

Principles of Economics - I.Com (Part-I)

Short Questions and Answers

Chapter 1: Nature and Scope of Economics

1. Define economics according to Adam Smith. What is its main focus?

According to Adam Smith, economics is the **science of wealth**. It studies how wealth is produced, exchanged and distributed. His definition gives primary importance to wealth.

2. Write the merits of Adam Smith's definition.

Adam Smith made the study of wealth an important part of economics. His definition drew attention to production, trade and the economic activities through which a nation becomes prosperous.

3. Give Marshall's definition of economics.

According to Alfred Marshall, economics is the study of mankind in the ordinary business of life. It studies how people earn income and use it to obtain the material things needed for their welfare.

4. Write the merits of Marshall's definition.

Marshall placed **human welfare** at the centre of economics. He explained that wealth is important because it helps people meet their needs and improve their standard of living.

5. Give Robbins' definition of economics.

According to Lionel Robbins, economics studies human behaviour as a relationship between **unlimited wants** and **scarce resources that have alternative uses**. People must therefore make choices about how to use their resources.

6. What are economic wants and scarcity?

Economic wants are desires that can be satisfied through goods and services. Scarcity means that the resources available to satisfy these wants are limited in comparison with the wants.

7. What is the economic problem?

The economic problem arises because human wants are unlimited, while the resources used to satisfy them are limited. People must choose which wants to satisfy and how to use their resources.

8. Differentiate between microeconomics and macroeconomics.

Microeconomics studies individual units of an economy, such as a consumer, a firm or a market. Macroeconomics studies the economy as a whole, such as national income, employment and the general price level.

9. What are economic laws? State their nature.

Economic laws describe general relationships between economic events. They show what is

likely to happen **when other relevant conditions remain unchanged**, but human behaviour can affect their results.

10. Differentiate between positive and normative economics.

Positive economics explains economic facts and **what is happening**, such as a rise in prices. Normative economics gives opinions about **what ought to happen**, such as whether the government should control prices.

Chapter 2: Consumer's Demand Theory

1. Define utility and distinguish it from usefulness.

Utility is the power of a good or service to satisfy a human want. Usefulness means that something is beneficial. A good may have utility because it satisfies a want even if it is not beneficial.

2. Define total utility and marginal utility.

Total utility is the total satisfaction received from consuming all units of a good. Marginal utility is the additional satisfaction received from consuming **one more unit** of that good.

3. What is the point of saturation?

The point of saturation is reached when a consumer does not get any additional satisfaction from another unit of a good. At this point, **marginal utility is zero** and total utility is at its maximum.

4. Differentiate between positive and negative marginal utility.

Marginal utility is positive when an additional unit increases satisfaction. It becomes negative when consuming another unit causes discomfort and reduces total satisfaction.

5. State the law of diminishing marginal utility.

The law states that as a consumer consumes successive units of the same good, the satisfaction obtained from each additional unit tends to decrease, provided other conditions remain the same.

6. Write four assumptions of the law of diminishing marginal utility.

The units consumed should be similar and of a suitable size. Consumption should be continuous, and the consumer's tastes and habits should remain unchanged during consumption.

7. Give two practical uses of the law of diminishing marginal utility.

The law helps explain why consumers are willing to buy more of a good when its price falls. It also explains why a person spends income on different goods instead of using it all on one good.

8. State the law of equi-marginal utility.

A consumer obtains maximum satisfaction by distributing income among different goods so that the **marginal utility from the last unit of money spent on each good is equal**.

9. What is consumer behaviour?

Consumer behaviour refers to the choices consumers make when buying and using goods and services. A consumer tries to obtain the greatest possible satisfaction from limited income.

10. Explain the relationship between total utility and marginal utility.

When marginal utility is positive, total utility increases. When marginal utility becomes zero, total utility reaches its maximum; if marginal utility becomes negative, total utility begins to fall.

Chapter 3: Demand

1. Define demand and quantity demanded.

Demand is the quantity of a good that consumers are **willing and able to buy** at different prices during a given period. Quantity demanded refers to the amount they are willing and able to buy **at one particular price**.

2. State the law of demand.

The law of demand states that, other things remaining the same, quantity demanded increases when price falls and decreases when price rises. Thus, price and quantity demanded have an inverse relationship.

3. Why does the demand curve slope downwards?

A demand curve slopes downwards from left to right because consumers normally buy more at a lower price and less at a higher price. It shows the inverse relationship described by the law of demand.

4. Write four assumptions of the law of demand.

The consumer's income and tastes remain unchanged. The prices of related goods and the number of buyers also remain unchanged.

5. What is a demand function?

A demand function shows the relationship between the demand for a good and the factors affecting it. These factors include its price, consumer income, tastes and the prices of related goods.

6. Differentiate between a rise in demand and a fall in demand.

A rise in demand means consumers buy more **at every price**, so the demand curve shifts to the right. A fall in demand means they buy less at every price, so the curve shifts to the left.

7. What is contraction of demand? How is it different from a fall in demand?

Contraction of demand is a decrease in quantity demanded caused by a rise in the good's **own price**. A fall in demand results from a change in another factor, such as income or taste.

8. Explain substitute goods, derived demand and compound demand.

Substitute goods can replace each other, such as tea and coffee. Derived demand arises

because a resource is needed to produce another good, such as labour for building houses. Compound demand occurs when one good is wanted for several uses, such as electricity.

9. Define price elasticity of demand and write its formula.

Price elasticity of demand measures how much quantity demanded responds to a change in price.

Formula: Price elasticity of demand = Percentage change in quantity demanded ÷ Percentage change in price.

10. Differentiate between point elasticity, arc elasticity and zero elasticity.

Point elasticity measures elasticity at a particular point on a demand curve. Arc elasticity measures it between two points. Zero elasticity means quantity demanded does not change when price changes.

Chapter 4: Supply

1. Define supply and state the law of supply.

Supply is the quantity of a good that sellers are **willing and able to offer for sale** at a given price during a given period. According to the law of supply, sellers normally offer more when price rises and less when price falls.

2. State two assumptions and two characteristics of supply.

The law assumes that production methods and production costs remain unchanged. Supply is related to a particular price and time period, and its curve normally slopes upwards from left to right.

3. What is extension of supply?

Extension of supply is an increase in quantity supplied due to a rise in the good's **own price**, while other factors remain unchanged. It is shown by movement along the same supply curve.

4. What is contraction of supply?

Contraction of supply is a decrease in quantity supplied due to a fall in the good's **own price**. It is also shown by movement along the same supply curve.

5. Differentiate between a rise and a fall in supply.

A rise in supply means sellers offer a greater quantity **at every price**, shifting the supply curve rightwards. A fall in supply means they offer a smaller quantity at every price, shifting it leftwards.

6. Differentiate between stock and supply.

Stock is the total quantity of a good available with a seller. Supply is only the quantity the seller is willing to offer for sale at a particular price during a particular period.

7. What is short-period supply?

Short-period supply is the quantity a producer can offer during a period in which some

factors of production are fixed. The producer cannot fully change the size of the business in this period.

8. What is long-period supply?

Long-period supply refers to supply over a period long enough for a producer to change all factors of production. A firm may expand or reduce its scale of production.

9. What is joint supply? Give an example.

Joint supply occurs when two or more goods are produced together from the same source or process. For example, raising sheep supplies both **wool and meat**.

10. What is compound supply?

Compound supply refers to a situation in which the supply of a good can come from different sources or the available stock can be directed towards different uses. The amount offered for one use depends partly on its other possible uses.

Chapter 5: Equilibrium Between Demand and Supply

1. Define equilibrium price.

Equilibrium price is the market price at which **quantity demanded equals quantity supplied**. At this price, buyers and sellers agree on the quantity to be traded.

2. What is market equilibrium?

Market equilibrium is the position where market demand and market supply are equal. As long as other conditions remain unchanged, there is no pressure for the price to rise or fall.

3. What is market price?

Market price is the price at which a good is actually bought and sold in a market at a particular time. It is affected by the demand for and supply of that good.

4. What is reserve price?

Reserve price is the minimum price at which a seller is willing to sell a good. Below this price, the seller prefers to keep the good rather than sell it.

5. Define a market.

A market is an arrangement through which buyers and sellers contact one another to buy and sell goods or services. They do not need to meet in one physical place.

6. What is a surplus in a market?

A surplus occurs when quantity supplied is greater than quantity demanded at the current price. Sellers may lower the price to sell the extra goods.

7. What is a shortage in a market?

A shortage occurs when quantity demanded is greater than quantity supplied at the current price. Competition among buyers may cause the price to rise.

8. What happens when market price is above equilibrium price?

At a price above equilibrium, sellers offer more than buyers want to purchase. This creates a surplus and puts downward pressure on the price.

9. What happens when market price is below equilibrium price?

At a price below equilibrium, buyers want more than sellers offer. This creates a shortage and puts upward pressure on the price.

10. How is equilibrium price determined?

Equilibrium price is determined by the interaction of market demand and market supply. It occurs at the point where the demand and supply curves meet.

Chapter 6: Laws of Return

1. State the law of increasing returns.

The law of increasing returns states that, as more units of a variable factor are used, output may increase by a greater proportion. This can happen because of better use of resources and specialization.

2. Why is increasing returns also called decreasing cost?

Under increasing returns, output increases faster than the use of inputs. As a result, the cost of producing each unit tends to decrease.

3. State the law of diminishing returns.

The law of diminishing returns states that if more units of a variable factor are added to fixed factors, the additional output from each new unit will eventually begin to fall.

4. What is the law of constant returns?

Constant returns occur when an increase in inputs causes output to increase in the same proportion. For example, doubling the inputs doubles the output.

5. What is the law of increasing costs?

The law of increasing costs means that producing additional units causes the cost of each extra unit to rise. It is associated with diminishing returns to a variable factor.

6. Define total product.

Total product is the total quantity of output produced by all the units of a variable factor employed with other factors of production.

7. Define average product and write its formula.

Average product is output produced per unit of a variable factor.

Formula: Average product = Total product ÷ Number of units of the variable factor.

8. Define marginal product and write its formula.

Marginal product is the addition to total output caused by employing one more unit of a variable factor.

Formula: Marginal product = Change in total product ÷ Change in units of the factor.

9. What are internal economies of scale?

Internal economies are savings in average cost that arise when an individual firm expands. For example, a larger firm may use specialized machinery and workers more efficiently.

10. What is large-scale production?

Large-scale production means producing goods in large quantities by using substantial amounts of labour, capital and machinery. It may allow a firm to benefit from specialization.

Chapter 7: The Costs and Revenue of Firm

1. Define a firm and cost of production.

A firm is a business unit that combines resources to produce goods or services for sale. Cost of production is the expenditure incurred in producing them, such as spending on materials, wages and power.

2. Define fixed cost with an example.

Fixed cost does not change with the level of output in the short run. A firm may have to pay **factory rent** even when it produces no goods.

3. Define variable cost with an example.

Variable cost changes when the quantity produced changes. The cost of **raw materials** normally rises when a firm produces more units.

4. Define average fixed cost and write its formula.

Average fixed cost is the fixed cost per unit of output.

Formula: Average fixed cost = Total fixed cost ÷ Quantity produced.

5. Define marginal cost and write its formula.

Marginal cost is the additional cost of producing one more unit of output.

Formula: Marginal cost = Change in total cost ÷ Change in output.

6. Define total revenue and write its formula.

Total revenue is the total money received by a firm from selling its output.

Formula: Total revenue = Price per unit × Number of units sold.

7. Differentiate between average revenue and marginal revenue.

Average revenue is the revenue received **per unit sold**. Marginal revenue is the **additional revenue** received by selling one more unit.

8. Differentiate between normal profit and abnormal profit.

Normal profit is the minimum return required to keep an entrepreneur in the business.

Abnormal profit is the profit earned **over and above normal profit**.

9. When does a firm suffer a loss?

A firm suffers a loss when its total revenue is less than its total cost. The loss equals the difference between total cost and total revenue.

10. Explain the short-run shutdown situation of a firm.

In the short run, a firm may continue despite a loss if it covers its variable costs. It normally shuts down if the price falls below **average variable cost**, because it cannot cover those costs.

Chapter 8: Perfect Competition

1. Define perfect competition.

Perfect competition is a market in which there are many buyers and sellers of a homogeneous product. No individual buyer or seller can influence the market price.

2. Write four characteristics of perfect competition.

Its characteristics include many buyers and sellers, identical products, freedom of entry and exit, and firms that accept the market price.

3. Why is a firm called a price taker under perfect competition?

A single firm sells only a small part of total market output. It cannot change the market price and must accept the price determined by overall demand and supply.

4. Why is the demand curve of a perfectly competitive firm horizontal?

A firm can sell its product at the market price. If it charges more, buyers can obtain the same product from other sellers, so its demand curve is horizontal.

5. What is industry equilibrium under perfect competition?

Industry equilibrium is the position where the total demand for the product equals its total supply. This determines the market price and quantity.

6. How is price determined under perfect competition?

Price is determined by the combined demand and supply of the whole industry. An individual firm accepts this price.

7. What is meant by a homogeneous product?

A homogeneous product is one that buyers consider identical regardless of the seller. Because products are alike, buyers have no reason to pay one firm a higher price.

8. What is freedom of entry and exit?

It means new firms can enter an industry and existing firms can leave it without major restrictions. This freedom affects the profits firms can earn in the long run.

9. Can one firm charge more than the market price? Explain.

A firm cannot normally sell at a higher price because buyers can purchase the identical product from other firms at the market price.

10. What profit do firms tend to earn in the long run?

Under perfect competition and free entry and exit, firms tend to earn **normal profit** in the long run. Abnormal profit attracts new firms, increasing supply.

Chapter 9: Monopoly

1. Define monopoly.

Monopoly is a market structure in which a single firm sells a good or service with no close substitute. The firm is the sole seller in that market.

2. Write two main conditions of monopoly.

There must be a single seller, and barriers must prevent or restrict other firms from entering the market.

3. What is pure monopoly?

Pure monopoly is a market in which there is only one seller of a product and buyers cannot find a close substitute for it.

4. Why does a monopolist's demand curve slope downwards?

A monopolist generally needs to reduce the price to sell more units. Therefore, the quantity buyers purchase increases as price falls.

5. Is a monopolist a price maker? Explain.

A monopolist has some power to choose its price because it is the only seller. However, it must consider demand: a higher price usually means fewer sales.

6. Why might a monopolist reduce its price?

A monopolist may reduce price to increase the quantity sold. It compares the extra revenue from sales with the extra cost of production.

7. Does a monopolist always earn abnormal profit?

No. A monopolist can earn abnormal profit or normal profit, and it may even suffer a loss. Its result depends on demand, revenue and cost.

8. What is a barrier to entry? Give an example.

A barrier to entry is an obstacle that makes it difficult for a new firm to enter a market. A legal licence or very high start-up cost may be a barrier.

9. Differentiate between monopoly and perfect competition.

Monopoly has **one seller**, while perfect competition has **many sellers**. A monopolist has some control over price; a perfectly competitive firm accepts the market price.

10. Why does a monopoly firm have control over its own supply?

As the only seller, the monopoly firm decides the quantity it will produce and offer for sale. Its decision is still limited by buyers' demand for the product.

Chapter 10: Factors of Production

1. Define land and give two examples.

Land includes all natural resources used in production. Examples include agricultural soil, water, forests and minerals.

2. Write four characteristics of land.

Land is a gift of nature and its total supply is limited. It cannot be moved from one place to another, and its quality differs between locations.

3. Define labour.

Labour is the physical or mental effort of people used to produce goods and services. In return for labour, workers normally receive wages.

4. What is mobility of labour?

Mobility of labour is the ability of workers to move from one occupation or geographical area to another to obtain employment.

5. Write four factors that can increase mobility of labour.

Education, job training, better transport and the availability of housing can help workers move between jobs and places.

6. Define capital and capital goods.

Capital consists of man-made resources used to produce other goods and services. Machinery, tools and factory buildings are examples of capital goods.

7. Write four functions of capital.

Capital provides tools and machinery, increases the productivity of labour, supports large-scale production and helps firms use improved technology.

8. Write four functions of an entrepreneur.

An entrepreneur organizes land, labour and capital; makes production decisions; introduces new ideas; and bears the risk of loss.

9. Define marginal productivity.

Marginal productivity is the addition to total output obtained by employing one more unit of a factor of production, while other factors remain unchanged.

10. What are real wages?

Real wages refer to the goods and services a worker can purchase with money wages. They show the **purchasing power** of wages.

Chapter 11: National Income

1. Define national income.

National income is the total income earned by the residents of a country from the production of goods and services during a year.

2. Define Gross Domestic Product.

Gross Domestic Product, or **GDP**, is the total market value of final goods and services produced **within the borders of a country** during a given period.

3. Define Gross National Product and write its formula.

Gross National Product, or **GNP**, is GDP plus net factor income earned by residents from abroad.

Formula: $GNP = GDP + \text{Net factor income from abroad}$.

4. Define Net National Product and write its formula.

Net National Product, or **NNP**, is GNP after deducting depreciation, which is the loss in value of capital goods through use.

Formula: $NNP = GNP - \text{Depreciation}$.

5. Differentiate between personal income and disposable personal income.

Personal income is the income actually received by individuals before personal taxes.

Disposable personal income is the amount left for spending and saving after personal taxes are paid.

6. What are transfer payments? Give two examples.

Transfer payments are payments received without providing a current good or service in return. Pensions and unemployment benefits are examples.

7. Name the three methods of measuring national income.

National income can be measured by the **product or output method**, the **income method** and the **expenditure method**. Each method looks at the same economic activity from a different side.

8. Write four difficulties in measuring national income.

The main difficulties include incomplete records, unpaid household work, double counting of goods and difficulty assigning a value to some services.

9. Write three factors that affect national income.

The size and skill of the labour force, the amount of capital, and the level of technology affect a country's ability to produce goods and services.

10. Define the multiplier and write its formula.

The multiplier shows the total change in national income caused by an initial change in investment. In a simple model:

Multiplier = $1 \div \text{Marginal propensity to save (MPS)}$.

Chapter 12: Money and Value of Money

1. Define money and state its main function.

Money is anything generally accepted in payment for goods and services and in settlement of debts. Its main function is to act as a **medium of exchange**.

2. What is barter? State one difficulty of barter.

Barter is the direct exchange of goods for other goods without using money. It requires each trader to want what the other offers, which can make exchange difficult.

3. Define legal tender money.

Legal tender money is money recognized by law for the payment of debts. A creditor must accept it when it is offered according to the law.

4. What is standard money?

Standard money is the main monetary unit used to state prices and settle payments in a country. Other forms of money are valued in terms of this unit.

5. Define the value of money.

The value of money means its **purchasing power**, or the quantity of goods and services it can buy. When the general price level rises, the value of money falls.

6. What is the velocity of circulation of money?

It is the average number of times a unit of money is used to make payments for goods and services during a given period.

7. Who presented the quantity theory of money in the form $MV = PT$?

The equation $MV = PT$ is associated with **Irving Fisher**. It relates the money supply and its velocity to the total value of transactions.

8. Define inflation.

Inflation is a sustained rise in the **general price level** of goods and services. As prices rise, the purchasing power of money falls.

9. Differentiate between an order cheque and a crossed cheque.

An order cheque is payable to the named person or someone properly authorized by that person. A crossed cheque is paid through a bank account rather than directly over the counter.

10. Define a bill of exchange.

A bill of exchange is a written and unconditional order directing one person to pay a stated sum of money to another person, either on demand or at a stated time.

Chapter 13: Business Cycle

1. Define the business or trade cycle.

A business cycle refers to repeated increases and decreases in the overall level of economic activity. It is seen in changes in production, income and employment.

2. Name the main phases of the business cycle.

The main phases are **prosperity, recession, depression and recovery**. Economic activity rises in some phases and falls in others.

3. What is prosperity?

Prosperity is a period of high economic activity. Production, investment, income and employment are generally high.

4. Define recession.

Recession is a period in which overall business activity begins to decline. Production, sales and employment usually fall.

5. Define depression.

Depression is a severe and prolonged decline in economic activity. It is usually marked by very low production and high unemployment.

6. What is recovery or revival?

Recovery is the phase following a downturn in which production, investment and employment begin to increase again.

7. What happens to employment during prosperity?

Employment normally increases because businesses produce more goods and services and need more workers.

8. What happens to employment during depression?

Employment normally falls because businesses reduce production and may dismiss workers.

9. Why is the rise and fall of economic activity called a cycle?

It is called a cycle because periods of expansion and contraction tend to occur repeatedly. However, each cycle need not last for the same length of time.

10. Differentiate between recession and recovery.

During recession, production and employment are declining. During recovery, they begin to rise after the decline.

Chapter 14: International Trade

1. Differentiate between international and domestic trade.

International trade is the exchange of goods and services **between countries**. Domestic trade takes place **within the borders of one country**.

2. Write four advantages of international trade.

International trade allows countries to specialize, gives consumers more choice, provides access to goods they cannot produce easily and offers producers a larger market.

3. Explain the theory of comparative cost.

The theory states that a country should specialize in producing a good for which it has a **lower opportunity cost** compared with another country. Countries can then gain through exchange.

4. Define specialization and give two advantages.

Specialization means concentrating resources on a particular product or task. It improves workers' skills and can increase total production.

5. Define balance of trade.

Balance of trade is the difference between the value of a country's **exports and imports of goods** during a given period.

6. Define balance of payments.

Balance of payments is a systematic record of a country's economic transactions with the rest of the world during a given period.

7. Differentiate between exports and imports.

Exports are goods and services sold to other countries. Imports are goods and services purchased from other countries.

8. What are invisible exports?

Invisible exports are **services** sold to people or businesses in other countries. Transport, tourism and professional services are examples.

9. Define terms of trade and write its formula.

Terms of trade compare the prices of a country's exports with the prices of its imports.

Formula: Terms of trade = $\text{Export price index} \div \text{Import price index} \times 100$.

10. Why do countries trade with one another?

Countries differ in their resources, climate, skills and production costs. Trade allows them to obtain goods they lack and to sell goods they can produce relatively efficiently.

Chapter 15: Public Finance

1. Define public finance.

Public finance is the study of government revenue, expenditure and borrowing. It explains how the government raises and uses money to meet public needs.

2. Differentiate between public finance and private finance.

Public finance concerns the income and spending of government and aims to serve the public. Private finance concerns the income and spending of individuals or businesses.

3. Define tax and state its purpose.

A tax is a compulsory payment imposed by the government. Tax revenue is used to finance public services such as education, health and roads.

4. Differentiate between direct and indirect tax.

A direct tax is imposed on a person and normally paid by that person, such as income tax. An indirect tax is charged on goods or services and may be passed on to buyers.

5. Differentiate between progressive and regressive tax.

In a progressive tax, the **tax rate increases as taxable income increases**. A regressive tax takes a larger proportion of income from lower-income people than from higher-income people.

6. Define a government budget.

A government budget is a statement of expected government revenue and planned expenditure for a financial year.

7. What is a surplus budget?

A surplus budget is one in which expected government revenue is **greater than** planned government expenditure.

8. Write four main heads of public expenditure.

Major areas of public expenditure include **education, health, defence and infrastructure** such as roads and public facilities.

9. Differentiate between Zakat and Ushr.

Zakat is an obligatory payment on wealth that meets its required conditions. Ushr is an obligatory payment associated with agricultural produce under its applicable rules.

10. Why does the government spend money on public services?

The government spends money to provide services that benefit society, such as schools, hospitals, roads and public safety. These services support public welfare and economic activity.