



ECONOMICS HARBOUR

UGC NET ECONOMICS STUDY MATERIAL
(NINTH EDITION)



UNIT 1

MICRO-ECONOMICS

Contact Us:

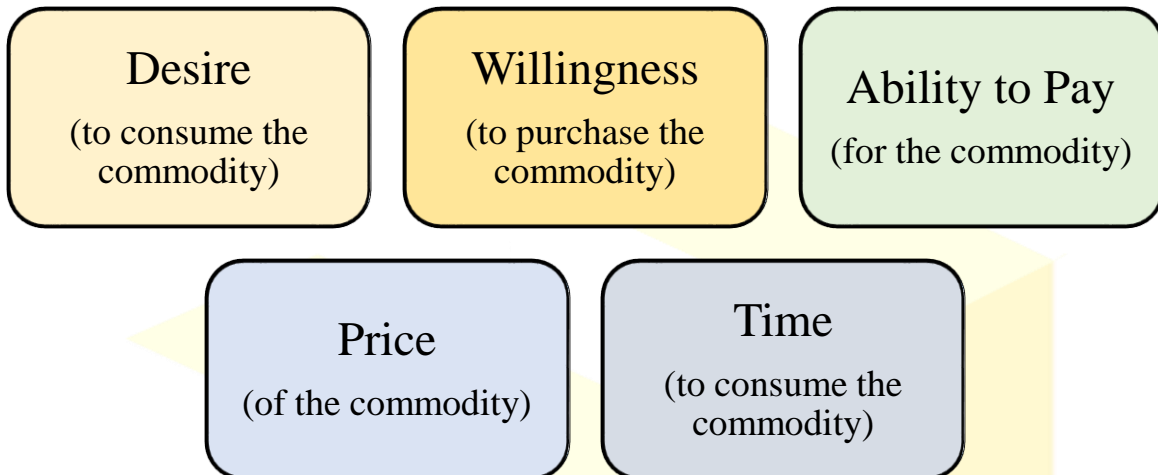
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CONCEPT OF DEMAND

The concept of demand was given by **Alfred Marshall in 1890s** in his book “*Principles of Economics*”.

Five characteristics of demand



Demand is a flow concept

Why?

Because it is seen with reference to a continuous flow of purchases over a period of time.

Demand Function

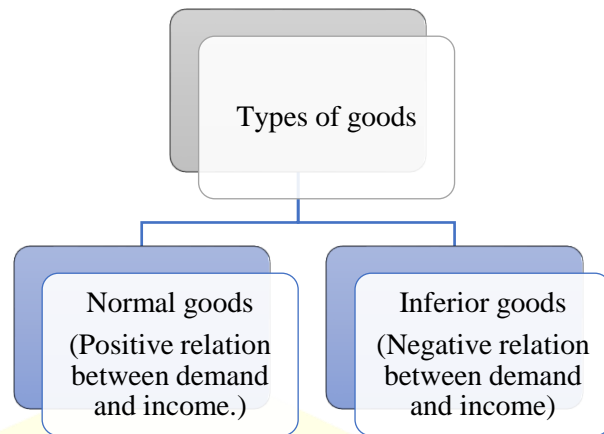
Functional relationship between demand and factors affecting the demand such as income, price of related goods, etc.

Quantity demanded is a function of:

1. **Price of own good:** There is an inverse relationship between price of the goods and its quantity demanded. Higher the price, less will be the quantity demanded of it and vice-versa.



2. **Income of the consumer:** The goods can be classified as:



3. **Price of related goods (Substitutes/Complements):** In case of **substitute goods** (goods consumed in place of), there is a **positive relationship between price of related goods and quantity demanded**. Higher the price of related good say Y, more will be the quantity demanded of X. In case of **complementary good** (goods consumed together), there is a **negative relationship between price of related good say Y and quantity demanded of X**.
4. **Tastes and preferences:** In case of favourable tastes, there is a positive relationship with the demand and in case of unfavourable tastes, there is a negative relationship with demand.
5. **Advertisement outlay:** Higher the advertisement outlay, more will be the demand, thus hinting on a positive relationship.
6. **Future expectations of price:** If prices are expected to rise in future, the demand at present will increase. Alternatively, if prices are expected to fall in future, the demand at present will fall.
7. **Number of customers in the market:** More are the consumers in a market, more will be the quantity demanded of a good and vice-versa.

Identify the relationship between following factors and demand. Tick the correct column.

<i>Factor</i>	Positive relationship	Negative relationship
1. Price		
2. Normal Goods		
3. Inferior Goods		
4. Substitute Goods		
5. Complementary Goods		
6. Favourable Tastes		
7. Unfavourable Tastes		
8. Advertisement Outlay		
9. Price to increase in future		
10. Price to decrease in future		
11. Number of consumers in the market.		

Check your answers:

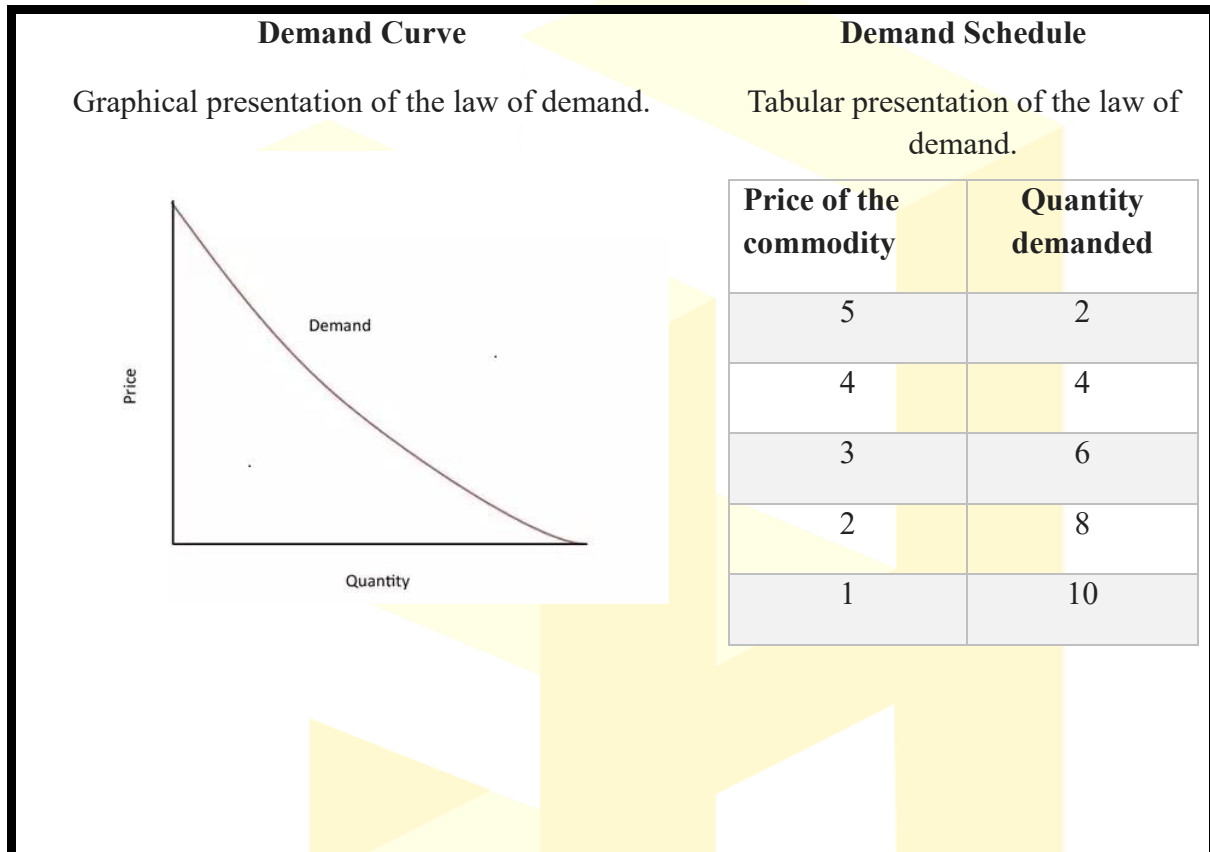
Score: 10-11: Excellent, 8-9: Good, 6-7: Satisfactory, 5 or below: Please study!

LAW OF DEMAND

The law of demand was given by **Alfred Marshall**. It is a **partial equilibrium analysis** and states that there is an inverse relationship between price of the commodity and the quantity demanded of it.

For your information!
Partial Equilibrium models consider only one market at a time, ignoring potential interactions across markets.

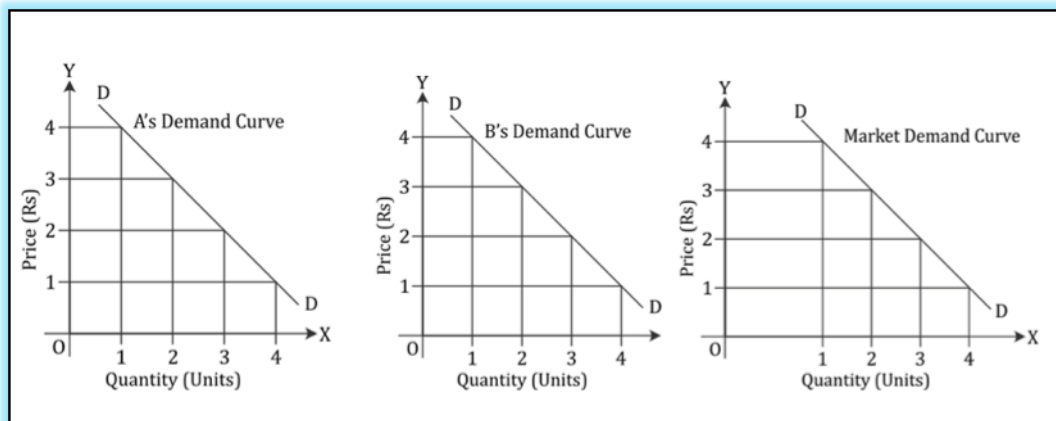
REPRESENTATION OF LAW OF DEMAND



Demand curve and demand schedule do not tell us what the price is, they only tell us how much quantity of the good would be purchased by the consumer at various possible prices.

Market Demand

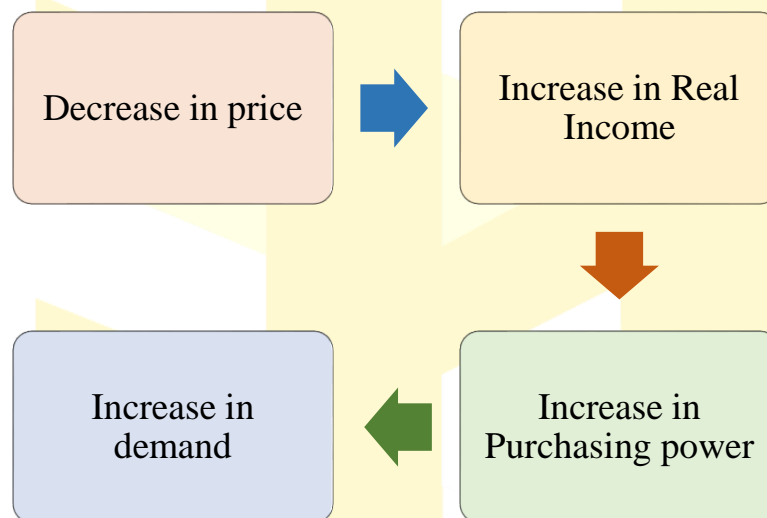
- ✓ Horizontal summation of individual demands.
- ✓ Affected by the population level, that is, larger the population, more will be the market demand.
- ✓ Market demand curve is flatter as to the individual demand.



Reasons for downward sloping demand curve

1. **Law of Diminishing Marginal Utility:** The law was given by **Alfred Marshall** and it states that “as the consumer consumes more and more of a good, the marginal utility derived from each successive unit keeps on decreasing.” As a result, a consumer would purchase subsequent units of a commodity only if its price decreases and vice-versa. Therefore, the demand curve slopes downwards.

2. **Income effect:**

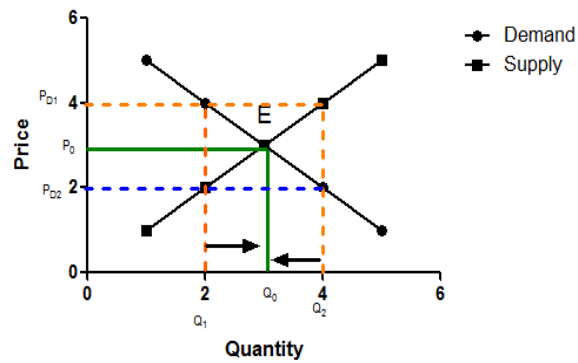


What is Real Income?

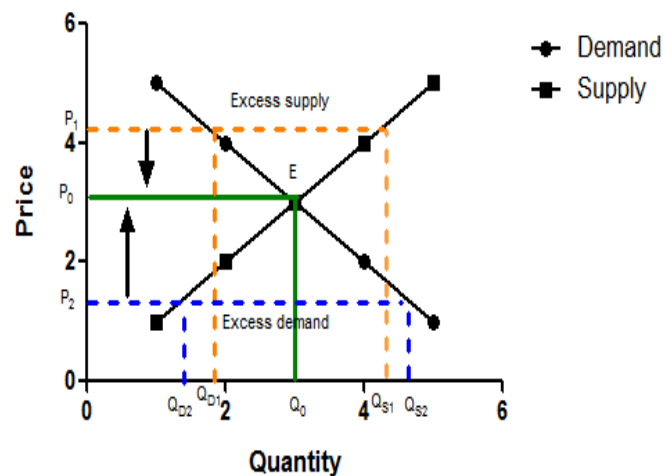
Real income is an economic measure that provides an estimation of an individual's actual purchasing power.

$$\text{Real Income} = \text{Nominal Income} \div \text{Price of the commodity}$$

3. **Substitution effect:** Marshall explained the downward sloping demand curve with the aid of **substitution effect alone**; and he **ignored the income effect on price change**.



2. **Walras Approach :-** Quantity dependent approach depends on price movement.

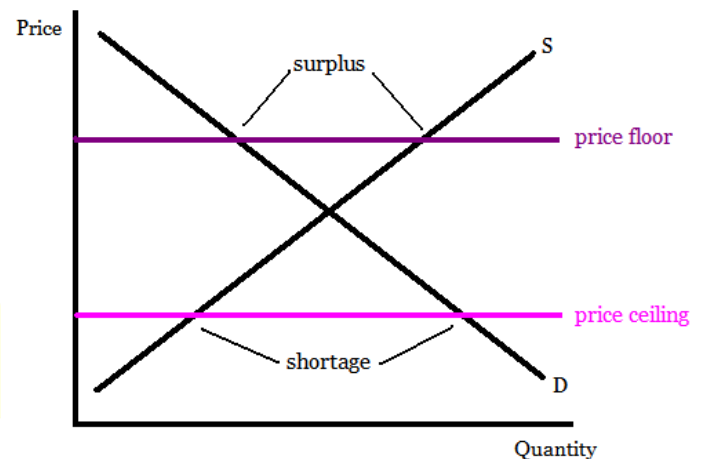


Shape of Demand curve	Shape of supply Curve	Particular Feature	Walras Stability	Marshall Stability
Downward	Upward	Intersecting	Stable	Stable
Upward	Downward	Intersecting	Unstable	Unstable
Downward	Downward	Supply curve cuts demand curve from above	Stable	Unstable
Downward	Downward	Supply curve cuts demand curve from below	Unstable	Stable
Upward	Upward	Supply curve cuts demand curve from above	Stable	Unstable
Upward	Upward	Supply curve cuts demand curve from below	Unstable	Stable

Government Intervention in terms of fixing maximum and minimum prices

Floor means the lowest limit. Floor price means the minimum price fixed by the government for a commodity in the market. It seems paradoxical, but is true that the government in most countries fixes floor price for most agricultural products, food grains in particular.

Ceiling means maximum limit. Price ceiling means maximum price of a commodity that the sellers can charge from the buyers. Often, the government fixes this price much below the equilibrium market price of a commodity so that it becomes within the reach of the poorer sections of the society.



How demand and supply curves change when government intervenes?

Rationing

Demand curve shifts upward to the right

Subsidies to producers

Supply curve shifts to the right

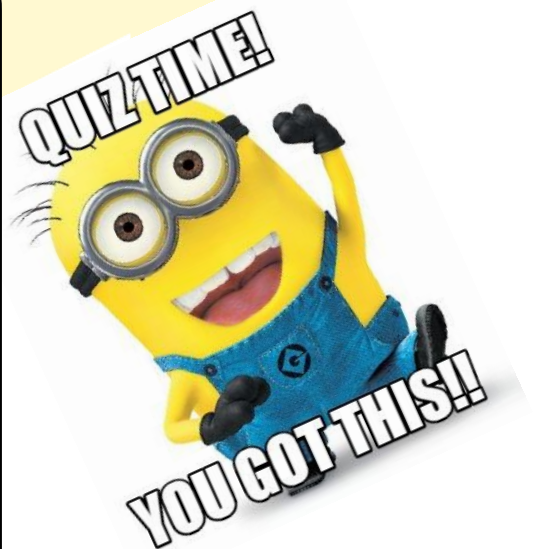
Taxes on producers

Supply curve shifts to the left

2-Minute Quiz

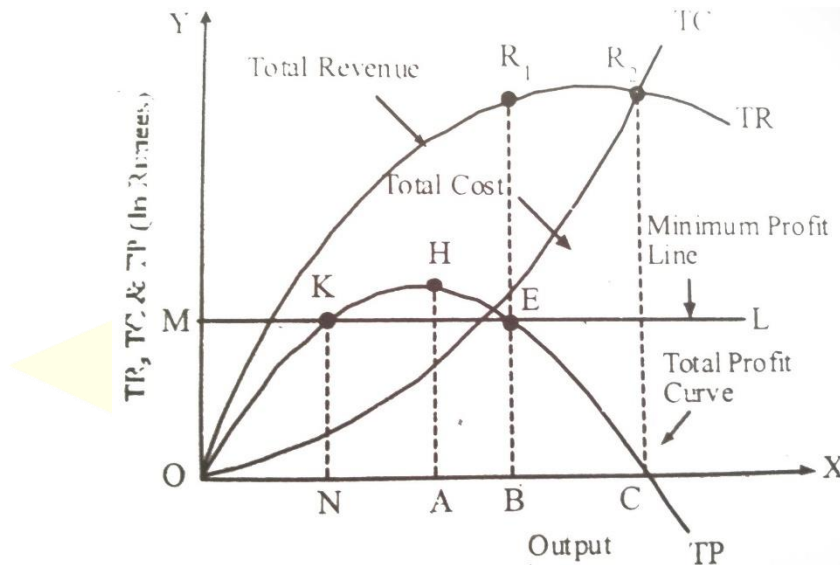
- Giffen paradox occurs when income effect is:
 - negative and is more than substitution effect.
 - equal to substitution effect.
 - greater than substitution effect.
 - less than the substitution effect.
- In the consumer behavior theory, the following theories consider risk and uncertainty factors are:
 - Hicks-Allen Indifference curve
 - revealed preference approach
 - Theory by Neumann-Morgenstein
 - Marshallian cardinalist approach.
- Slutsky equation deals with the decomposition of:
 - Goods into necessities and luxuries.
 - goods into superior and inferior goods.
 - goods into high priced and low priced.
 - price effect into substitution and income effects.

Correct Answers: 1) A, 2) C, 3) D



BAUMOL'S SALES MAXIMISATION MODEL

The main aim of the model is to maximise the sales or maximising revenue from sales, subject to some minimum level of profits.



L is the minimum profit line which should be earned to satisfy the shareholders.

The managers aim to maximise revenues instead of maximising the profits. As a result, the firm does not operate at A level of output. Rather it works at B output level, so as to maximise the sales and hence revenue. If the firm produced more than B, then profits would become less than the minimum profit level, hence causing disequilibrium to the shareholders. Therefore, the management prefers to produce output till B.

It should be noted that profit maximisation leads to lesser output as compared to revenue maximisation.

The **reasons** behind managers working towards maximising sales instead of profits are as follows:

1. Sales is considered to be the main criteria for the index of performance of the firm by various financial institutions.
2. The managers are more satisfied by maximising revenue instead of maximising profits in which they get no share.
3. Salaries and perks of the managers are dependent on the sales earning.
4. The day to day problems can more easily be solved by growing the sales of the firm, hence increasing revenue.
5. Increasing sales implies more share of the firm in the market and hence increasing the bargaining power of the firm.

MARRIS MODEL OF MAXIMISATION OF GROWTH RATE

According to R. Marris, the managers do not aim to maximise profits. Rather they aim to maximise the balanced growth rate of the firm. It can be expressed as

$$\text{Maximise: } G = G_d = G_c$$

Where: G_d is the growth of product market, G_c is the growth of supply of capital.

It should be noted that utility of managers is a function of,

$$U_{\text{managers}} = F(G_d, \text{Job Security})$$

And Utility of owners is a function of

$$U_{\text{owner}} = F(G_c)$$

Marris also talked about two types of constraints

1. **Managerial constraints:** These are related to the skills of manager and research & Development.

2. **Financial constraints:** He talked about a few ratios:

a. **Debt Ratio/Leverage ratio** = $\frac{\text{Debt}}{\text{Gross value of assets}}$
Higher the ratio, lesser the security.

b. **Liquidity Ratio** = $\frac{\text{Liquid assets}}{\text{Total assets}}$
Higher the ratio, higher is the security.

c. **Retention Ratio** = $\frac{\text{retained profits}}{\text{Total assets}}$
Higher the ratio, higher the security.

Financial Constraint is a combination of debt ratio, liquidity ratio and retention ratio.

Rationale for Maximizing Growth Rate

Managers do not maximize the absolute size of the firm but the rate of growth.

Utility function of managers:

$$U_m = f(G_d, S)$$

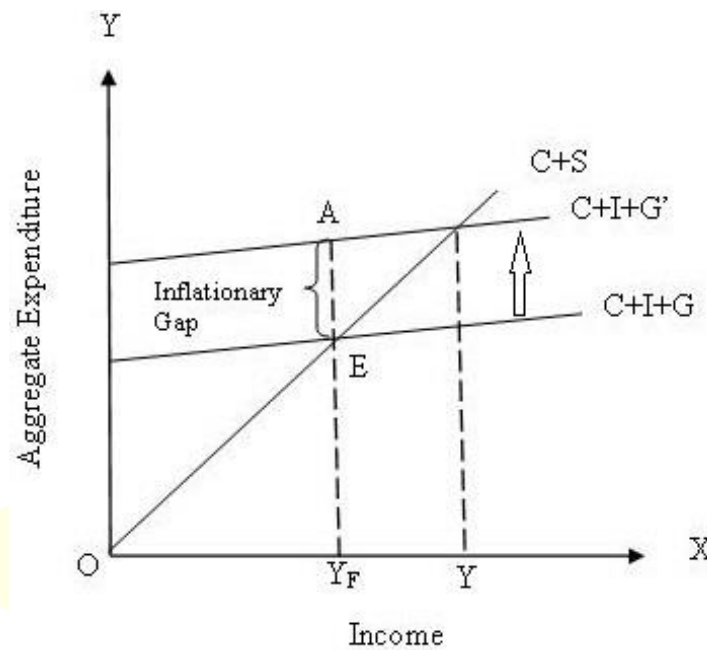
Where G_d = Growth rate of product market or demand (+), S = Measure of job security (+)

Utility of owners:

$$U_{\text{owner}} = F(G_c)$$

Where: G_c = Growth rate of capital supply

G_c depends on debt ratio, liquidity ratio, retention ratio



Increase in government expenditure

Full employment of resources; resources will not increase ($\text{Demand}_{\text{Factor}} > \text{Supply}_{\text{Factor}}$)

Increase in factor prices

Inflationary pressures

Inflationary gap only generates money income without creating matching real output because economy is in full employment equilibrium.

