2. Basic Principles In Business Economics

Q:1 Explain the Principles of Scarcity and effeciency?

(A) Twin Principle of Scarcity and Efficiency :-

(a) **Scarcity :-** Economics is the study of How an economy manages its Scarce Resources among alternative uses to Satisfy Human wants. Economics always deals with Optimum allocation of scarce resources.

i) **Human wants are Unlimited :-** "Individuals desires For various goods and services and conditions of life is called Human wants"

These wants are different For different People at different Places. All Human wants cannot be Fully Satisfied.

ii) **Economic Resources are Limited :-** Resources are available in the form of Factors of Production i.e - Land, Labour, Capital and Entrepreneur. These economic Resources are Scarce in nature which are used to Produce goods and Services in the economy. But as Resources are Limited so the

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Produced goods and services are also limited to Satisfy Human wants.

iii) **Resources Have Alternative Uses :-** The Limited Resources are Used in alternative ways.

Example - A Piece of Land Can be Used for Factory, Agriculture, Housing Transport etc.

when Limited resources are Used for one desired Options then other options will be Sacrificed

Thus, Scarcity is an Universal problem whether an economy is Poor or Rich. No economy has abundant (Plenty) resources to Satisfy unlimited wants of People.

Business Economics deals with business firm which also face the problem of Scarcity of Resources. So Producer Unable to supply desired level of Out-Put. Similarly Consumer also face Problem of Scarcity of Resources so Consumer Unable to demand desired Level of goods and Services.

(b) **Efficiency :-** " When Economy is getting the maximum benefits from its Scarce Resources is Called Efficiency "

Efficiency is Concerned with Optimum level of Production and Distribution of the Scarce resources of the economy.

(c) **Types of Efficiency :-**

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1. **Productive Efficiency :-** Productive Efficiency is achieved when firms produce goods and services at Lowest Cost due to competition among firms.

2. **Allocative Efficiency :-** Allocative Efficiency is achieved when firms produce Variety of goods and services as per Consumer's Taste and Preference.

3. **Technical Efficiency :-** Technical Efficiency is achieved when the maximum Output is being produced with a given Combination of inputs.

4. **Efficiency in Consumption :-** Consumption Efficiency is achieved when Consumers enjoys maximum Satisfaction with minimum Expenditure.

5. **Efficiency in Specialisation and Exchange :-**

This efficiency can be achieved when firms becoming Specialise in Producing and Selling goods to Consumers On the other side Consumers are specialise in doing Jobs to Purchase goods and services.

Thus both Seller and buyer gets benefits from goods and services.

Thus, Economic Efficiency is achieved when each goods is produced at Minimum Cost. All Individuals and firms get the Maximum benefits from their Scarce Resources.

Q:2 Explain the Incremental and Marginal Principle?

(A) Marginal Principle :- Rational People do their best to achieve best from the given opportunities.

Example - A Rational buyer wants to enjoy maximum Satisfaction with Minimum Expenditure.
A Rational seller wants to enjoy maximum Profit with Minimum Investment.

Due to Scarcity of Resources, all economic activities give rise to some benefits and some Costs. Main aim of economic decisions it to maximise Net benefits.

Net Benefit will increase when Marginal Benefit > Marginal Cost.

Net Benefit will be maximum when Marginal Benefit = Marginal Cost.

(B) Marginal Analysis Helps in Decision-Making :-

Marginal Analysis plays an important Role in Decision-Making Process. The Theory of Marginalism was Developed by - Prof. Alfred Marshall of Cambridge University According to him a Producer will Continue its Production till MR = MC.

Producer enjoys maximum Profit when MR > MC.

Marginal Decisions are taken by - Households, individuals, Consumers, Producers, Government etc.

Marginal means Extra benefit or Extra Cost due to change in Out Put.

© Important Margin Concepts :-

1. **Marginal Utility :-** MU means changes in TU due to consumption of one more unit of output.

$$MU = \frac{\Delta TU}{\Delta Q} \quad \text{OR} \quad MU_n = TU_n - TU_{n-1}$$

2. **Marginal Product :-** MP means changes in Total Product (TP) due to change in amount of inputs (Labour) used.

$$MP = \frac{\Delta TP}{\Delta L} \quad \text{OR} \quad MP_n = TP_n - TP_{n-1}$$

3. **Marginal Revenue :-** MR means change in Total Revenue (TR) due to increase in quantity sold by one unit

$$MR = \frac{\Delta TR}{\Delta Q} \quad \text{OR} \quad MR_n = TR_n - TR_{n-1}$$

4. **Marginal Cost :-** MC means the change in Total cost (TC) due to increase in the quantity produced by one unit.

$$MC = \frac{\Delta TC}{\Delta Q} \quad \text{OR} \quad MC_n = TC_n - TC_{n-1}$$

(D) Incremental Principle :-

"The term Incremental means the Total additional cost or Total additional benefit arise due to managerial Decision."

The Incremental Concept is the study of Incremental Cost and Incremental Revenue.

"Incremental Cost means Change in Total Cost."

"Incremental Revenue means Change in Total Revenue"

Incremental Cost and Revenue shows change in

TR due to decisions taken by Firm.

An Incremental Decision will be profitable when —

1) It Reduce Cost and bring more Revenue.
2) It increase TR as compare to TC.
3) It helps to decrease the Cost to great extent.
4) It helps to Increase Revenue to great Extent.

Example :- A businessman decided to open a New branch in New city. This is an Incremental Decision This decision will be based on comparision between Incremental Cost and Incremental Revenue.

This concept is mostly used by Progressive firms.

Q:3 Explain the Profit Maximisation Principle by Total Cost and Total Revenue Approach ?

(A) Profit Maximisation Principle :-

Every Rational Firm wants to earn maximum Profit.

" Maximum Profit means Pure Profit which is a Surplus of Total Revenue over Total Cost "

Profit is the amount Left with the entrepreneur after making Payments to all Factors of Production.

Economic (Pure) Profit = Total Revenue - (Explicit + Implicit cost)

(B) Equilibrium of A Firm :- A Firm enjoys its Equilibrium with maximum Profit where it is not

Possible to increase or decrease its out put.

$$\text{Profit} = TR - TC$$
$$\pi = TR - TC$$

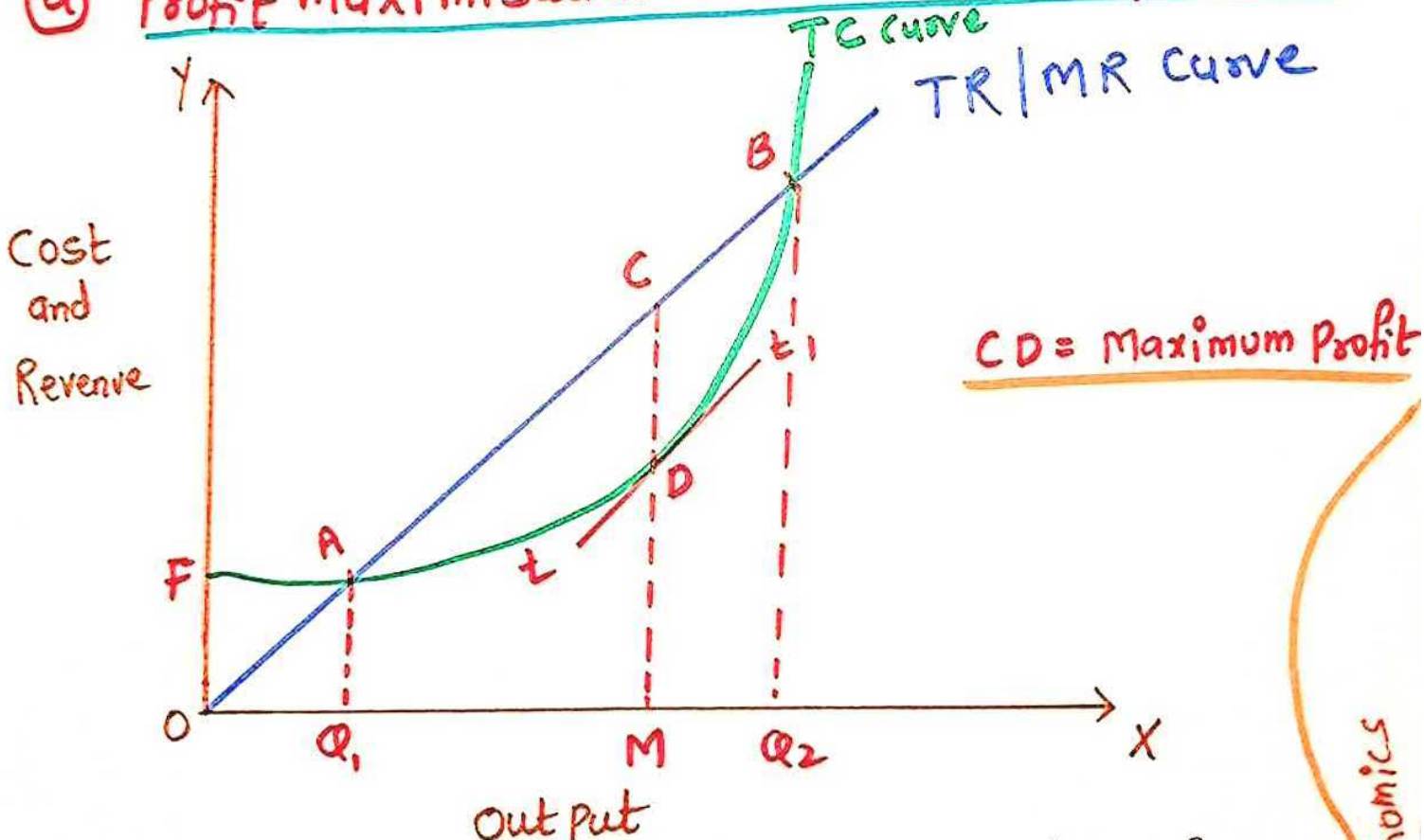
Thus a firm is in equilibrium, where differen between TR and TC is maximum.

© Profit Maximisation Principle Approach

1. TR and TC Approach
2. MR and MC Approach

1. Total Revenue and Total Cost Approach :-

(a) Profit Maximisation Under Perfect competition :-



CD = Maximum Profit

1) On x-axis, Out put and on Y-axis cost and Revenue are shown.
2) TR is Total Revenue Curve which is a straight line through Origin because Uniform Price is Followed in Perfect

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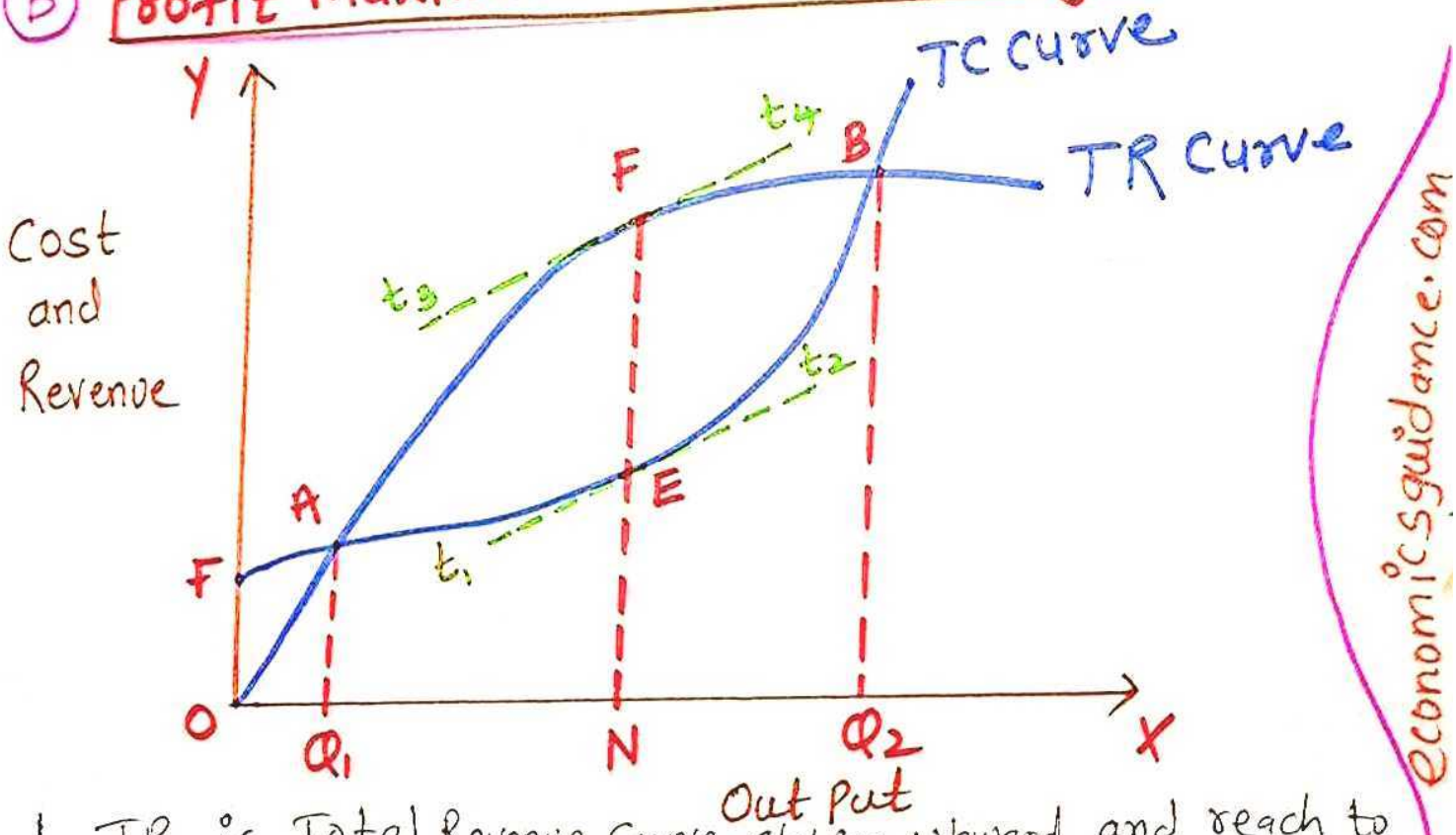
Competition.

3) The Slope of Total Revenue Curve also shows slope of Marginal Revenue because TR increase in Same Proportion with increase in sales.

4) TC is Total Cost Curve which is U-shaped Avg. Cost Curve.
It intersect TR Curve at Point A and Point B.
At Point A Less Out Put Q_1 is Produced where TR=TC.
At Point B more Out Put Q_2 is Produced where TR=TC.

5) But at Out Put level - M, Producer enjoy maximum Profit = CD i.e maximum difference between TR and TC.

(b) Profit Maximisation Under Monopoly :-



1. TR is Total Revenue Curve sloping upward and reach to its maximum Point then start falling.
In monopoly or any imperfect market a firm can sell additional unit at Lower Price. Thus TR Curve

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is sloping upward but at diminishing Rate.

2) TC is Total cost Curve sloping upward and having U-shaped.

3) At Point A, Firm Produce Less Out Put Q_1 where TR = TC
At Point B, Firm Produce More Out Put Q_2 where TR = TC
But Firm enjoy equilibrium at EF level where difference between TR and TC is maximum.
Here Tangents are drawn on TR and TC curve which are Parallel.

Q84 Discuss the Profit Maximisation Principle by MR and MC approach ?

(A) Marginal Revenue and Marginal Cost Approach :-

Marginal Revenue is the Rate of Change in Total Revenue i.e change in the slope of Total Revenue.
Similarly Marginal cost is the Rate of change in Total cost i.e change in the slope of Total cost.
Hence, the Profit Maximizing output is determined where difference between TR and TC is maximum and MR = MC.
Thus, a producer achieve equilibrium Level with maximum Oput where MR = MC.

(B) Profit Maximisation Under Perfect Competition :

Under Perfect competition Demand Curve is Perfectly Elastic where - MR = AR = Price

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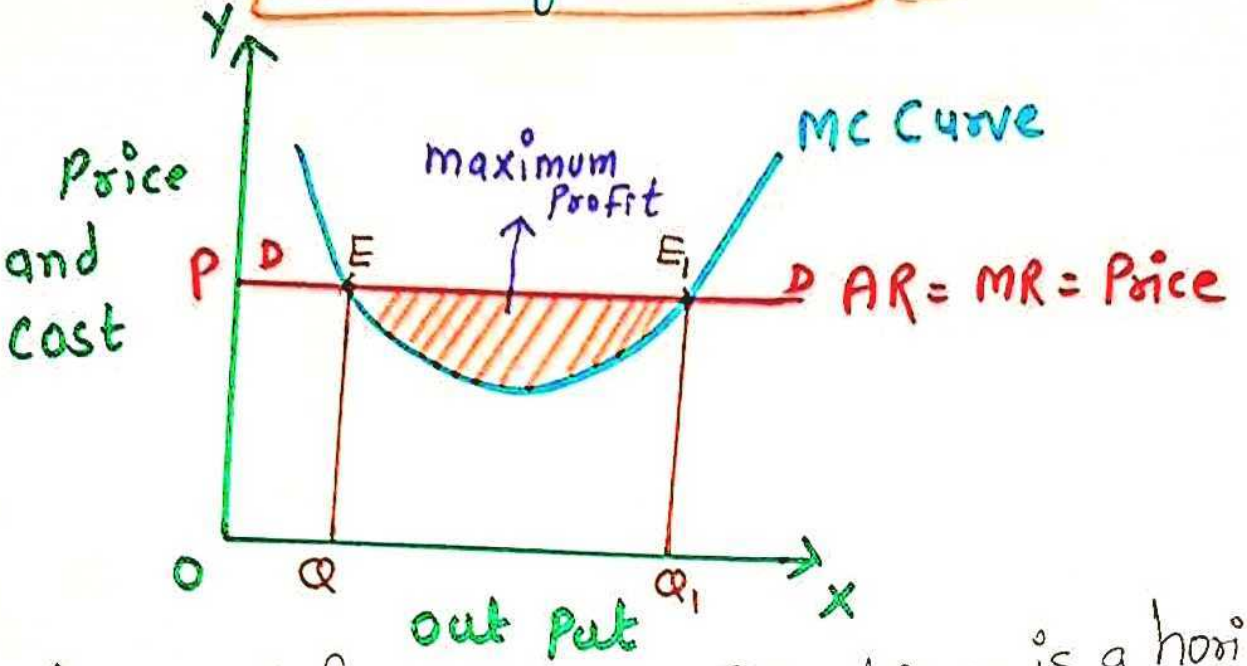
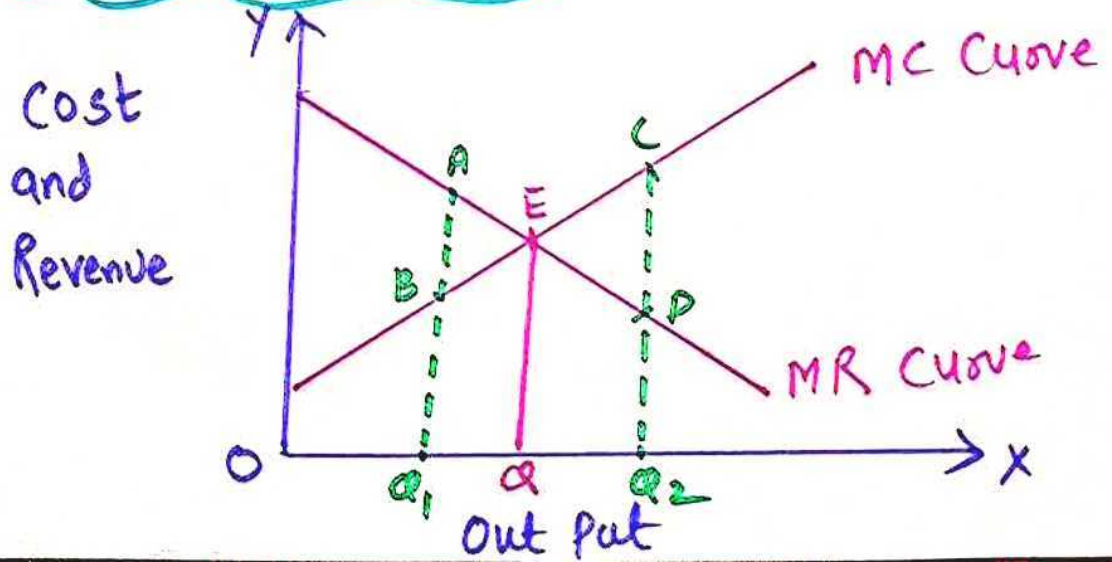


1) Under Perfect competition, Demand Curve is a horizontal Straight line where AR = MR = Price.
2) MC Curve is U-shaped curve which intersect MR Curve at Two Points E and E_1.
At Equilibrium E, Less output OQ is Produced where MR = MC.
At Equilibrium E_1, More out put OQ_1 is Produced where again MR = MC.
3) Thus a Producer enjoy maximum profit at Equilibrium E_1 where MC curve intersect MR Curve from below.

© Profit Maximisation Under Imperfect Competition



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1) Under Imperfect Competition, Demand Curve of Firm is Sloping downward where Price is greater than MR. Here firm can sell more by reducing Price.

2) A Firm enjoys Equilibrium where MR Curve interseet MC Curve at Point E. Here Producer enjoy maximum Profit at OQ level of Output. (MR = MC)

3) If Producer Reduce its Output to OQ_1, its Profit margin will be Reduced by ABE Level. (MR > MC)

4) If Producer increase its output to OQ_2, Firm will suffer the Loss ECD level because MC is exceed to MR. (MC > MR)

Q:5 Explain the Concept of Market Economy and Invisible Hand ?

(A) Market Economy AND Invisible Hand :-

In Market economy, each buyers and sellers are Free to take their own economic decisions.

" The demand and supply decision of Individuals and Firms are transmitted to each other through their effect on Prices. This is called Price Mechanism "

Excess of Demand over Supply create Problem of Shortage which Raise the Price of goods and services

Higher Prices motivate Producers to Produce and supply more to earn higher Profits.
On the other side Higher Price reduce Purchasing Power of buyers.
When Supply is exceed over demand there will be Surplus which result in fall in Prices of goods and services.
The Price where Demand is equal to supply is called equilibrium price.

(B) Invisible Hands :- In Market economy, Price Mechanism helps to bring Changes in Demand and Supply and bring about equality between Demand and supply.

According to Adam Smith-
" In a market economy, Resources are Allocated by Invisible hands of market according to Consumer Demand "

In market economy, all buyers and sellers are working Freely and improve their own economic situations.
There is Non-Intervention Policy of government.

(C) Prices act as Incentives and Signals :- In market economy, Changes in Price act as incentives and Signals to buyers and sellers.

Example :- Higher Price motivate Producers to Produce more and Sell more and earn more Profits.

A rise in demand Leads to Rise in Price of goods and Services. Now Producer divert their resources from Lower Price goods to higher Price goods where they can earn more Profits.
When there is Shortage of goods will also raise the Price of goods. Again it act as incentives to Firms to Produce more goods.
Thus Market Prices are act as Signals to Producers to Produce more or Less. The effeciency of market depends upon → How buyers and Sellers are giving Respond to Price Signals.
A market economy is working freely in the environment of Decentralised Decision making.
Self-Interest is the Motivating Force and Competition is the Regulating Force which work together to Control market Price.. Thus market economy is working with Invisible Hands

Q:6 Explain the Concept of Production Possibility Frontier?

(A) **Production Possibility Frontier :-** Due to Scarcity of Resources is difficult for Producer to take decision- How much to Produce? Each Producer has to allocate its Scarce Resources in efficient way so that he can Produce maximum Variety of goods and Services

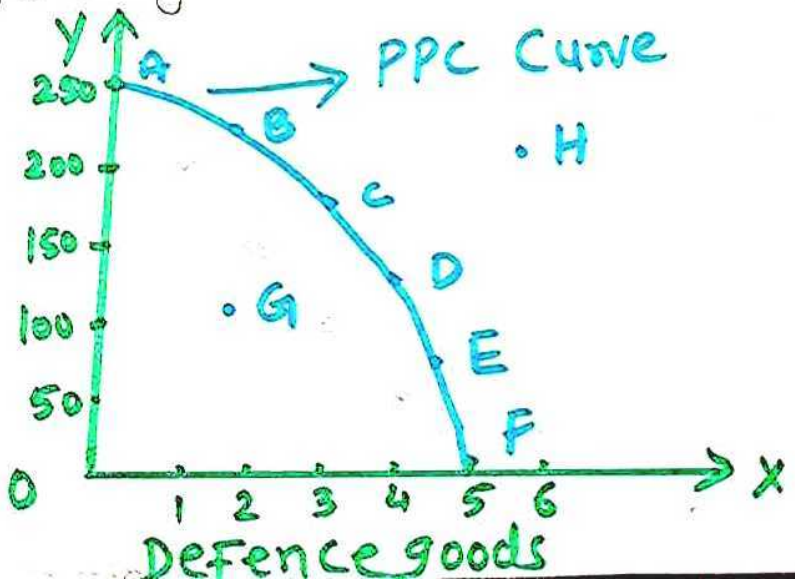
(B) Production Possibility Schedule :-

Production Combination	Consumer Goods (in 1000 units)	Defence Goods (in 1000 Units)
A	250	0
B	200	1
C	150	2
D	100	3
E	50	4
F	0	5

In above schedule we observe—

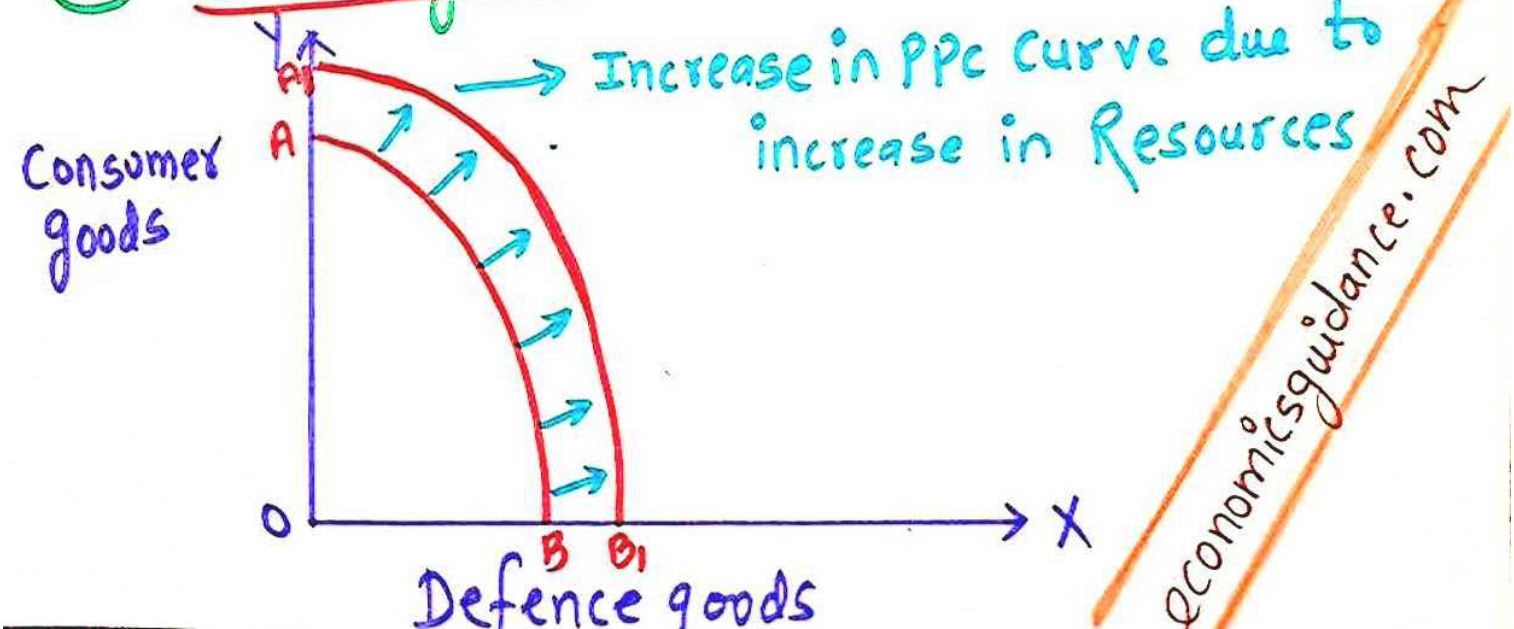
1) An economy shows different combination A to F for Producing Consumer goods and Defence goods with available resources like - man power, Technology, Investment, Organisational ability etc.
2) Combination - A shows Production of only Consumer goods. and Combination - F shows Production of only Defence goods
3) Combination - B shows more Consumer goods but less Defence goods.
4) Combination - E shows Less Consumer goods but more Defence goods.

(C) Diagram :-



1) In above diagram PPC is Production Possibility Frontier which shows Combination of consumer goods and Defence goods.
2) The PPC Curve shows Trade-OFF between Consumer and Defence goods. It means more Consumer goods will result in Less Defence goods and Vice Versa.
3) A Country Cannot Produce Out side the PPC Curve Suppose at Point-H because Resources are not available with economy.
4) Similarly economy Cannot Produce at any Point inside PPC-Curve because it will result in wastages of Resources like at Point-G.
5) Thus Point on PPC Curve like A B C D E F will indicate Maximum Output with Scarce Resources In Reality no economy can Produce on its PPC but it can be near to its PPC.

(D) Shifting the PPC :-



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1) In above diagram, AB is given - Maximum Production Possibility with given Resources.
2) If economy get New Resources, better skill and Technology, Discover New Technology, New Innovation etc. then PPC will be shifted to right side - A_1B_1.
3) It shows Larger Production Possibility between Consumer and Defence goods.

Q:7 Explain the Concept of Opportunity Cost?

(A) Opportunity cost :- Micro and Macro Economics mostly use the concept of Opportunity Cost.

Opportunity cost is useful in decision-making involving a choice between different alternatives available. We Knew that - Resources are Limited so we cannot Produce all the commodities. Even Resources have alternative uses.

Thus we have to make some choice and Sacrifice Some Options.

(B) Meaning :-

"An Opportunity cost is the cost of an alternative that must be foregone in order to Pursue a certain action."

The opportunity cost implies -

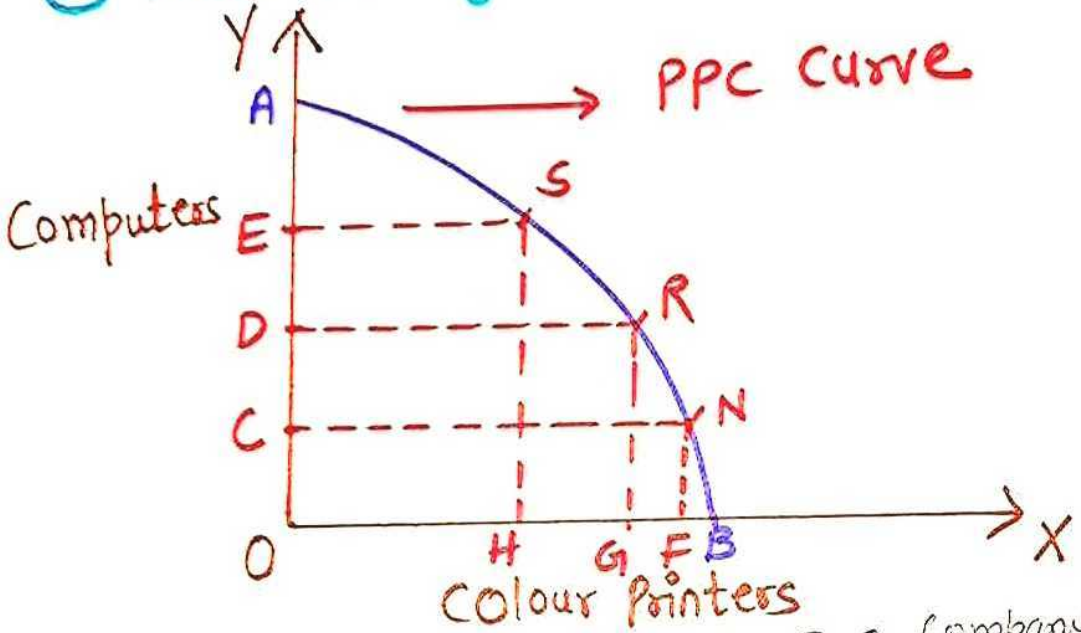
1. The Calculation of Sacrifice cost.
2. Sacrifice may be real or Monetary.
3. Opportunity Cost measured Cost of Sacrificed alternatives

(C) Example :-

The Cost of going to College for a year is not only Tution Fees, books, Travelling expenditure etc but also the Foregone Wages during the year of study.

Thus, Opportunity cost of anything is the only the Next best alternative Foregone.

(D) Opportunity Cost and PPC :-



1) AB is the PPC Curve of a Company Producing Computers and Colour Printers with given resources of Land, Labour and Capital.

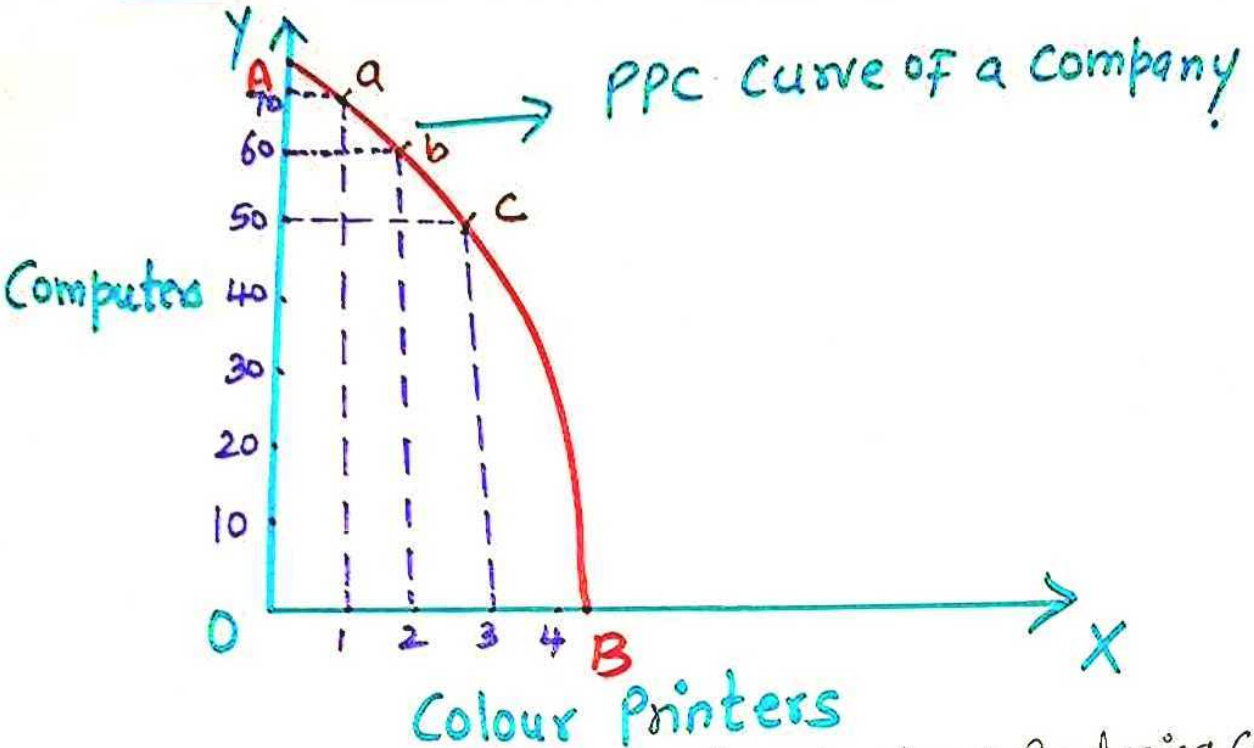
2) It is able to produce OA - Computers or OB - Colour Printers or S, R, N Combination on PPC Curve.

3) Suppose at Present Company is Producing OC - Computers and OF - Colour Printers at N - Combination.

4) Now Company wants to increase the Production of Computers to OD Level, then it reduce the Production of Colour Printers to OG level.

5) It means opportunity cost of Extra-CD Computer = GF Less Colour Printers

E] PPC and Increasing opportunity cost :-



1. AB is the PPC curve of a company producing Computers and Colour Printers with given Resources of Land, Labour and Capital.
2) Suppose Company is Producing 50 Computers and 3 Colour Printer at C-Combination.
Now Company wants to increase Production to 60 Computers, then 2-Colour Printers can be Produced at b-Combination.
3) It means Opportunity Cost of 10 Computers = 1 Colour Printer.
4) Here Company wants to Produce more Computers and Less Colour Printer because Opportunity Cost of Computers is Very high.

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Q:8 Explain the concept of Accounting Profit and Economic Profit?

(A) **Accounting Profit :-** " The accounting Profit is the difference between Total Revenue and Accounting Cost "

Accounting Profit = Total Revenue - Accounting Cost

TR = P x Q

Accounting Cost = Explicit Cost

i) **Total Revenue :-** " Total Revenue is the total Sale Proceeds earned by a firm from the sale of certain amount of commodity at given price "

TR = Price x quantity

ii) **Money Cost :-** " Money Cost means the money Expenditure incurred by firm For Producing goods and Services "

Types of Money Cost

1) Explicit Costs
2) Implicit Costs

1) **Explicit Costs :-** " Explicit Money Cost means direct Contractual Payments made to Factors of Production "

Explicit Cost include :—

i) Rent of Factory Premises
ii) wages and Salaries
iii) Interest on Capital Invested

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iv) Cost of Raw-materials.
v) Power, fuel, Electricity Charges
vi) Transport, Marketing and Advertisement costs.
vii) Insurance Premium
viii) Licence Fees, Property Tax etc.

This Explicit Money Cost are known as Accounting Cost.

(2) **Implicit Costs :-** "Implicit money cost means imputed (Internal) payments which are not actually Paid out by the firm"

Implicit Cost arise when the Entrepreneur supplies Certain Factors Owned by himself.

i) Rent of Land Premises Owned by Entrepreneur.
ii) Wages of Labour rendered by the Entrepreneur.
iii) Interest on Capital invested by the Entrepreneur.
iv) Normal Profit which Entrepreneur should get for his Organisation and Management.

(B) **Economic Profit :-** "The Economic Profit is the difference between Total Revenue and Economic Cost"

Economic Profit = Total Revenue - Economic cost
Eco. Profit = TR - (Explicit cost + Implicit Cost)

Implicit Costs are the Opportunity Cost of the factors Owned and Used by entrepreneur.

Q:9 Fill in the blanks with most appropriate term From those given below each Questions :—

1) In every economy resources are a-Scarce
a) Scarce b, plenty c) available.

2) Human wants refer to all the goods and services individuals b- desire
a) need b) desire c) have

3) Problem OF b-Scarcity is an Universal Problem
a) Resources b) Scarcity c) wants.

4) b- Allocative efficiency occurs when goods and Services are distributed according to consumer Preferences
a) Technical b) Allocative c) Productive.

5) b- Marginal Principle is integral to short-run decisions about Profit maximisation.
a) equi-marginal b) marginal c) efficiency.

6) Price Mechanism is the system in a a-Market economy which brings about equality between Demand and supply.
a) market b) Socialist c) Mixed

7) The most notable incentive in economics is b- Price
a) Profit b) Price c) Revenue.

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8) IF the Production is not efficient, the economy will be a- inside the PPC
a) inside b) Outside c) on

9) The trade-OFFs People and Society face helps us to Understand the concept of b- opportunity Cost
a) Money b) opportunity c) Total

10. An accountants concept of Profit is the a-business Profit.
a) business b) economic c) maximum

Q:10 State whether the following statements are True or false giving reasons :-

1. Economics deals with the Production of Scarce Resources.

Ans:- False. Reasons :- Q:1 - A Part

2. The Resources have alternative Uses.

Ans:- True. Reasons :- Q:1 - iii - Point

3. The Term incremental refers to the Total additional Cost or benefit of implementing a managerial decisions

Ans: True. Reasons :- Q:2 - D Part

4. Profit is maximised at the Point where Total Revenue is greater than Total Cost.

Ans:- False. Reasons :- Q:3 - a Point

5. In a market Economy Prices act as incentives and signals.

Ans:- True. Reasons :- Q:5 - C Part

6. PPC Shows the maximum Combinations output the economy Can Produce using all the available Resources.

Ans. True. Reasons :- Q:6 - A and B Part.

7. The Opportunity Cost is the Loss of the Opportunity to Pursue the most attractive alternative given at the Same time and resources.

Ans. True. Reasons :- Q:7 - A and B Part.