires strict supervision to get required quantity of output.
6. ***Determination Of Labor Cost*** - Piece rate system helps to fix per unit labor cost in advance. Time rate system does not help to fix labor cost per unit in advance.
7. ***Flow Of Production*** - Piece rate system does not bring uniformity in the flow of production and causes an excessive wastage of inputs. Time rate system helps maintain a uniform flow of production and ensures an efficient use of materials, tools and equipments.
8.

<u>TOPIC-5: MINIMUM WAGES ACT 1954</u>
MINIMUM WAGES: The lowest wage payable to employees in general or to designated employees as fixed by law or by union agreement.

MINIMUM WAGES ACT 1948
1) The **Minimum Wages Act 1948** is an Act of Parliament concerning Indian labour law that sets the minimum wages that must be paid to skilled and unskilled labours. The Indian Constitution has defined a 'living wage' that is the level of income for a worker which will ensure a basic standard of living including good health, dignity, comfort, education and provide for any contingency. However, to keep in mind an industry's capacity to pay the constitution has defined a 'fair wage'. Fair wage is that level of wage that not just maintains a level of employment, but seeks to increase it keeping in perspective the industry's capacity to pay.

2) A minimum wage is such a wage that it not only guarantees bare subsistence and preserves efficiency but also provides for education, medical requirements and some level of comfort. India introduced the Minimum Wages Act in 1948,giving both the Central government and State government jurisdiction in fixing wages.
3) The act is legally non-binding, but statutory. Payment of wages below the minimum wage rate amounts to forced labour. Wage Boards are set up to review the industry's capacity to pay and fix minimum wages such that they at least cover a family of four's requirements of calories, shelter, clothing, education, medical assistance, and entertainment.
4) Under the law, wage rates in scheduled employments differ across states, sectors, skills, regions and occupations owing to difference in costs of living, regional industries' capacity to pay, consumption patterns, etc. Hence, there is no single uniform minimum wage rate across the country and the structure has become overly complex. The highest minimum wage rate as updated in 2012 is Rs. 322/day in Andaman and Nicobar to Rs. 38/day in Tripura

<u>TOPIC 6: MONEY</u>

Meaning of Money:

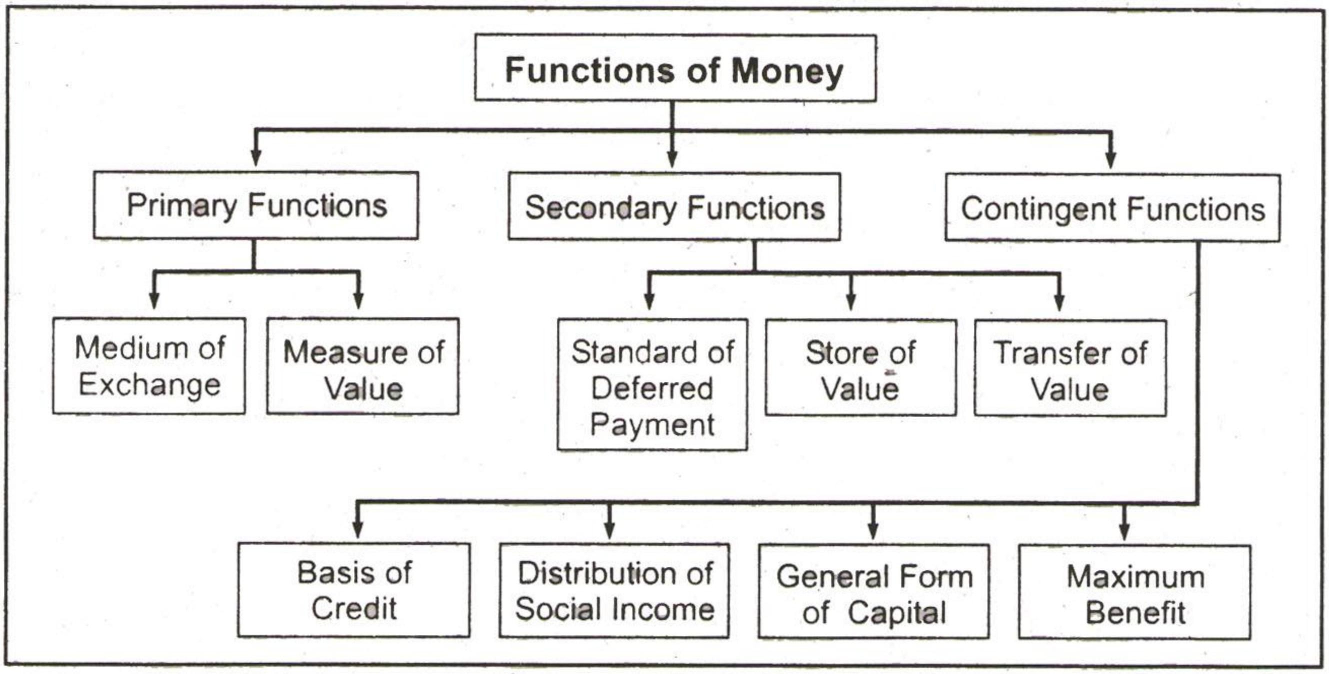
1) Money is a token or item which acts as a medium of exchange that has both legal and social acceptance with regards to making payment for buying commodities or receiving services, as well as repayment of loans.
2) In addition, money also functions as a standard of value and a store of value because with the help of money, the value of various goods and services can be measured. According to a small number of economists, money is a standard of deferred payment.
3) Money refers both to currency, specifically a large number of currencies that circulate under the legal tender status, and different types of financial deposit accounts, for example savings accounts, demand deposits, as well as certificates of deposit.
4) According to the theory of modern economy, currency is the most minuscule constituent of money supply. Money has no similarities with real value as real value is the fundamental component of the study of economics. The study of economics has a key focus on money and money is mostly associated with finance. If money is absent, then the economy becomes ineffective, and on the contrary, the efficient use of money results in increased productivity and wealth.

Functions of Money –

1) **Money as a Medium of Exchange**: - The function of money as a medium of exchange solves all the difficulties of barter system. There is no necessity for a double coincidence of wants in the money economy. The man with cow who wants to purchase cloth need not seek a cloth seller who wants a cow. He can sell his cow in the market for money and then purchase cloth with the money obtained.
2) **Money as Measure of Value**:- In money economy values of all commodities are expressed in terms of money. Money is like the yard stick of cloth merchant, as yard-stick measures all varieties of cloth, money measures the value of all varieties goods. This function of money makes transactions easy and also fair.
3) **Standard of Deferred Payment**:- In a money economy the contracts are made for future payments terms of money instead of goods and promise to repay the loan in money. In this way money is the standard of deferred payments. This function stimulates all kinds of economic activities which depend on borrowed money.
4) **Money as a Store of Value**:- Goods cannot be stored because they are perishable. People receive their incomes in money form and keep their savings in money form in banks. In this way, money is used to store value of commodities.
5) **Store of value**: - In order to be a medium of exchange, money must hold its value over time; that is, it must be a store of value. If money could not be stored for some period of time and still remain

valuable in exchange, it would not solve the double coincidence of wants problem and therefore would not be adopted as a medium of exchange

6) **Medium of exchange**: - Money's most important function is as a medium of exchange to facilitate transactions. Without money, all transactions would have to be conducted by barter, which involves direct exchange of one good or service for another



Classification of Money

1) **Commodity Money**- It is the simplest kind of money which is used in barter system where the valuable resources fulfill the functions of money. The value of this kind of money comes from the value of resource used for the purpose. It is only limited by the scarcity of the resources. Ex: gold coins, beads, shells, pearls, stones, tea, sugar, metal

2) **Fiat Money** - The word fiat means the "command of the sovereign". Fiat currency is the kind of money which don't have any intrinsic value and it can't converted into valuable resource. The value of fiat money is determined by government order which makes it a legal instrument for all transaction purposes. The fiat money need to be controlled as it may affect entire economy of a country if it is misused. Today Fiat money is the basis of all the modern money system. The real value of fiat money is determined by the market forces of demand and supply. Ex : Paper money, Coins

3) **Fiduciary Money**- Today's monetary system is highly fiduciary. Whenever, any bank assures the customers to pay in different types of money and when the customer can sell the promise or transfer it to somebody else, it is called the fiduciary money. Fiduciary money is generally paid in gold, silver or paper money. There are cheques and bank notes, which are the examples of fiduciary money because both are some kind of token which are used as money and carry the same value.

4) **Commercial Bank Money** - Commercial Bank money or demand deposits are claims against financial institutions that can be used for the purchase of goods and services. A demand deposit account is an account from which funds can be withdrawn at any time by cheque or cash withdrawal without giving the bank or financial institution any prior notice.

TOPIC 7: INFLATION

What is Inflation? Meaning

1) Inflation refers to a continuous rise in general price level which reduces the value of money or purchasing power over a period of time.
2) Statistically speaking, inflation is measured in terms of a percentage rise in the price index (i.e. percentage rate per unit time) usually for an annum (a year) or for 30-31 days (a month).

According to Crowther,
"Inflation is a state in which the value of money is failing i.e. the prices are rising."

According to Coulbourn,
"Inflation is too much of money chasing too few goods."

Features of Inflation
The characteristics or features of inflation are as follows:-

1. Inflation involves a process of the persistent rise in prices. It involves rising trend in price level.
2. Inflation is a state of disequilibrium.
3. Inflation is scarcity oriented.
4. Inflation is dynamic in nature.
5. Inflationary price rise is persistent and irreversible.
6. Inflation is caused by excess demand in relation to supply of all types of goods and services.
7. Inflation is a purely monetary phenomenon.
8. Inflation is a post full employment phenomenon.
9. Inflation is a long-term process.

Topic 4-Types of Inflation

Types of Inflation on Rising Prices

Types of inflation on the basis of rising prices or rate of inflation:-

1. **Creeping Inflation**: When prices are gently rising, it is referred as Creeping Inflation. It is the mildest form of inflation and also known as a **Mild** Inflation or **Low** Inflation. According to **R.P. Kent**, when prices rise by not more than (upto) 3% per annum (year), it is called Creeping Inflation.
2. **Chronic Inflation**: If creeping inflation persist (continues to increase) for a longer period of time then it is often called as Chronic or **Secular** Inflation. Chronic Creeping Inflation can be either Continuous (which remains consistent without any downward movement) or Intermittent (which occurs at regular intervals). It is called chronic because if an inflation rate continues to grow for a longer period without any downturn, then it possibly leads to Hyperinflation.
3. **Walking Inflation**: When the rate of rising prices is more than the Creeping Inflation, it is known as Walking Inflation. When prices rise by more than 3% but less than 10% per annum (i.e between 3% and 10% per annum), it is called as Walking Inflation. According to some economists, walking inflation must be taken seriously as it gives a cautionary signal for the occurrence of running inflation. Furthermore, if walking inflation is not checked in due time it can eventually result in Galloping inflation.
4. **Moderate Inflation**: Prof. Samuelson clubbed together concept of Crepping and Walking inflation into Moderate Inflation. When prices rise by less than 10% per annum (single digit inflation rate), it is known as Moderate Inflation. According to Prof. **Samuelson**, it is a stable inflation and not a serious economic problem.
5. **Running Inflation**: A rapid acceleration in the rate of rising prices is referred as Running Inflation. When prices rise by more than 10% per annum, running inflation occurs. Though economists have not suggested a fixed range for measuring running inflation, we may consider price rise between 10% to 20% per annum (double digit inflation rate) as a running inflation.
6. **Hyperinflation**: Hyperinflation refers to a situation where the prices rise at an alarming high rate. The prices rise so fast that it becomes very difficult to measure its magnitude. However, in quantitative terms, when prices rise above 1000% per annum (quadruple or four digit inflation rate), it is termed as Hyperinflation. During a worst case scenario of hyperinflation, value of national currency (money) of an affected country reduces almost to zero. Paper money becomes worthless and people start trading either in gold and silver or sometimes even use the old barter system of commerce. Two worst examples of hyperinflation recorded in world history are of those experienced by **Hungary** in year 1946 and **Zimbabwe** during 2004-2009 under **Robert Mugabe**'s regime.
7. **Fiscal Inflation** : It occurs due to excess government expenditure or spending when there is a budget deficit.
8. **Population Inflation** : Prices rise due to a rapid increase in population.
9. **Foreign Trade Induced Inflation** : It is divided into two categories, viz., (a) Export-Boom Inflation, and (b) Import Price-Hike Inflation.
10. **Export-Boom Inflation** : Considerable increase in exports may cause a shortage at home (within exporting country) and results in price rise (within exporting country). This is known as Export-Boom Inflation.
11. **Import Price-Hike Inflation** : If a country imports goods from a foreign country, and the prices of imported goods increases due to inflation abroad, then the prices of domestic products using imported goods also rises. This is known as Import Price-Hike Inflation.
12. **Demand-Pull Inflation** : Inflation which arises due to various factors like rising income, exploding population, etc., leads to aggregate demand and exceeds aggregate supply, and tends to raise prices of goods and services. This is known as Demand-Pull or **Excess Demand** Inflation.
13. **Cost-Push Inflation** : When prices rise due to growing cost of production of goods and services, it is known as Cost-Push (Supply-side) Inflation. For e.g. If wages of workers are raised then the unit cost of production also increases. As a result, the prices of end-products or end-services being produced and supplied are consequently hiked.

Main Causes of Inflation

1) **Cost Push Inflation -** Cost-push inflation occurs when businesses respond to rising production costs, by raising prices in order to maintain their profit margins. Higher costs shift a firm's supply curve upwards and lead to an increase in price. There are many reasons why costs might rise:

- **Rising imported raw materials costs** perhaps caused by inflation in countries that are heavily dependent on exports of these commodities or alternative by a fall in the value of the Rs in the foreign exchange markets which increases the price of imported inputs

- **Rising labour costs** - caused by wage increases which exceed any improvement in productivity. This cause is important in those industries, which are labour-intensive. If labour costs amount for example to 25% of a firms total costs then a 10% increase in the total wage bill will cause the firms total costs to rise by 2.5%.

- **Higher indirect taxes imposed by the government** for example a rise in the specific duty on alcohol and cigarettes, an increase in fuel duties or perhaps a rise in the standard rate of Value Added Tax or an extension to the range of products to which VAT is applied. These taxes are levied on producers who, depending on the price elasticity of demand and supply for their products can opt to pass on the burden of the tax onto consumers. For example, if the government was to choose to levy a new tax on aviation fuel, then this would contribute to a rise in cost-push inflation.

2) **Demand Pull Inflation -** Demand-pull inflation is likely when there is full employment of resources and short run aggregate supply is inelastic. In these circumstances an increase in AD will lead to a general increase in prices. AD might rise for a number of reasons some of which occur together at the same moment of the economic cycle

- **A depreciation of the exchange rate,** which increases the price of imports and reduces the foreign price of Indian exports. If consumers buy fewer imports, while foreigners buy more exports, Aggregate demand will rise. If the economy is already at full employment, prices are pulled upwards.
- **A reduction in direct or indirect taxation**. If direct taxes are reduced consumers have more disposable income causing demand to rise. A reduction in indirect taxes will mean that a given amount of income will now buy a greater real volume of goods and services. Both factors can take aggregate demand and real GDP higher and beyond potential GDP.
- **The rapid growth of the money supply** perhaps as a consequence of increased bank and building society borrowing if interest rates are low and consumer confidence is high. Monetarist economists believe that the root causes of inflation are monetary in particular when the monetary authorities permit an excessive growth of the supply of money in circulation beyond that needed to finance the volume of transactions produced in the economy.
- **Rising consumer confidence and an increase in the rate of growth of house prices** both of which would lead to an increase in total household demand for goods and services
- **Faster economic growth in other countries** providing a boost to UK exports overseas. Remember that export sales provide an extra flow of income and spending into the UK circular flow. Exports are counted as an injection of AD.

Effects of Inflation

1. **Impact of Inflation on Savers:** When inflation is high, people may lose confidence in money as the real value of savings is severely reduced. Savers will lose out if interest rates are lower than inflation – leading to negative real interest rates. This has certainly happened in the UK during 2009-2011.
2. **Inflation Expectations and Wage Demands:** Price increases lead to higher **wage demands** as people try to maintain their real living standards. This process is known as a 'wage-price spiral'.
3. **Arbitrary Re-Distributions of Income:** Inflation tends to hurt people in jobs with **poor bargaining positions** in the labour market - for example people in low paid jobs with little or no trade union protection may see the real value of their pay fall. Inflation can also favour borrowers at the expense of savers as inflation erodes the real value of existing debts.
4. **Business Planning and Investment:** Inflation can disrupt business planning. Budgeting becomes difficult because of the uncertainty created by rising inflation of both prices and costs - and this may reduce planned investment spending.
5. **Competitiveness and Unemployment:** Inflation is a possible cause of higher unemployment in the medium term if one country experiences a much higher rate of inflation than another, leading to a **loss of international competitiveness** and a subsequent worsening of their trade performance.

Benefits of inflation

1. **Higher revenues and profits**: A low stable rate of inflation of say between 1% and 3% allows businesses to raise their prices, revenues and profits, whilst at the same time workers can expect to see an increase in their pay packers. This can give psychological boost and might lead to rising investment and productivity.
2. **Tax revenues**: The government gains from inflation through what is called '**fiscal drag effects'**. For example many indirect taxes are ad valorem in nature, e.g. VAT at 20% - so as prices rise, so does the amount of tax revenue flowing into the Treasury.
3. **Cutting the real value of debt**: Low stable inflation is also a way of helping to reduce the real value of outstanding debts – there are many home owners with huge mortgages who might benefit from a period of inflation to bring down the real burden of their mortgage loans. The government too might welcome a period of higher inflation given the huge level of public sector debt!
4. **Avoiding deflation**: Perhaps one of the key benefits of positive inflation is that an economy can manage to avoid some of the dangers of a deflationary recession

Measures to Control Inflation

The various methods to control inflation are given below however the most common ones are Monetary and Fiscal Policies:

1. Monetary Policy - With growth of 3.8%, demand in the economy could be growing faster than capacity can grow to meet it. This leads to inflationary pressures. We can term this demand pull inflation. Therefore, reducing the growth of Aggregate demand, should reduce inflationary pressures.
Monetary policy is the policy of the central bank of the country, which is the supreme monetary and banking authority in a country. The central bank may use such methods as the bank rate, open market operations, the reserve ratio and selective controls in order to control the credit creation operation of commercial banks and thus restrict the amounts of bank deposits in the country. This is known as tight money policy. Monetary policy to control inflation is based on the assumption that a rise in prices is due to a larger demand for goods and services, which is the direct result of expansion of bank credit. To the extent this is true; the central bank's policy will be successful.
Monetary policy may not be effective in controlling inflation, if inflation is due to cost-push factors. Monetary policy can only be helpful in controlling inflation due to demand-pull factors.
Let us see how increasing the rate can help control inflation
A higher interest rate should also lead to higher exchange rate, which helps to reduce inflationary pressure by

- Making imports cheaper.
- Reducing demand for exports and
- Increasing incentive for exporters to cut costs.

2. Fiscal Policy - It is the policy of a government with regard to taxation, expenditure and public borrowing. It has a very important influence on business and economic activity. Taxes determine the size or the volume of disposable income in the hands of the public. The proper tax policy to control inflation will avoid tax cuts, introduce new taxes and raise the rates of existing taxes. The purpose being to reduce the volume of purchasing power in the hands of the public and thus reduces their demand. A precisely similar effect will be achieved if voluntary or compulsory savings are increased. Savings will reduce current demand for goods and thus reduce the inflationary rise in prices.
As an anti-inflationary measure, government expenditure should be reduced. This indicates that demand for goods and services will be further reduced. This policy of increasing public revenue through taxation and decreasing public expenditure is known as surplus budgeting. However, there is one important difficulty is this policy. It may be easy to increase revenue in times of inflation when people have more money income, but difficult to reduce public expenditure.
During war times as well as during a period of development, it is absolutely impossible to reduce the planned expenditure. If the government has already taken up a scheme or a group of schemes, it is ruinous to give them up in the middle. Therefore, public expenditure cannot be used as an anti-inflationary measure. Lastly, public debt, i.e., the debt of the government may be managed in such a way that the supply of money in the country may be controlled.
The government should avoid paying back any of its previous loans during inflation so as to prevent an increase in the circulation of money. Moreover, if the government manages to get a surplus budget, it should be used to cancel public debt held by the central bank. The result will be anti-inflationary since money taken from the public and commercial banks is being cancelled out and is removed from circulation. But the problem is how to get a budget surplus, which is extremely difficult.

3. Price Control and Rationing
This is the most important and effective method available during war and other critical times particularly because both monetary and fiscal policies are more or less useless during this period. Price control implies the establishment to legal upper limits beyond which prices of particular goods should not rise. The purpose of rationing, on the other hand, is to distribute the goods in short supply in an equitable manner among all people, irrespective of their wealth and social status. Price control and rationing generally go together. The chief objection behind use of this method to fight inflation is that they restrict the freedom of the consumers and thus limit their welfare. Besides, its success depends on administrative efficiency, which in many underdeveloped countries is very low.

4. Other Methods

Another important anti-inflationary device is to increase the supply of goods through either increased production or imports. Production may be increased by shifting factors of production from the production of less inflation sensitive goods, which are in comparative abundance to the production of those goods which are in short supply and which are inflation-sensitive. Moreover, shortage of goods internally may be relieved through imports of inflation sensitive goods, either on credit or in exchange for export of luxury goods and other non-essentials.

5. Realistic Methods

1. Increase the supply of goods and services: When the supply of goods and services is increased, the prices will come down.
2. Population planning: Control on population by adopting different measures of family planning will reduce the demand and finally prices will be controlled.
3. Price control policy: The govt. should adopt strict price control policy against the profiteers and hoarders.
4. Economic Planning: Effective economic planning is necessary to control the inflation in the country.

TOPIC 5: CAPITAL & CAPITAL FORMATION

Meaning of Capital

Capital is that part of wealth which can be used for further production of wealth. According to Marshall, "Capital consists of all kinds of wealth, other than free gifts of nature, which yield income." Therefore, every type of wealth other than land which helps in further production of income is called capital.

In this way, money, machine, factories, etc. are included in capital provided they are used in production. For instance, if a man has an income of Rs 10,000 per month and out of it he invests Rs 6,000 in a business, this amount of Rs 6000 is called capital. In the same way, plough, tractor and other agricultural implements of farmers are also Capital. The house in which a man resides is his wealth and the house which is given on rent is his capital.

Characteristics of Capital:

Capital has its own peculiarities which distinguish it from other factors of production. Capital possesses the following main characteristics:

1. Man Produces Capital
2. Capital is a Passive Factor of Production
3. Capital is a Produced Means of Production
4. Capital is Variable
5. Capital is more Mobile than other Factors of Production
6. Capital Depreciates
7. Capital is Stored-up Labour
8. Capital is Destructible

Stages in capital Formation

Capital formation in a country involves three crucial steps. They are the following:

Creation of savings → Mobilization of savings → Investment

Creation of Savings

Firstly, the country has to encourage its people to save money. Generally, attractive at the same time feasible interest rates and government bonds that offer tax exemption play a vital role in creating a savings habit among people. Once people are ready to save money, the second task is to mobilize the savings through proper channels such as banks, post offices, government treasuries and so on. It is government's responsibility to establish a convenient method to deposit money for the people. Thirdly, accumulated money through savings should be invested with proper planning (capital formation). Hence, capital formation in a country has three distinct stages.

Among the three stages, the first stage i.e., creation of savings is the most challenging task. The reason is that there are various factors governing the savings habits of the people. Amount of money a society saves depends upon two important factors: (i) the ability to save and (ii) the willingness to save.

The Ability to Save

The ability to save is an important factor in determining the level of capital accumulation. If the people of a country do not have money to save, there is no possibility of capital formation. There are various factors determine the ability to save of the people. They are the following:

Income level*:* There is a positive relationship between income and savings. If the income on an individual is high, his savings are also high and vice versa. Therefore, income level plays a vital role in determining the amount of savings. A country with majority of poor people may not be able to carry out capital formation successfully if no action is taken to alleviate poverty.

Income distribution*:* It is observed that rich people save more than the poor people do. The reason is that the poor people spend substantial amount of income on food alone. Therefore, unequal distribution of income rather helps to increase the overall savings level. However, the unequal distribution of income certainly affects the overall welfare of the society negatively.

Taxation*:* Both direct taxes and indirect taxes affect the ability to save. If the direct taxes are too high, money left in the hands of rich people may not be enough to save given the luxurious life they lead. If indirect taxes are too high, it may affect the capacity of the poor people to save. Hence, government should take extra care while imposing taxes.

The Willingness to Save

The following factors determine the willingness of the people to save:

Characteristics of a person*:* Characteristics of a person play a vital role in determining the willingness to save. For instance, a prudent person takes a wise decision to save for the future, a person with lot of family affection saves for his family, a person with miserly nature saves money a lot, a person who has desire for social prestige saves money to become rich and a person with business motive saves money to become an entrepreneur.

External situations*:* An atmosphere that promises a prosperous future induces people to save money. A situation of civil war or substantial political turmoil makes the people indifferent towards savings. In such abnormal situations, savings level tends to be low.

Inflation*:* If the inflation rate is very high and the rate of interest for savings is not enough to cope with the high inflation rate, the willingness of the people to save diminishes. In such situations, people tend to invest on other products such as land and gold.

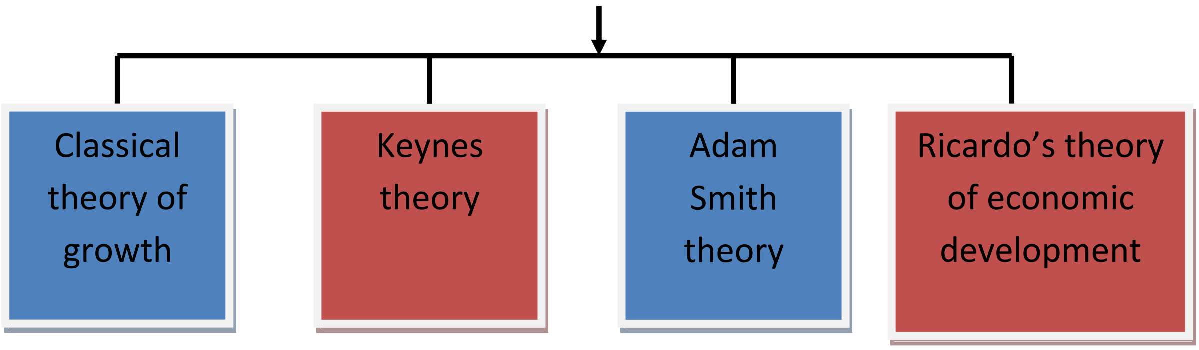
Rate of interest*:* This is a very important factor in determining the willingness to save. If the rate of interest is attractive, people tend to save more money and vice versa.

Chapter-4 : Development & Theories of Growth

Topic-1 : Meaning of growth & development

Point	Economic Development	Economic Growth
Implications	Economic growth refers to an increase in the real output of goods and services in the country	Economic development implies changes in income, savings and investment along with progressive changes in socio-economic structure of country (institutional and technological changes).
Factors	Growth relates to a gradual increase in one of the components of Gross Domestic Product: consumption, government spending, investment, net exports	Development relates to growth of human capital indexes, a decrease in inequality figures, and structural changes that improve the general population's quality of life.
Measurement	Quantitative. Increases in real GDP.	Qualitative.HDI (Human Development Index), gender- related index (GDI), Human poverty index (HPI), infant mortality, literacy rate etc.
Effect	Brings quantitative changes in the economy	Brings qualitative and quantitative changes in the economy
Relevance	Economic growth is a more relevant metric for progress in developed countries. But it's widely used in all countries because growth is a necessary condition for development.	Economic development is more relevant to measure progress and quality of life in developing nations.
Scope	Growth is concerned with increase in the economy's output	Concerned with structural changes in the economy

TOPIC-2 THEORIES OF ECONOMIC GROWTH



Analysis of the Classical Theory

The classical theory of economic development, as enunciated by Prof. Adam Smith, might be analyzed in the following way:

1. **Policy of Free Trade.** The classical economists did not admit of state-intervention of any sort in their theory of economic development. In this theory, the economists believed that the economy shall be directed by itself. The trade should be totally free and conditions of 'full or perfect competition' by recognized. Really speaking, the classicists were opposed to any sort of intervention by the state at all.
2. **Capital-Formation, As Basis of Economic Development.** All the classical economists believed that 'capital-formation' as the basis of the economic development. The savings are very necessary for the capital-accumulation. These economists also argued that only the landlords or the capitalists could be capable of effecting the savings. The labour class doesn't they get the wages hardly sufficient for their living.
3. **Profit is the Basis of Investment.** In the classical theory, 'profit was considered to the Basis of 'investment'. The capital-formation and its accumulation, as well as the investments shall be higher if there shall be more of the profits. Hence, investments must depend upon the quantum of profits available.
4. **The Tendency of Diminishing Profits.** The classical economists considered that the profits do not always necessarily increase. Most often, when there is an increase in the competition trend, the profits tend to decline along with competitive tendency going up. IN such situation, the profits frequently decline.
5. **Stable Condition.** In view of almost all the classicists, the process of capital accumulation finally ends with the condition of stability in it. Once the profits begin to diminish, this order continues unendingly until the profits reach the 'Zero' level in the economy, the increase in population is not stopped, the capital-accumulation is not over, and the wage-rates don't reach the subsistence-level.

Critical Evaluation of the Classical Theory

1. **Ignoring the Significance of Technical Knowledge.** The technical knowledge occupies a significant place in the economic development. But in the process of development, the classical economists have not given any special significance to the technical knowledge. Adam Smith recognized the importance of improved technical knowledge in the economic development. In his opinion, due to the use of technical knowledge, division of labour and expansion of markets take place. As against it, Ricardo had held that due to the use of improved technical knowledge, the labour is substituted and the other unfavorable consequences come up.
2. **Ignoring the Middle-Class.** The classical economists, in their theories of development, not only attached significance to the activities of mostly the capitalists and the landlords, but rather ignored and criticized the activities of the middle-class who, in fact, very much provide necessary encouragement to the economic development.
3. **Ignoring the Public Sector.** In the opinion of the classical economists, the total or perfect competition and the private sector are the criticism of the economic development. These economists totally forgot the significance of the public sector. In the present age, the public sector occupies a special role in the economic development.
4. **Wrong concept of wages and Profit.** The concepts of wages and profits, as laid down by the classical thinkers, are wrong and mistaken. In view of the economic development of the western world, Ricardo and Malthus, both were treated to be the false prophets in the science of Economics.
5. **Static/Stable Economy.** The economists like Adam Smith became despaired regarding the 'development' due to being afraid of the static or stable economy. Really speaking, the classical economists wrongly interpreted the process of economic development.
6. **Based on Unreal (Imaginary) Laws.** The theories or laws like the diminishing returns on land and the Malthusian theory of population were treated to be unreal or hypothetical laws now-a-days. The fear or risk of the law of diminishing returns of the classical economists seems to be undue or unnecessary. The development of the modern agricultural techniques has enhanced the productivity of land.

The Keynesian Theory of Economic Growth

Achievement of full employment is growth

Unemployment is the result of lack of effective demand

There should be increase in expenditure on consumption

Increase in investment

1) **Achievement of full employment is growth** :According to Keynes the achievement of full employment is growth. Full employment is not only related to judicious use of all factors of production. In this stage, so many avenues of employment are created that a man does not wait for employment, but employment waits for the man. Full employment occurs when national income increases, which depends on effective demand.
2) **Unemployment is the result of lack of effective demand :** Keynes has made clear in his theory of employment that unemployment is the result of lack of effective demand. Effective demand is directly related to full employment. When there is unemployment in a country the effective demand should be increased and this increase is the cause and result of aggregate output income. The increase in income is used in having consumer and capital goods and thus there is an increase in effective demand. Thus is economic is to be developed, there should be full employment which depends on effective demand and the latter is determined by the expenditure on consumption and the expenditure on capital goods.
3) **Increase in expenditure on consumption.** Keynes says that if people do not spend their increased income on consumption, there is a drop in the effective demand and producers are unable to self their products. Increase in income can be helpful in economic growth only when there is a corresponding increase in consumption.

Keynes suggests two ways of increasing effective demand through increase in the expenditure on consumption goods.

(i) Tax the rich and the money so collected on the poor; reduce prices of commodities; control inflation; make necessary arrangements for social welfare.

(ii) Create demand through advertisement, fashions and fads,

Keynes says that when there is an increase in consumption expenditure, it affects investments. When investment increases the producers get more income. The increased income by the producers is spent on consumption goods and capital goods. Thus increase in income takes place repeatedly. The expenditure incurred by some producers becomes the income of other producers because they are able to sell more goods. Thus also income goes on increasing and is many times more than the expenditure on capital goods.

4) **Increase in investment.** Effective demand comprises,

(i) Consumption Demand and

(ii) Investment Demand. The investment demand is related to marginal efficiency of capital and rate of interest. The marginal efficiency of capital depends upon supply price of capital assets and prospective yield from capital assets. The rate of interest is affected by liquidity preference of the public and the supply of money in the economy.

Applicability of Keynes theory to underdeveloped countries

It is a debatable question whether Keynesian theory of economic growth applies to underdeveloped economy. But most of the economists are of the opinion that the theory does not apply to such countries. The argument put forth by them are as follows.

1. The unemployment in underdeveloped countries is structural whereas in developed countries it is cyclical. In the developed countries unemployment exists in industrial countries only whereas in developing economics unemployment is in agricultural sector and it is disguised

2. Keynesian theory of economic growth is based on developed monetary system which is a feature of developed countries and not of developing countries.

3. In the underdeveloped countries liquidity preference is greater and capital formation does not take place to the extent in which it takes place in advanced nations.

4. Keynesian economics is short term economics. Inertia of which long term analysis is necessary.

5. In the underdeveloped countries there is mass poverty and people spent most of their small income on consumption and very little remains for investment. In developed countries people have great capacity for saving and less capacity for consumption when their income increases. Keynes suggests the ways to increase consumption but does not say anything about reduction in saving. His theory can apply to underdeveloped economics.

6. In developed countries production is capital incentive. It is not so in underdeveloped countries. To achieve full employment in these countries labour incentive techniques of production are employed. Thus Keynesian theory of growth does not apply to underdeveloped countries.

<u>**Adam Smith's Theory of Economic Growth**</u>

Free Enterprise and Competition.

Division of Labour

The Development Process

Determination of Wages.

Determination of Profit

Determination of Rent

Determination of Rate of Interest

Order of the Development

Adam Smith is considered to be the father (or founder) of economic development.

The following are the main theories pertaining to the e economic growth as presented by Adam Smith:

(1) **Free Enterprise and Competition.** In the opinion of Adam Smith, free enterprise and uninterrupted competition are very necessary for economic development. The activity of economic development may grow only in the free environment. The state should not interfere in the economic development in any way.

(2) **Division of Labour.** Among the factors affecting the economic progress, Adam Smith has given an important place to the division of labour. By division of labour, the productive efficiency and competence increase and less time is taken in the production of the things, goods, machines and resources, and their researches are encouraged.

Adam Smith had mentioned three limitations in increasing and developing the process of productivity through the division of labour :

(i) Quantum of exchange;
(ii) The quantity of capital used in the productive activities; and
(iii) Limits or conditions of the market of the commodity.

(3) **The Development Process.** According to Adam Smith, the process of development is cumulative. The capital is formed by increase in the demand of commodities and it ultimately leads to the division of labour. The general standard of production is raised and there is an increase in the real income, with the last effect on the market, as its expansion. By an increase n income, there is also an increase in the savings and the quantity of capital. Thus slowly, by and by, the process of economic development goes on further.

(4) **Determination of Wages.** In the opinion of Adam Smith, the determination of wages depends upon the bargaining capacity between the laborers and capitalists. He was of the view that when there is the accumulation of capital on a rapid, the capitalists are required to face much competition for getting the labour force. Hence the rate of wages goes up, but along with the increase in the demand of laborers, the population also increases, consequently there is increased supply of laborers. If the supply of labour exceeds the need, the rate of wages shall decline and will consequently lead to a decline in the increasing population and this rate shall be appropriated according to the demand. Adam Smith also felt that if the workers were given higher wages, they will enlarge the size of their families, with more number of children born, hence they must be given wages only equal to or sufficient merely for their subsistence, so that there might be the chance of maximum profits.

(5) **Determination of Profit.** The views of Adam Smith are not clear regarding the profit'. In his opinion, for the development, the profits must be going on increasing. He also conceived that by the increase in accumulation of capital, there is an labour supply too, but simultaneously there is also a fall in the profits. These go on fluctuating (i.e. rising or declining) till there I sufficient increase in the population as per need and the stock of capital is quite sufficiently swelled up.

(6) **Determination of Rent.** In the words of Smith, rent which has been treated to have been paid as price in return for the land is the monopolistic price in its natural form. Rent is considered to be the product of those powers which the land-owners hand over in return to the cultivators. Thus the rent has been treated to be the total monopolistic income of the land –owner.

(7) **Determination of Rate of Interest.** Prof. Smith considered that the rate of interest must be low for the purpose of development. The rate of interest influences of accumulation of capital. In this opinion, if the money-lender gets interests at a low rate, he makes attempt to get interest in huge quantity so that he could maintain his standard of living as it-is. But despite innumerable efforts, when there is no increase in the rate of interest, the money-lenders begin to direct and control the business them-selves, and invest the capital in it so that the speed of economic development could be increased.

According to Adam Smith, an industries country could make progress on the basis of low interest-rate and more business. When that country will progress, there shall be increase in the accumulation of capital too. Consequently, the interest-rate shall be go down and there be no sort of profit by investments.

(8) **Order of the Development.** According to Adam Smith in the process of development, first of all there is the development of agriculture, thereafter of the constructive process, and in the end it is followed by the development of trade.

Merits of Adam Smith's Theory

The following are the chief merits of Smith's theory of economic development:

(i) Smith has emphasized upon thrift for capital-formation which is very essential for the under-developed countries.
(ii) Adam Smith has assigned great significance to the balanced development and division of labour.
(iii) Adam Smith has provided an important place to 'capital' for the development.
(iv) Free-trade policy is most suitable for a country like India
(v) In this theory, the productive resources and their importance for the development have been admitted.

Demerits (Shortcomings) of Smith's Theory

The Chief shortcomings or drawbacks of Adam Smith's theory of development might include the following:

(i) Smith has given less importance to the state in his theory of development while in the under-developed countries; the state plays a very prominent role with reference to the development.
(ii) Adam Smith has ignored the significance of the functions of the entrepreneur in the development work which is fully wrong.
(iii) Adam Smith has held that development is useful for all the classes, but it is proper or correct.
(iv) Being afraid of the static economy, Smith was quite despaired with regard to development.
(v) In connection with the trade-cycles, Adam Smith has not expressed any views.

Ricardo's Theory of Economic Development

After removing the anomalies existing hitherto in Adam Smith's theory of development, Ricardo has attempted to develop and present them in a better way. The view of Ricardo pertaining to the economic development are contained in his standard work, entitled as 'The Principles of Political Economy and Taxation', published in the year 1817. The following are some of the main elements contained in his views regarding economic development:

(1) **Capital-Formation and Economic Development.** In his theory of development, Ricardo has said that capital-formation plays an important role in the economic development. The main basis of capital is 'savings' and the main basis of savings is 'thrift'. By resorting to the most efficient use of the means of production, the producers increase the total production and maximize their profits. Ricardo was also of the opinion that the one and the only single source of capital-formation and capital, is the 'profit' only. According to him, the laborers should be paid the wages, just equivalent or sufficient to meet their expenses of subsistence, and only then the profit and capital-formation could be maximized. To enhance the quantum of profit and reduce the wage-rates, it is very essential to lower the costs of subsistence.

(2) **Increase of Population and Economic Development.** Ricardo was also of the opinion that when there is an increase in the speed of economic development of any country there is also an increase in the demand of laborers, and in case of restricted labour-supply, the wage-rates go up. By increase in the wage-rates, the population increases and due it the problem of food grains emerges up which raises their prices. By higher prices of food- grains, the cost of subsistence goes up and consequently the wages also shoot up. If, out of the total production, wages and rent are taken away, the profit is very much reduced. With a decline in the profits, the production is adversely affected. In this way, the food problem caused by the increasing population is an inseparable part of the Ricardian analysis.

(3) **The Law of Diminishing Production.** Ricardo also felt that when the resources are continuously consumed, the law of diminishing returns applies due to which, on the hand the efficiency of labour declines, and on the other, the productive capacity of land diminishes. In such a condition, the wages become established on the subsistence level. Due to a decline in the quantum of profits, the capital-formation is stopped, the production becomes static and the economic development becomes stagnant.

(4) **Free Trade.** Ricardo had supported and upheld the free trade which shall result into adequate utilization of the natural resources, resulting further into the increase in the income on national and international levels, leading to the decline in prices and by encouragement to industrials, the economic development shall be possible.
(5) **Tax-Free Rent.** Ricardo also thought that the occupation of agriculture could be successful only when the rent of land is kept tax-free.
(6) **No Tax on Profits.** Ricardo was also of this opinion that there should be imposed no tax on the profits, since it adversely affects the capital-formation.

Merits of Ricardian Theory
The following are the chief merits of Ricardian theory:
(1) Significance to the Agricultural Development. The most important merit of Ricardian theory is that, according to it, the agricultural development occupies the most important position in economic growth of any country. No country could industrially develop without its agricultural development.
(2) Significance of Savings. In this theory, Ricardo has stressed upon the significance of savings and has said that unless there is an increase in the savings, the capital could not be accumulated.
(3) Importance of the Rate of Profit. Ricardo also supported the view that unless there is more of the profit, there could not be possible the accumulation of capital.
(4) The Foreign Trade. For reforming the economic condition of the country, Ricardo has very much stressed upon the foreign trade since by it the resources are utilized to their maximum & there is the increase in income.
(5) Importance of Population Control. In the Ricardian theory, practical importance has been given to the population control.

Demerits or Drawbacks of Ricardian Theory
The following are the main demerits of Ricardian theory of economic growth:
(1) **Ignoring the Value of Technical Knowledge.** Ricardo has specified in his theory that the continuous use of improved devices of production substitutes the machines for labour-power and thus adverse results come out. Ricardian view in this approach doesn't agree with the reality, since the cause of rapid development of progressive nations was the agriculturist and the technical progress.
(2) **Based on the Wrong Nation of Static Condition.** Ricardo's theory of economic development is based on the wrong concept of static or fixed condition of the economy.
(3) **Undue Importance to Law of Diminishing Production.** In the ricardian theory, the terror of the application of the law of diminishing production seems to be unnecessary. The modern agricultural techniques and their development, have increased the productivity of land.
(4) **It is Not the Theory of Economic Development; rather of the distribution.** Schumpeter has held that the Ricardian theory is not any theory of economic development, but it is rather a theory of distribution which determines the shares of the workers, landlords and the capitalists.
(5) **Unpractical Policy of Free Trade.** Ricardian theory is based on the unpractical policy of free trade. Now-a-days, there is no such economy which is free from state intervention, and perfect competition exists there.

Topic-3 Stages of Economic growth by Rostow
Prof. Rostow had studied thoroughly the conditions of several countries and on that basis, has made the above categories or stage though which the economic development of a country usually passes.

I. Stage of 'Traditional Society'
in the opinion of Prof. Rostow, this is the very first stage of economic development. In this stage, the methods and techniques of agriculture are quite indigenous and stereo-typed as well as rigid. The trade and industry are mostly in a backward condition. In this stage, most of the resources of the country are

engaged in cultivation or agriculture. In no sphere, the use of agriculture and scientific techniques is made. The political power is concentrated within the hands of the big landlords.
The concept of 'traditional' society is not static under any conditions. At least some changes might be brought and made effective in the spheres of irrigation and agriculture. The landlords occupy a special position in the traditional society. In such a stage, the production and the productivity, both are on a lower level. The chief source of national income is the agriculture. There is less of mobility for shifting from one occupation to the other. In such a condition, the means of transport in the country, the trade, the state activities and the income per head, all are much less.

Main Characteristics

(i) In this stage, the main occupation of this inhabitants of the country is 'agriculture'
(ii) In this stage, the level of publicity and the technical knowledge is very low.
(iii) The level of production and productivity both, is also very low.
(iv) Production activities are undertaken on the traditional pattern.
(v) The total economy of the country is in a weak and underdeveloped condition.
(vi) The means of transport and communication too are in a very backward condition.
(vii) Political power is concentrated in the hands of the landlords.
(viii) The economic activities of the state are very limited.

II. Stage of 'Pre-conditions for Take-off'

This is the second important stage of development. In this condition, society begins to make use of the scientific methods and techniques, and abandons the traditional methods. The means of transport get relatively cheaper. The expansion of trade is apparent. The powers of the landlords go on declining and there arises the political awakening among the people. Some of the changes are apparently seen. The techniques of production are also under the course of change. In this stage, there are changes in the socio-political institutions in accordance with the economic development.
There is an increase in the savings and investments. The banking institution begins to be established here and there. The entrepreneurs get a chance to come up. Such ideology is now developed among the people that the economic development is essential also from the individual, social and national angels of vision Really speaking, in this stage there occur such changes in the economy that for achieving the situation of the take-off, the favorable background is created by and by.

Main characteristics

(i) Efforts are made to bring technological revolution in the agricultural sphere.
(ii) There begins expansion in the banks and the means of transport and communication.
(iii) The relative significance of agriculture begins to decline and ratio of working population goes on a rise.
(iv) The importance of landlords is lowered is the territory, and in its place, there is established a national and competent government.
(v) Efforts are made to bring change in the attitude of the social and institutional elements.
(vi) Due to education and other effects, society moves toward the developing stage. Interest begins to develop in the masses toward the development.
(vii) There is a fall in the demand of unskilled agricultural labourers. In the other new spheres, the demand for efficient workers increases.
(viii) The quantum of capital investment reaches upto 10% in the opinion of Prof. Rostow, and the production per capita increases.
(ix) The government also lays great emphasis upon the public welfare activities.

III. Stage of the 'Take-off'

This is very important stage of economic growth. It is such a stage of economic progress within which the economy is in a condition of self-sufficiency. The economy has not to depend upon the other countries for the needed supply of materials and equipments for developmental activities.

In fit, the old, hackneyed and stereo-typed mores and obstacles are over. There remains no need to depend upon the foreign capital. The economy could be able to proceed forward rapidly without any external or foreign assistance. It could touch the highest level or the climax of the production within a short time.

IV. **Stage of 'rive to maturity'**

In the opinion of Prof. Rostow, after having achieved the stage of take-off, the economy begins to move toward the maturity under which the development continues to go on. In this stage, various industries are generally over. As compared to the population increase, the methods and the so-created system spread throughout the whole economy.

Really speaking, maturity is that stage when the society makes use of modern technology on the maximum resources. Due to the sufficient development of industries and use of modern techniques in agriculture, the pressure of population on agriculture is reduced and there are major changes in the forms of foreign trade. In this international sphere, the country achieves an important place. In it the rate of investment goes up from 10% to 20%.

Main Characteristics

(i) In this stage, the rise in the national income is more than the increase in the population.
(ii) New industries, base on advanced technology, are set up in different regions.
(iii) In this stage, the use of modern techniques is resorted to in the spheres of agriculture and industries.
(iv) The rate of investment rises from 10% to 20%.
(v) There is also change in the structure of power and its qualities.

V. Stage of 'High Mass Consumption'

This is the last stage of development. The commodities the use of which was considered to be comfort and luxuries in the past stages become the common necessities of life in this stage. The common masses are in a position to make use of such commodities for their so-called necessities now. The comfortable and luxurious items are used upto the maximum. Everyone tries to acquire their latest models and is ever keen for it.

The main cause of the people's eagerness to achieve the latest and luxurious things is that the income of people is sufficiently high. There remain no problems of production in this stage. Rather adversely, there is the problem of over-production, i.e. the chances are that the production might exceed the quantum required for its consumption. There is not much scope or margin for the improvement in the technical level of the commodities.

Mains Characteristics

(i) In this stage, the level of production and consumption is the highest.
(ii) Almost the condition of full employment is created in the country in this stage.
(iii) The production of the items of comforts and luxuries is there on a very high level.
(iv) There is an unanticipated rise in the industrial population.
(v) In it, the income per capita of the people is very high.
(vi) In this stage, there is no scarcity of production and the country is diverted toward the establishment of a welfare state.

Criticism

The main criticism of Rostow theory of economic stages are as under :

1. **Traditional society not essential :** A number of nations like Canada, United States etc. were born free of traditional societies and they derived the preconditions from Britain, a country already advanced.

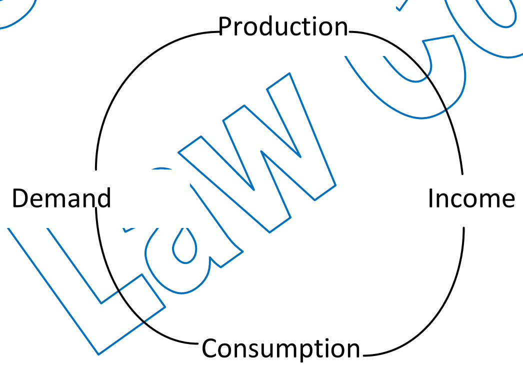
2. **Overlapping in the stages :** The experience of most countries tell us that development in agriculture continued even in the take-off stage. Similarly, social overhead capital in transport has been one of the leading sectors in the take-off. It shows that there is considerable overlapping in the different stages.
3. **The Stage of Maturity Misleading:** It contains all the features of the take-off then there lies the need of separate stage where the growth process becomes self-sustained. It can be self-sustained in the take-off stages.
4. **The Stage of High Mass Consumption not Chronological :** The age of high mass consumption is so defined that certain countries like Canada and Australia have entered this stage before even reaching the stage of maturity.
5. **Pre-condition may not precede the Take-off :** In the cases of Pre-condition it is not necessary that they must precede the take-off. There is no reason to believe that an agricultural revolution and accumulation of social overhead capital in transport must take place before the take-off.

Topic -4 : Theory of growth by Joseph Schumpeter (Schumpeterian Theory)

Assumption of the theory

Following are the assumption in Schumpeterian theory

1. There is perfectly competitive economy & perfect competition
2. The economy is in stationary state i.e. perfect competitive equilibrium which implies there are
    - No profits
    - No interest rates
    - No savings
    - No investments
    - No involuntary unemployment
3. Circular flow



There is circular flow in the economy i.e. every process repeats itself is the same manner year after year i.e. all economic activities are repetitive

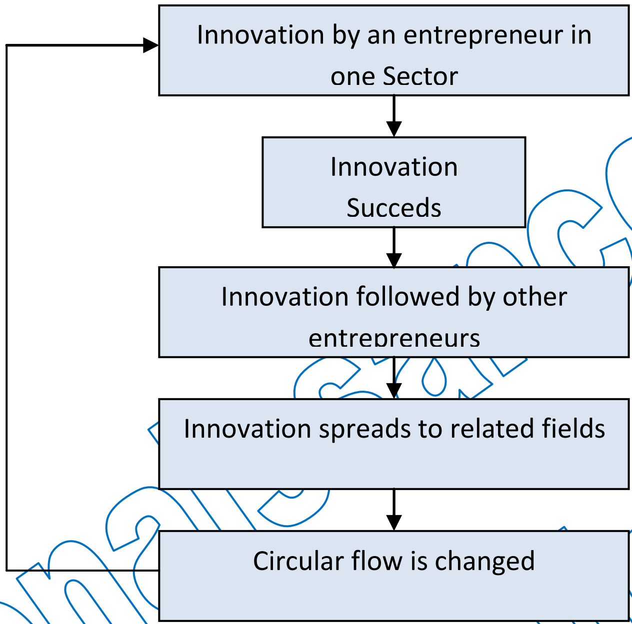
Statement of the theory

According to schumpter "Every economy is in a state of stationary equilibrium in which every economic activity repeats itself in the same manner. Development is a spontaneous process which is brought about by disturbance of equilibrium which forever alters & displaces the previously existing cob state."

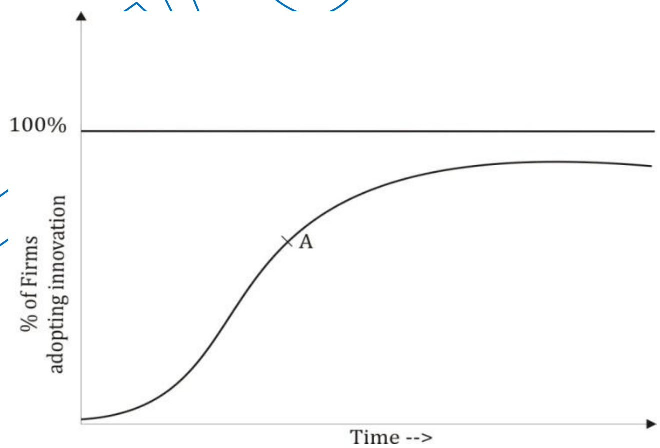
Breaking the Circular Flow

1. Breaking up of circular flow starts with innovation by an entrepreneur. An entrepreneur launches new product for the purpose of earning profits.
2. The innovation entrepreneurs are financed by banks in launching new products. This is known as credit expansion. In return, entrepreneurs pay certain interest on credit; this is because investment in innovations is risky as innovation may fail in the market.

3. If the innovation becomes successful & profitable, other entrepreneurs follow it or copy it. Innovations in one field or sector lead to innovation in related fields.
   The whole process is shown diagrammatically as follows: -



4. The spread of innovation is shown in the following figure: -
   We take time in x axis & on y axis, we take percentage of firms adopting innovation.



The curve is S shaped. Initially the firms are slower to adopt innovation (as shown by OA) But soon the adoption of innovation becomes faster (as shown by AI). But it never reaches 100% adoption by firms.

Role of Innovator

1. According to schumpter the role of innovation is played by a entrepreneur, not by a capitalist.
2. An entrepreneur is a man who introduced something entirely new. He does not provide funds, but borrows it & directs their use in the proper direction.
3. To perform his economic functions, the entrepreneur requires 2 things:-
   - Technical knowledge to produce new products

- The power of use of credit (loan) overt eh factors of production.

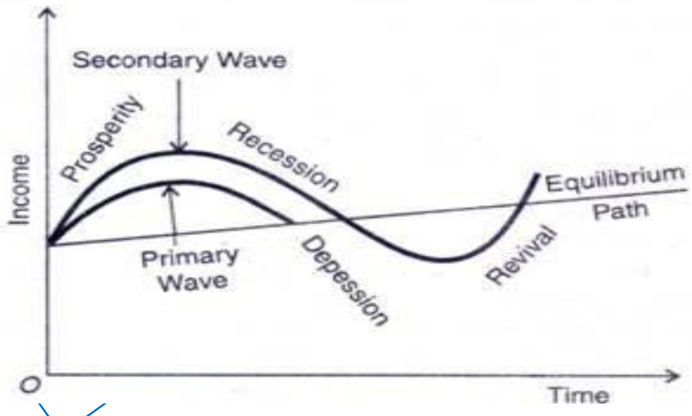
Role of profits

1. Profit means "Surplus over costs".
   Profits = Total Receipt – Total expensess
2. Profits arise due to dynamic changes in the product resulting from an innovation.
3. Profits are more in the beginning of innovation, but as the innovation become general profits decrease & cease to exist.

Cyclical Process

1. Schumpter assumes a cyclical process of upswings & down wings in an economy
2. Up wings = Prosperity phase: Down wings = Recession phase
3. Upwings are a result of primary wave of innovation primary wave of innovation result in over optimism & speculation & thus development is accelerated & it results prosperity or ups wing
4. Downs wings are a result of recession in the economy recession starts when the innovation becomes general.
5. In this cycle, the prosperity is stated by the primary wave of innovation, secondary wave (which represents the prosperity phase) is superimposed on the primary wave of innovation.
6. When recession starts, the cycle continues downward & goes below the equilibrium level to depression phase.

Another innovation starts a primary wave, which results in upswing or prosperity.



Chapter 5

Topic 1 : Functions of commercial

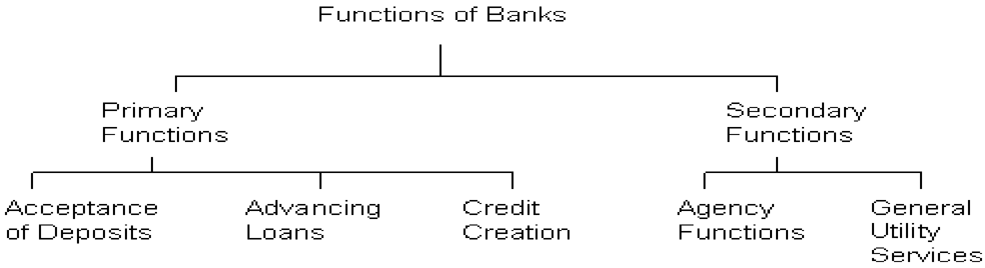


Figure: Functions of Banks

Bank

1. Accepting Deposits: The first important function of a bank is to accept deposits from those who can save but cannot profitably utilize this saving themselves. People consider it more rational to deposit their savings in a bank because by doing so they, on the one hand, earn interest, and on the other, avoid the danger of theft. To attract savings from all sorts of individuals, the banks maintain different types of accounts:

(i) Fixed Deposit Account: Money in these accounts is deposited for fixed period of time (say one, two, or five years) and cannot be withdrawn before the expiry of that period. The rate of interest on this account is higher than that on other types of deposits. The longer the period, the higher will be the rate of interest. Fixed deposits are also called time deposits or time liabilities.

(ii) Current Deposit Account: These accounts are generally maintained by the traders and businessmen who have to make a number of payments every day. Money from these accounts can be withdrawn in as many times and in as much amount as desired by the depositors. Normally, no interest is paid on these accounts; rather, the depositors have to pay certain incidental charges to the bank for the services rendered by it. Current deposits are also called demand deposits or demand liabilities.

(iii) Saving Deposit Account: The aim of these accounts is to encourage and mobilise small savings of the public. Certain restrictions are imposed on the depositors regarding the number of withdrawals and the amount to be withdrawn in a given period. Cheque facility is provided to the depositors. Rate of interest paid on these deposits is low as compared to that on fixed deposits.

(iv) Recurring Deposit Account: The purpose of these accounts is to encourage regular savings by the public, particularly by the fixed income group. Generally money in these accounts is deposited in monthly installments for a fixed period and is repaid to the depositors along with interest on maturity. The rate of interest on these deposits is nearly the same 3s on fixed deposits.

(v) Home Safe Account:

Home safe account is another scheme aiming at promoting saving habits among the people. Under this scheme, a safe is supplied to the depositor to keep it at home and to put his small savings in it. Periodically, the safe is taken to the bank where the amount of safe is credited to his account.

2. Advancing of loans

The second important function of a bank is advancing of loans to the public. After keeping certain cash reserves, the banks lend their deposits to the needy borrowers. Before advancing loans, the banks satisfy themselves about the credits worthness of the borrowers. Various types of loans granted by the banks are discussed below:

(i) Money at Call: Such loans are very short period loans and can be called back by the bank at a very short notice of say one day to fourteen days. These loans are generally made to other banks or financial institutions.

(ii) Cash Credit: It is a type of loan, which is given to the borrower against his current assets, such as shares, stocks, bonds, etc. Such loans are not based on personal security. The bank opens the account in the name of the borrowers and allows him to withdraw borrowed money from time to time up to a certain limit as determined by the value of his current assets. Interest is charged only on the amount actually withdrawn from the account.

(iii) Overdraft: Sometimes, the bank provides overdraft facilities to its customers though which they are allowed to withdraw more than their deposits. Interest is charged from the customers on the overdrawn amount.

(iv) Discounting of Bills of Exchange: This is another popular type of lending by the modern banks. Through this method, a holder of a bill of exchange can get it discounted by the bank. In a bill of exchange, the debtor accepts the bill drawn upon him by the creditor *(i.e,* holder of the bill) and agrees to pay the amount mentioned on maturity. After making some marginal deductions (in the form of commission), the bank pays the value of the bill to the holder. When the bill of exchange matures, the bank gets its payment from the party, which had accepted the bill. Thus, such a loan is self-liquidating.

(v) Term Loans: The banks have also started advancing medium-term and long-term loans. The maturity period for such loans is more than one year. The amount sanctioned is either paid or credited to the account of the borrower. The interest is charged on the entire amount of the loan and the loan is repaid either on maturity or in installments.

3. Credit Creation: A unique function of the bank is to create credit. In fact, credit creation is the natural outcome of the process of advancing loan as adopted by the banks. When a bank advances a loan to its customer, it does not lend cash but opens an account in the borrower's name and credits the amount of loan to this account. Thus, whenever a bank grants a loan, it creates an equal amount of bank deposit. Creation of such deposits is called credit creation which results in a net increase in the money stock of the economy. Banks have the ability to create credit many times more than their deposits and this ability of multiple credit creation depends upon the cash-reserve ratio of the banks.

4. Promoting Cheque System: Banks also render a very useful medium of exchange in the form of cheques. Through a cheque, the depositor directs the bankers to make payment to the payee. Cheque is the most developed credit instrument in the money market. In the modern business transactions, cheques have become much more convenient method of settling debts than the use of cash.

5. Agency Functions:

Banks also perform certain agency functions for and on behalf of their customers:

(i) **Remittance of Funds:** Banks help their customers in transferring funds from one place to another through cheques, drafts, etc.

(ii) Collection and Payment of Credit Instruments: Banks collect and pay various credit instruments like cheques, bills of exchange, promissory notes, etc.

(iii) Execution of Standing Orders: Banks execute the standing instructions of their customers for making various periodic payments. They pay subscriptions, rents, insurance premium, etc. on behalf of their customers.

(iv) Purchasing and Sale of Securities: Banks undertake purchase and sale of various securities like shares, stocks, bonds, debentures etc. on behalf of their customers. Banks neither give any advice to their customers regarding these investments nor levy any charge on them for their service, but simply perform the function of a broker.

(v) Collection of Dividends on Shares: Banks collect dividends, interest on shares and debentures of their customers.

(vi) Income Tax Consultancy: Banks may also employ income-tax experts lo prepare income-tax returns for their customers and to help them to get refund of income-tax.

(vii) Acting as Trustee and Executor: Banks preserve the wills of their customers and execute them after their death.

(viii) Acting as Representative and Correspondent: Sometimes the banks act as representatives and correspondents of their customers. They get passports, travelers tickets, book vehicles, plots for their customers and receive letters on their behalf.

6. General Utility Function:

In addition to agency services, the modern banks provide many general utility services as given below:

(i) Locker Facility: Banks provide locker facility to their customers. The customers can keep their valuables and important documents in these lockers for safe custody.
(ii) Traveller's Cheques: Banks issue traveller's cheques to help their customers lo travel without the fear of theft or loss of money. With this facility, the customers need not take the risk of carrying cash with them during their travels.
(iii) Letter of Credit: Letters of credit are issued by the banks to their customers certifying their creditworthiness. Letters of credit are very useful in foreign trade.
(iv) Collection of Statistics: Banks collect statistics giving important information relating to industry, trade and commerce, money and banking. They also publish journals and bulletins containing research articles on economic and financial matters.
(v) Underwriting Securities: Banks underwrite the securities issued by the government, public or private bodies. Because of its full faith in banks, the public will not hesitate in buying securities carrying the signatures of a bank.
(vi) Gift Cheques: Some banks issue cheques of various denominations (say of Rs. 11, 21, 31, 51.101, etc.) to be used on auspicious occasions.
(vii) Acting as Referee: Banks may be referred for seeking information regarding the financial position, business reputation and respectability of their customers.
(viii) Foreign Exchange Business: Banks also deal in the business of foreign currencies. Again, they may finance foreign trade by discounting foreign bills of exchange.

Topic-2 : central bank

Central bank is a national bank that provides financial and banking services for its country's government and commercial banking system, as well as implementing the government's monetary policy and issuing currency.
The central bank generally performs the following functions:
1. Bank of Note Issue:
The central bank has the sole monopoly of note issue in almost every country. The currency notes printed and issued by the central bank become unlimited legal tender throughout the country.
In the words of De Kock, "The privilege of note-issue was almost everywhere associated with the origin and development of central banks."
However, the monopoly of central bank to issue the currency notes may be partial in certain countries. For example, in India, one rupee notes are issued by the Ministry of Finance and all other notes are issued by the Reserve Bank of India.
The main advantages of giving the monopoly right of note issue to the central bank are given below:
(i) It brings uniformity in the monetary system of note issue and note circulation.
(ii) The central bank can exercise better control over the money supply in the country. It increases public confidence in the monetary system of the country.
(iii) Monetary management of the paper currency becomes easier. Being the supreme bank of the country, the central bank has full information about the monetary requirements of the economy and, therefore, can change the quantity of currency accordingly.
(iv) It enables the central bank to exercise control over the creation of credit by the commercial banks.
(v) The central bank also earns profit from the issue of paper currency.
(vi) Granting of monopoly right of note issue to the central bank avoids the political interference in the matter of note issue.
2. Banker, Agent and Adviser to the Government:
The central bank functions as a banker, agent and financial adviser to the government,
(a) As a banker to government, the central bank performs the same functions for the government as a commercial bank performs for its customers. It maintains the accounts of the central as well as state government; it receives deposits from government; it makes short-term advances to the government; it

collects cheques and drafts deposited in the government account; it provides foreign exchange resources to the government for repaying external debt or purchasing foreign goods or making other payments,
(b) As an Agent to the government, the central bank collects taxes and other payments on behalf of the government. It raises loans from the public and thus manages public debt. It also represents the government in the international financial institutions and conferences,
(c) As a financial adviser to the lent, the central bank gives advise to the government on economic, monetary, financial and fiscal ^natters such as deficit financing, devaluation, trade policy, foreign exchange policy, etc.
3. Bankers' Bank:
The central bank acts as the bankers' bank in three capacities:
(a) custodian of the cash preserves of the commercial banks;
(b) as the lender of the last resort; and (c) as clearing agent. In this way, the central bank acts as a friend, philosopher and guide to the commercial banks
As a *custodian of the cash reserves* of the commercial banks the central bank maintains the cash reserves of the commercial banks. Every commercial bank has to keep a certain percentage of its cash balances as deposits with the central banks. These cash reserves can be utilised by the commercial banks in times of emergency.

The centralization of cash reserves in the central bank has the following advantages:
(i) Centralised cash reserves inspire confidence of the public in the banking system of the country.
(ii) Centralised cash reserves provide the basis of a larger and more elastic credit structure than if these amounts were scattered among the individual banks.
(iii) Centralised reserves can be used to the fullest possible extent and in the most effective manner during the periods of seasonal strains and financial emergencies.
(iv) Centralised reserves enable the central bank to provide financial accommodation to the commercial banks which are in temporary difficulties. In fact the central bank functions as the lender of the last resort on the basis of the centralised cash reserves.
(v) The system of contralised cash reserves enables the central bank to influence the creation of credit by the commercial banks by increasing or decreasing the cash reserves through the technique of variable cash-reserve ratio.
(vi) The cash reserves with the central bank can be used to promote national welfare.
4. Lender of Last Resort:
As the supreme bank of the country and the bankers' bank, the central bank acts as the lender of the last resort. In other words, in case the commercial banks are not able to meet their financial requirements from other sources, they can, as a last resort, approach the central bank for financial accommodation. The central bank provides financial accommodation to the commercial banks by rediscounting their eligible securities and exchange bills.

The main advantages of the central bank's functioning as the lender of the last resort are :
(i) It increases the elasticity and liquidity of the whole credit structure of the economy.
(ii) It enables the commercial banks to carry on their activities even with their limited cash reserves.
(iii) It provides financial help to the commercial banks in times of emergency.
(iv) It enables the central bank to exercise its control over banking system of the country.
5. Clearing Agent:
As the custodian of the cash reserves of the commercial banks, the central bank acts as the clearing house for these banks. Since all banks have their accounts with the central bank, the central bank can easily settle the claims of various banks against each other with least use of cash. The clearing house function of the central bank has the following advantages:
(i) It economies the use of cash by banks while settling their claims and counter-claims.
(i) It reduces the withdrawals of cash and these enable the commercial banks to create credit on a large scale.

(ii) It keeps the central bank fully informed about the liquidity position of the commercial banks.

Reserve Bank

The Reserve Bank of India is India's Central Banking Institution, which controls the Monetary Policy of the Indian Rupee. It commenced its operations on 1 April 1935 during the British Rule in accordance with the provisions of the Reserve Bank of India Act, 1934.
Major functions of the RBI are as follows:

1. Issue of Bank Notes:
The Reserve Bank of India has the sole right to issue currency notes except one rupee notes which are issued by the Ministry of Finance. Currency notes issued by the Reserve Bank are declared unlimited legal tender throughout the country.

This concentration of notes issue function with the Reserve Bank has a number of advantages: (i) it brings uniformity in notes issue; (ii) it makes possible effective state supervision; (iii) it is easier to control and regulate credit in accordance with the requirements in the economy; and (iv) it keeps faith of the public in the paper currency.

2. Banker to Government: As banker to the government the Reserve Bank manages the banking needs of the government. It has to-maintain and operate the government's deposit accounts. It collects receipts of funds and makes payments on behalf of the government. It represents the Government of India as the member of the IMF and the World Bank.
3. Custodian of Cash Reserves of Commercial Banks: The commercial banks hold deposits in the Reserve Bank and the latter has the custody of the cash reserves of the commercial banks.

4. Custodian of Country's Foreign Currency Reserves: The Reserve Bank has the custody of the country's reserves of international currency, and this enables the Reserve Bank to deal with crisis connected with adverse balance of payments position.

5. Lender of Last Resort: The commercial banks approach the Reserve Bank in times of emergency to tide over financial difficulties, and the Reserve bank comes to their rescue though it might charge a higher rate of interest.

6. Central Clearance and Accounts Settlement: Since commercial banks have their surplus cash reserves deposited in the Reserve Bank, it is easier to deal with each other and settle the claim of each on the other through book keeping entries in the books of the Reserve Bank. The clearing of accounts has now become an essential function of the Reserve Bank.

7. Controller of Credit: Since credit money forms the most important part of supply of money, and since the supply of money has important implications for economic stability, the importance of control of credit becomes obvious. Credit is controlled by the Reserve Bank in accordance with the economic priorities of the government.

Topic-3 : Money market,Credit & bank, Rural money market

Money Market Concept, Meaning

There are two types of financial markets viz., the money market and the capital market. The money market in that part of a financial market which deals in the borrowing and lending of short term loans generally for a period of less than or equal to 365 days. It is a mechanism to clear short term monetary transactions in an economy.

Definitions of Money Market

1. According to **Crowther**, "The money market is a name given to the various firms and institutions that deal in the various grades of near money."
2. According to the **RBI**, "The money market is the centre for dealing mainly of short character, in monetary assets; it meets the short term requirements of borrowers and provides liquidity or cash to the lenders. It is a place where short term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also by the government."
3. According to **Nadler and Shipman**, "A money market is a mechanical device through which short term funds are loaned and borrowed through which a large part of the financial transactions of a particular country or world are degraded. A money market is distinct from but supplementary to the commercial banking system."
4. These definitions help us to identify the basic characteristics of a money market. A money market comprises of a well organized banking system. Various financial instruments are used for transactions in a money market. There is perfect mobility of funds in a money market. The transactions in a money market are of short term nature

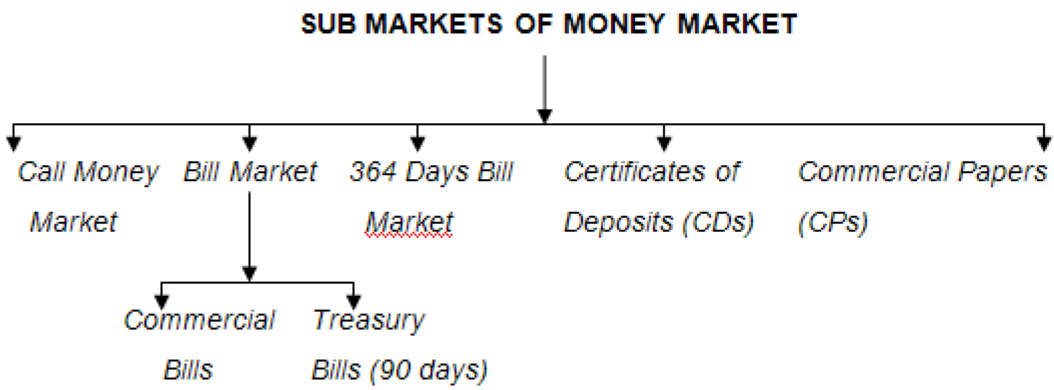
Functions of Money Market

The money market is the market which deals with short term funds in the economy. It refers to the institutional arrangements facilitating borrowings and lending of short term funds.
Money market is an important part of the economy.

The major functions of money market are given below:-

1. To maintain monetary equilibrium. It means to keep a balance between the demand for and supply of money for short term monetary transactions.
2. To promote economic growth. Money market can do this by making funds available to various units in the economy such as agriculture, small scale industries, etc.
3. To provide help to Trade and Industry. Money market provides adequate finance to trade and industry. Similarly it also provides facility of discounting bills of exchange for trade and industry.
4. To help in implementing Monetary Policy. It provides a mechanism for an effective implementation of the monetary policy.
5. To help in Capital Formation. Money market makes available investment avenues for short term period. It helps in generating savings and investments in the economy.
6. Money market provides non-inflationary sources of finance to government. It is possible by issuing treasury bills in order to raise short loans. However this dose not leads to increases in the prices.

Apart from those, money market is an arrangement which accommodates banks and financial institutions dealing in short term monetary activities such as the demand for and supply of money.



Money Market instruments mainly include Government securities, securities issued by private sector and banking institutions—

1. Government Securities
2. Money at Call and Short Notice
3. Bills Rediscounting
4. Inter-Bank Participation
5. Money Market Mutual Funds
6. Call Money Market and Short-term Deposit Market
7. Treasury Bills
8. Certificates of Deposits
9. Inter-Corporate Deposits
10. Commercial Bills
11. Commercial Paper
12. Gilt-edged (Government) Securities
13. Repo Market

1) ***Government Securities:*** The Reserve Bank of India issues securities on behalf of the Government. The term Government Securities includes Central Government Securities, State Government Securities and Treasury Bills. The Government dated securities can be purchased for a minimum amount of Rs. 10,000/- and the Treasury bills of Rs. 25,000/- and in multiple thereof. The State Government Securities can be purchased for a minimum amount of Rs.1, 000/-.

1) ***Bills Rediscounting Scheme:*** This is a money market scheme whereby banks may raise funds by issue of usance from issuing notes in convenient lots and maturities matching the genuine trade bills discounted by them. This instrument promotes liquidity in the market. Here the seller draws a bill of exchange and the buyer accepts it. Suppose, When X sells on credit and X (seller) needs money in the meantime, it may approach to the bank for discounting the bill and the seller get the money. Now, the bank which has discounted the bill may require getting it 'rediscounted' with some other bank to get the fund. This is called 'bill rediscounting'. The bank has a facility to rediscount the bills with the RBI and other approved institutions like LIC, GIC, UTI, ICICI etc

3) Inter-Bank Participation Certificate: Inter-Bank Participation Certificates are instruments issued by scheduled commercial banks only to raise funds or to deploy short term surplus. This instrument is issued as per RBI guidelines for two purposes:
a. on risk sharing basis
b. without risk sharing
Inter-Bank Participation without risk sharing can have tenure of 90 days only where, the issuing bank as borrowing and the participating bank advances to the banks. In case of risk sharing basis, the lender bank shares losses with the borrowing banks by mutually determining the interest rate.

The tenure may be for 90 to 180 days.

4) Money Market Mutual Funds (MMMFs):
To provide safety, liquidity and return, MMMFs are formed which collect the small savings of a large number of savers and invest them in the capital market. This concept is extended to money market. Hence, the concept of money market mutual funds has coming up. The SEBI revises the guidelines on MMMFs from time to time relating to maximum limit of investment.

5) Treasury Bills: Treasury Bills are discounted securities issued at a discount face value as per the short term requirement of the Government of India. RBI issues Treasury Bills on a prefixed day and at a fixed amount. There are four types of Treasury Bills:
a. 14-day Tbill maturity is in 14 days.
b. 91-day Tbill maturity is in 91 days.
c. 182-day Tbill maturity is in 182 days.
d. 364-day Tbill maturity is in 354 days.
These are highly liquid money market instruments. It is a zero default risk bearing paper. It helps in deployment of idle funds for very shorts periods as well.

6) Certificates of Deposits: These are issued according to the guidelines of the Reserve Bank of India in dematerialized form or Usance Promissory Note for the fund deposited at a bank or other financial institution. It is a negotiable money market instrument whose minimum deposit should be Rs.1 lakh and the multiples of Rs. 1 lkh thereafter. The maturity period of Certificates of Deposits should not be less than 15 days and not more than 1 year. But, it should not be less than 1 year and exceed 3 years for financial institution.

7) Inter-Corporate Deposits:Inter-Corporate Deposits are unsecured loan extended by one corporate to another. As the cost of funds for a corporate is higher than a bank, the rates in this market are higher than those in the other market.

8) Commercial Bills:These are the bills accepted by the buyer for goods and services on credit from the seller and which may be kept upto the due date and encased by the seller or may be endorsed to a third party. The bills being bills of exchange may be discounted with the banks or financial institutions. These bills may again be the rediscounted at the bank.

9) Commercial Papers (CP):It is an additional unsecured money market instrument to the investors as a source of short term borrowing. This instrument is issued in the form of a promissory note or dematerialized form. Every issuer has to appoint an Issuing and Paying Agent (IPA) for the issue of commercial papers and only a scheduled bank can act as an IPA for issuance of CP. The investor are given the Issuing and Paying Agent (IPA) certificate as well as issued physical certificates or arrangement is made for crediting the CP to the investor's account with a depository. The CP issued for a maturity period between a minimum of 7 days and a maximum up to one year from the date of issue in the denomination of Rs. 5 lakh or multiples thereof. The main purposes of introducing CP are—

1. To enable the high level corporate borrowers such as leasing and financing of companies, manufacturing and financial institutions etc.
2. To diversify the sources of short term borrowing
3. To provide instrument for bank and financial institution in the money market.

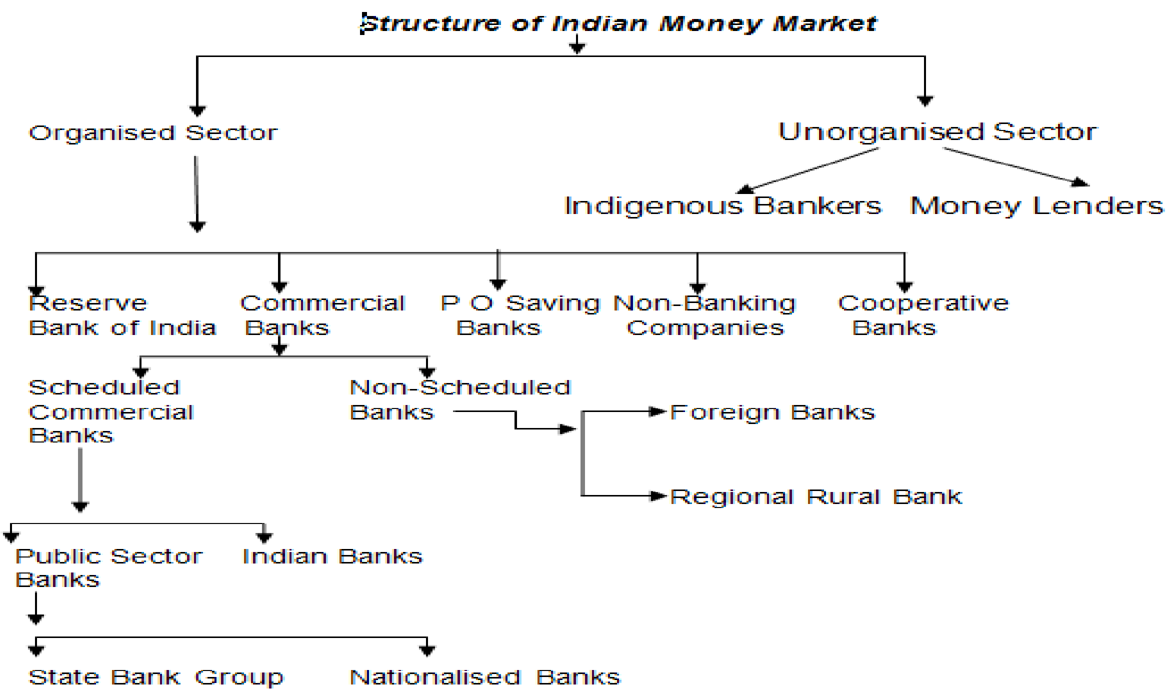
10)Gilt-edged (Government) Securities:Gilt-edged (Government) Securities have great demand by the banks to maintain the Net Demand and Time Liquidities (NDTL) position of the bank through its buying and selling. These securities are issued by Governments such as Central and State

Governments, Semi-Government Authorities, Municipalities etc. They are long dated securities and held by the RBI. These issues are notified a few days before opening for subscription and offer is kept open for two to three days. The rate of interest is lower but it is payable half yearly.

11). Repo Market:This money market instrument helps in collateralised short- term borrowing and lending through sale or purchase operation in debt instruments. Here the securities are sold by the holders to the investors with an agreement to repurchase them at a predetermined rate and date.On the other hand, under the reverse repo transactions, securities are purchased with a simultaneous commitment to resell at a predetermined rate and date

Participants of money market

a. Central and State Government
b. Public sector undertaking
c. Private sector companies
d. Non-banking financial institutions
e. Mutual funds
f. Insurance companies
g. Primary dealers



Money market is the market for lending and borrowing of short term funds. A well developed money market denotes an implementation of effective monetary policy. But the Indian money market suffers from many weaknesses.

1. ***Lack of integration:*** The Indian Money Market is divided into two sectors viz, the organised and unorganised money market. But both the markets are completely separate from each other. They are working independently and have little effect on each other. RBI is fully effective in controlling the organised sector. But, it has very less control on the unorganised sector.
2. ***Lack of rational interest rates structure:*** The Indian Money Market exist too many interest rates. For example, the deposit and lending rates of commercial banks, the borrowing rate of Government etc. In the past these created excess demand for credit and the RBI had to rely often on cash reserve ratio. Though the RBI has tried to bring rationality in the interest rates, the situation in the Indian money market is still not effective.
3. ***Existence of Unorganised Money Market:*** The existence of the unorganised sector in money market still prevails in Indian Money Market. The indigenous banker does not make any distinction between short term and long-term finance. They have no coordination with each other and have no link with other banking sectors. They do not follow any sound banking regulations. The RBI has no control over these bankers.
4. ***Absence of an organised bill market:*** In Indian Money Market, there is an absence of adequate bill market. There is an absence of commercial bill market or a discount for short term commercial bills. There are many factors responsible for the underdeveloped bill market such as (i) relying more on cash transaction, (ii) cash credit of commercial bank, (iii)seller's limited use of bills, (iv) imposition of heavy stamp duty, (v) absence of acceptance houses etc.
5. ***Shortage of funds in the Money Market:*** The lack of banking habit, inadequate banking facility, less saving habit, etc created have shortage of fund in the money market. On the other hand, the increasing demand for loanable funds in the money market far exceeds its supply.
6. ***Inadequate banking facility***: Now-a-days, the commercial banks have opened many new branches of banking facilities. But, it still leaves much scope for further development. In a developing country like India, people live below poverty line and have less saving habit. Their savings are very small and they do not have much access to banking facilities till now.

<u>Topic 4: Fiscal Policy</u>

Meaning of Fiscal Policy

The fiscal policy is concerned with the raising of government revenue and incurring of government expenditure. To generate revenue and to incur expenditure, the government frames a policy called budgetary policy or fiscal policy. So, the fiscal policy is concerned with government expenditure and government revenue.In other words, fiscal policy refers to the policy of the government with regard to taxation, public expenditure and public borrowings.

The importance of fiscal policy is high in underdeveloped countries. The state has to play active and important role. In a democratic society direct methods are not approved. So, the government has to depend on indirect methods of regulations. In this way, fiscal policy is a powerful weapon in the hands of government by means of which it can achieve the objectives of development.

Tools of fiscal policy

1) Government Spending

Government spending includes the purchase of goods and services - for example, a fleet of new cars for government employees or missiles for national defense. Government spending is a fiscal policy tool because it has the power to raise or lower real GDP. By adjusting government spending, the government can influence economic output.

In addition to the primary effect of government spending on the economy, this spending multiplies through the economy as it affects businesses who sell the goods and services bought by the government. Consumers then go on to spend the paychecks they earn from those businesses, stimulating real GDP even more.

2) Taxes

Taxes are a fiscal policy tool because changes in taxes affect the average consumer's income, and changes in consumption lead to changes in real GDP. So, by adjusting taxes, the government can influence economic output. Taxes can be changed in several ways. Firstly, marginal tax rates can be raised or lowered. Secondly, they can be eliminated entirely, or the tax rules can be modified.

3) Transfer Payments

Transfer payments include things like Social Security, welfare or unemployment checks. These checks go out all over the country on a monthly basis and serve as the income for tens of millions of consumers. Transfer payments are fiscal policy tools in the same way that taxes are because changes in transfer payments lead to changes in consumer income, and when consumers spend more of their income, this influences economic output.

FISCAL POLICIES MEASURES

Fiscal policy during the recession

- increase in government spending
- reduction in personal income taxes
- reduction in business taxes
- increase in transfer payments
- practicing deficit budget

Fiscal policy during inflation

- decrease in government spending
- increase in personal income taxes
- increase in business taxes
- reduction in transfer payments
- practicing surplus budget

Main Objectives of Fiscal Policy In India

1. Development by effective Mobilisation of Resources

The principal objective of fiscal policy is to ensure rapid economic growth and development. This objective of economic growth and development can be achieved by Mobilisation of Financial Resources.
The central and the state governments in India have used fiscal policy to mobilise resources.
The financial resources can be mobilised by :-

1. **Taxation** : Through effective fiscal policies, the government aims to mobilise resources by way of direct taxes as well as indirect taxes because most important source of resource mobilisation in India is taxation.
2. **Public Savings** : The resources can be mobilised through public savings by reducing government expenditure and increasing surpluses of public sector enterprises.
3. **Private Savings** : Through effective fiscal measures such as tax benefits, the government can raise resources from private sector and households. Resources can be mobilised through government borrowings by ways of treasury bills, issue of government bonds, etc., loans from domestic and foreign parties and by deficit financing.

2. Efficient allocation of Financial Resources

The central and state governments have tried to make efficient allocation of financial resources. These resources are allocated for Development Activities which includes expenditure on railways, infrastructure, etc. While Non-development Activities includes expenditure on defence, interest payments, subsidies, etc.
But generally the fiscal policy should ensure that the resources are allocated for generation of goods and services which are socially desirable. Therefore, India's fiscal policy is designed in such a manner so as to encourage production of desirable goods and discourage those goods which are socially undesirable.

3. Reduction in inequalities of Income and Wealth

Fiscal policy aims at achieving equity or social justice by reducing income inequalities among different sections of the society. The direct taxes such as income tax are charged more on the rich people as compared to lower income groups. Indirect taxes are also more in the case of semi-luxury and luxury items, which are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of Poverty Alleviation Programmes to improve the conditions of poor people in society.

4. Price Stability and Control of Inflation

One of the main objective of fiscal policy is to control inflation and stabilize price. Therefore, the government always aims to control the inflation by Reducing fiscal deficits, introducing tax savings schemes, Productive use of financial resources, etc.

5. Employment Generation

The government is making every possible effort to increase employment in the country through effective fiscal measure. Investment in infrastructure has resulted in direct and indirect employment. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generates more employment. Various rural employment programmes have been undertaken by the Government of India to solve problems in rural areas. Similarly, self employment scheme is taken to provide employment to technically qualified persons in the urban areas.

6. Balanced Regional Development

Another main objective of the fiscal policy is to bring about a balanced regional development. There are various incentives from the government for setting up projects in backward areas such as Cash subsidy, Concession in taxes and duties in the form of tax holidays, Finance at concessional interest rates, etc.

7. Reducing the Deficit in the Balance of Payment

Fiscal policy attempts to encourage more exports by way of fiscal measures like Exemption of income tax on export earnings, Exemption of central excise duties and customs, Exemption of sales tax and octroi, etc.
The foreign exchange is also conserved by Providing fiscal benefits to import substitute industries, Imposing customs duties on imports, etc.
The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem. In this way adverse balance of payment can be corrected either by imposing duties on imports or by giving subsidies to export.

8. Capital Formation

The objective of fiscal policy in India is also to increase the rate of capital formation so as to accelerate the rate of economic growth. An underdeveloped country is trapped in vicious (danger) circle of poverty mainly on account of capital deficiency. In order to increase the rate of capital formation, the fiscal policy must be efficiently designed to encourage savings and discourage and reduce spending.

9. Increasing National Income

The fiscal policy aims to increase the national income of a country. This is because fiscal policy facilitates the capital formation. This results in economic growth, which in turn increases the GDP, per capita income and national income of the country.

10. Development of Infrastructure

Government has placed emphasis on the infrastructure development for the purpose of achieving economic growth. The fiscal policy measure such as taxation generates revenue to the government. A part of the government's revenue is invested in the infrastructure development. Due to this, all sectors of the economy get a boost.

11. Foreign Exchange Earnings

Fiscal policy attempts to encourage more exports by way of Fiscal Measures like, exemption of income tax on export earnings, exemption of sales tax and octroi, etc. Foreign exchange provides fiscal benefits to import substitute industries. The foreign exchange earned by way of exports and saved by way of import substitutes helps to solve balance of payments problem.

Conclusion On Fiscal Policy

The objectives of fiscal policy such as economic development, price stability, social justice, etc. can be achieved only if the tools of policy like Public Expenditure, Taxation, Borrowing and deficit financing are effectively used.

Though there are gaps in India's fiscal policy, there is also an urgent need for making India's fiscal policy a rationalised and growth oriented one.

The success of fiscal policy depends upon taking timely measures and their effective administration during implementation.

The instrument of monetary policy are tools or devise which are used by the monetary authority in order to attain some predetermined objectives. There are two types of instruments of the monetary policy as shown below.

Topic-5 Monetary Policy

What is Monetary policy: Monetary policy is the process by which the monetary authority (central bank) of a currency controls the supply of money, often targeting an inflation rate or interest rate to ensure price stability and general trust in the currency. Further goals of a monetary policy are usually to contribute to economic growth and stability, to low unemployment, and to predictable exchange rates with other currencies.

(A) Quantitative Instruments or General Tools

- The Quantitative Instruments are also known as the General Tools of monetary policy. These tools are related to the Quantity or Volume of the money.

- The Quantitative Tools of credit control are also called as General Tools for credit control. They are designed to regulate or control the total volume of bank credit in the economy. These tools are indirect in nature and are employed for influencing the quantity of credit in the country. The general tool of credit control comprises of following instruments:
  - **Bank Rate Policy (BRP)**

- The Bank Rate Policy (BRP) is a very important technique used in the monetary policy for influencing the volume or the quantity of the credit in a country.

- The bank rate refers to rate at which the central bank (i.e RBI) rediscounts bills and prepares of commercial banks or provides advance to commercial banks against approved securities. It is "the standard rate at which the bank is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the RBI Act".

- If the RBI increases the bank rate than it reduce the volume of commercial banks borrowing from the RBI. It deters banks from further credit expansion as it becomes a more costly affair. Even with increased bank rate the actual interest rates for a short term lending go up checking the credit expansion.

- On the other hand, if the RBI reduces the bank rate, borrowing for commercial banks will be easy and cheaper. This will boost the credit creation. Thus any change in the bank rate is normally associated with the resulting changes in the lending rate and in the market rate of interest.

2. Open Market Operation (OMO)
The open market operation refers to the purchase and/or sale of short term and long term securities by the RBI in the open market. This is very effective and popular instrument of the monetary policy. The OMO is used to wipe out shortage of money in the money market, to influence the term and structure of the interest rate and to stabilize the market for government securities, etc.

3. Variation in the Reserve Ratios (VRR)
The Commercial Banks have to keep a certain proportion of their total assets in the form of Cash Reserves. Some part of these cash reserves are their total assets in the form of cash. Apart of these cash reserves are also to be kept with the RBI for the purpose of maintaining liquidity and controlling credit in an economy. These reserve ratios are named as Cash Reserve Ratio (CRR) and a Statutory Liquidity Ratio (SLR). The CRR refers to some percentage of commercial bank's net demand and time liabilities which commercial banks have to maintain with the central bank and SLR refers to some percent of reserves to be maintained in the

form of gold or foreign securities. In India the CRR by law remains in between 3-15 percent while the SLR remains in between 25-40 percent of bank reserves. Any change in the VRR (i.e. CRR + SLR) brings out a change in commercial banks reserves positions.

(B) Qualitative Instruments or Selective Tools

The Qualitative Instruments are also known as the Selective Tools of monetary policy. These tools are not directed towards the quality of credit or the use of the credit. They are used for discriminating between different uses of credit. It can be discrimination favoring export over import or essential over non-essential credit supply. This method can have influence over the lender and borrower of the credit. The Selective Tools of credit control comprises of following instruments.

1. Fixing Margin Requirements

The margin refers to the "proportion of the loan amount which is not financed by the bank". Or in other words, it is that part of a loan which a borrower has to raise in order to get finance for his purpose. A change in a margin implies a change in the loan size. This method is used to encourage credit supply for the needy sector and discourage it for other non-necessary sectors. This can be done by increasing margin for the non-necessary sectors and by reducing it for other needy sectors. Example:- If the RBI feels that more credit supply should be allocated to agriculture sector, then it will reduce the margin and even 85-90 percent loan can be given.

2. Consumer Credit Regulation

Under this method, consumer credit supply is regulated through hire-purchase and installment sale of consumer goods. Under this method the down payment, installment amount, loan duration, etc is fixed in advance. This can help in checking the credit use and then inflation in a country.

3. Publicity

This is yet another method of selective credit control. Through it Central Bank (RBI) publishes various reports stating what is good and what is bad in the system. This published information can help commercial banks to direct credit supply in the desired sectors. Through its weekly and monthly bulletins, the information is made public and banks can use it for attaining goals of monetary policy.

4. Credit Rationing

Central Bank fixes credit amount to be granted. Credit is rationed by limiting the amount available for each commercial bank. This method controls even bill rediscounting. For certain purpose, upper limit of credit can be fixed and banks are told to stick to this limit. This can help in lowering banks credit expoursure to unwanted sectors.

5. Moral Suasion

It implies to pressure exerted by the RBI on the indian banking system without any strict action for compliance of the rules. It is a suggestion to banks. It helps in restraining credit during inflationary periods. Commercial banks are informed about the expectations of the central bank through a monetary policy. Under moral suasion central banks can issue directives, guidelines and suggestions for commercial banks regarding reducing credit supply for speculative purposes.

6. Control Through Directives

Under this method the central bank issue frequent directives to commercial banks. These directives guide commercial banks in framing their lending policy. Through a directive the central bank can influence credit structures, supply of credit to certain limit for a specific purpose. The RBI issues directives to commercial banks for not lending loans to speculative sector such as securities, etc beyond a certain limit.

7. Direct Action

Under this method the RBI can impose an action against a bank. If certain banks are not adhering to the RBI's directives, the RBI may refuse to rediscount their bills and securities. \Secondly, RBI m'ay refuse credit supply to those banks whose borrowings are in excess to their capital. Central bank can penalize a bank by changing some rates. At last it can even put a ban on a particular bank if it dose not follow its directives and work against the objectives of the monetary policy.

These are various selective instruments of the monetary policy. However the success of these tools is limited by the availability of alternative sources of credit in economy, working of the Non-Banking Financial Institutions (NBFIs), profit motive of commercial banks and undemocratic nature off these tools. But a right mix of both the general and selective tools of monetary policy can give the desired results.

Topic 6 : Taxation

A good tax system should possess the following characteristics:

1. It should ensure maximum social advantage. Taxation should be used to finance public services.
2. It should cause minimum aggregate sacrifice. In a good tax system, the allocation of taxes among tax payers is made according to the ability to pay. It falls more heavily on the rich and less on the poor. It should be reasonably progressive so as to minimise the gap of inequality of income and wealth in the community, thereby ensuring their better distribution.
3. In a good tax system, taxes are universally applicable in the sense that persons with same ability to pay are treated in the same way without any discrimination whatsoever. In the Indian tax system, however, this attribute is lacking to some extent. For instance, income tax is not universal in India, as no income tax is levied on agricultural incomes.
4. It should contain a predominance of good taxes satisfying most of the canons of taxation. That is to say, the taxes imposed should be more or less equitable, convenient to pay, economical, certain, productive, flexible and simple as far as possible.
5. The entire structure of the tax system should have built-in flexibility, so that changes are possible according to the changing conditions of a dynamic economy. It should be possible to add or withdraw a tax without destroying the entire system and its balancing effect. A rigid tax structure is very unsatisfactory. Taxation must cope with the changing needs of the modern government. The capacity to adjust itself to the dynamic conditions of an economy is a virtue of a good tax system.
6. A good tax system should be a balanced one. It means there must exist not one kind of taxes but all types in the right proportion. In other words, it should not contain just progressive, regressive or proportional taxes only, but a healthy combination of all such taxes. Similarly, it should have a balance of direct and indirect taxes.

Types of Taxes (Direct & Indirect Taxes)

7. The tax system should be multiple, but then took a great multiplicity is not desirable. Dalton, however, suggests that a good tax system has to be also a reasonably efficient administrative system.
8. Further, in a good tax system there is simplicity, implying the absence of any unnecessary and avoidable complexities.
9. A good tax system should not hamper the development of trade and industry, but instead help the rapid economic development of the country. Taxation is designed to mobilise the surplus resources in the economy and not deprive the private sector of its resources.
10. Above all, the most fundamental characteristic of a good tax system is the appreciation of the rights and problems of the tax payer. A good tax system must contain the majority of such taxes which produce good effects on production and equitable distribution of national income and wealth. To achieve the socialistic goals of public policy a good tax system plays a very important role.

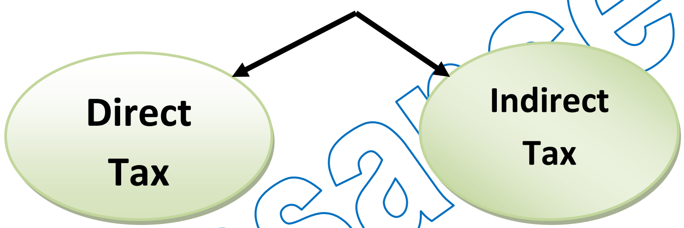
Basis of Classification of taxes

The basis of classifying taxes into direct tax and indirect tax is "Whether the burden of the tax is shiftable to others or not." If it is not shiftable, i.e., when liability to pay and burden falls on the same person, it is a direct tax. If burden of a tax is shiftable, it is an indirect tax.

Differences between Direct and Indirect Taxes of India

Note: The basis of classifying taxes into direct and indirect taxes is "who ultimately bears the burden of a tax."

Types of Taxes



What is Direct tax:

- ***When (i) liability to pay a tax and (ii) the burden of that tax falls on the same person, the tax is called a direct tax.***
- A direct tax is the tax whose burden is borne by the person on whom it is imposed, i.e., its burden cannot be shifted to others.

Examples of Direct tax

(i) Income tax is a direct tax because the person whose income is taxed is liable to pay the tax directly to the government and bear the burden of the tax himself.
(ii) corporate tax—It is levied on profit of corporations and companies,
(iii) Wealth tax—It is imposed on property of individuals depending upon the value of property.
(iv) Gift tax—It is paid to the government by the recipient of gift depending on value of gift,
(v) Estate duty—It is charged from successor of inherited property.
(vi) Expenditure tax
(vii) Fringe benefit tax (imposed by state govt.) are other examples of direct taxes. It is difficult to avoid direct taxes as they are levied directly on income and property of persons who pay directly to the government.

Merits of direct taxes:

(i) Direct taxes help in reducing disparities in income and wealth of people,
(ii) They are economical because cost of collection for government is relatively low,
(iii) Social and economic Justice is achieved to some extent because direct taxes are based on ability to pay.
Direct taxes are generally considered progressive taxes because they are based on the ability to pay. A progressive tax is one the rate of which increases with rise in income and decreases with fall in income.

What is Indirect tax:

- **When (i) liability to pay a tax is on one person and (ii) the burden of that tax falls on some other person, the tax is called an indirect tax.**
- Thus, it is a tax whose burden can be shifted to others.

Examples of Indirect taxes

(i) Sales tax:
It is an indirect tax because liability to pay tax is that of shopkeeper who in turn realises the tax amount from the customer by including it in the price of the commodity. Other examples of indirect tax are
(ii) Excise duty:
It is paid by the producer (manufacturer) of goods, who recovers it from wholesalers and retailers,
(iii) Custom duty:
It is charged from importer of goods from a foreign country which is recovered from retailers and customers,
(iv) Entertainment tax:
It is charged from cinema owners, who recover it from cinema viewers,
(v) Service tax:
It is imposed on selling services (like serving meals in hotels) to customers. Similarly,
(vi) **Octroi** (chungi) and
(vii) **'Value added tax'**

'Value added tax' is other examples of indirect taxes. In short, all taxes levied on goods and services in different forms (like on production, sale, transport, etc.) are called indirect tax.

Merits of indirect taxes:

(i) Indirect taxes are convenient to realise because they are Included in the price of the commodity.
(ii) They have wider coverage since every member (consumer) of society is taxed through price of the commodity.
(iii) Consumption of harmful commodities like wine, cigarettes, etc. is curtailed, thus serving social purpose.

Topic 7: International Monetary Fund

Introduction to IMF

- During the early years of the 20th century, the world suffered through the Great Depression. This happened during the 1930s. In addition to this, there were also two world wars. Due to this, the global economic system collapsed quickly. This had a major impact on international trade.

- As a result, countries were witnessing the plummeting living standards caused by unemployment. During World War II, Anglo-American discussions focused on the increasing demand for an institution that could take care of international finances, cooperation, and even promote international trade.

The Bretton Woods Conference

1) From 1st July to 22nd July 1944, 730 delegates from 44 allied nations met at the Mount Washington Hotel. The hotel is located in Bretton Woods, State of New Hampshire, United States. The issue at hand was the regulation of post war global monetary, and restoring financial order

2) The British delegation wanted a fund that could help all the member nations economically, but only during emergencies or times of crisis.

3) On the other hand, the United States delegation wanted an institution that could function like a bank .It wanted permission for member countries to borrow money for all kinds of purposes. Of course, the money would be borrowed as a loan, and would have to be repaid in a specified time frame. Finally, the United States motion was accepted.

4) During the Bretton Woods Conference, a lot of agreements were signed to legally establish the General Agreement on Tariffs & Trade (GATT), the International Bank for Reconstruction & Development (World Bank or IBRD) and the International Monetary Fund (IMF).

5) The International Monetary Fund was founded on 27th December, 1945. A treaty called the Articles of Agreement was signed by 29 member countries.

Basically, the purpose of the IMF was to (a) achieve the international advantages of the gold standard without subjecting nations to its internal disadvantages; and (b) achieve internal advantages of paper standard while avoiding its international disadvantages.

Management Of Fund :

The twelve member executive committee manages the affairs of IMF. Five members are the representatives of U.K, U.S.A, China, France and India. The remaining are elected by the other members countries. Its head office in in U.S.A.

Source Of fund of IMF :

The initial capital of IMF was 8.5 billion dollar which was contributed by the 49 members. The quota of each member country was fixed in proportion to the national income and volume of foreign trade. Every country was required to pay in the form of gold and domestic currency.

FUNCTIONS OF IMF FUND

1. **Merchant Of Currencies :-**

IMF main function is to purchase and sell the member countries' currencies.

2. Helpful For The Debtor Countries :-

If any country is facing adverse balance of payment and facing the difficulty to get the currency of creditor country, it can get short term credit from the fund to clear the debt. The IMF allows the debtor country to purchase foreign currency in exchange for its own currency upto 75% of its quota plus an addition 25% each year. The maximum limit of the quota is 200% in special circumstances.

3. Declared Of Scarce Currency :-

If the demand of any particular country currency increases and its stock with the fund falls below 75% of its quota, the IMF can declare it scare. But IMF also tries to increase its supply by these methods.

1. Purchasing :- IMF purchases the scare currency by gold.

2. Borrowing :- IMF borrows from those countries scare currency who has surplus amount.

3. Permission :- IMF allows the debtor countries to impose restrictions on the imports of creditor country.

4. To promote exchange stability :- The main aim of IMF is to promote exchange stability among the member countries. So it advises the member countries to conduct exchange transactions at agreed rates. On the other hand one country can change the parity of the currency without the consent of the IMF but it should not be more than 10%. If the changes are on large scale and IMF feels that according the circumstances of the country these are essential then it allows. The country can not change the exchange rate if IMF does not allow