

**AS-2365**  
**M.COM. FIRST SEMESTER EXAMINATION, 2013**  
**MANAGERIAL ECONOMICS- II**

**MODEL ANSWER**

**SECTION – A**

I.

1. According to Jeremy Bentham, Maximisation of utility means: **(d) Both (a) and (b).**
2. Utility is a concept related to **(b) Psychology**
3. Revealed Preference theory is based on the assumptions such as : **(e) all the above.**
4. Disadvantages of large scale production are **(a) Loss of the motive of self interest.**
5. Higher Isoquants means **(b) Higher level of Production.**
6. Rightward shift in the demand curve is caused due to **© A rise in income.**
7. Write the formula for Net Present Value: Ans. The net present value (NPV) of a project is the sum of the present values of all the cash flows – positive as well as negative – that are expected to occur over the life of the project. The general formula for NPV is:

$$NPV =$$

Where C is the cash flow at the end of year t, n is the life of the project, and r is the discount rate, I is Initial Investment.

8. What is expansion path: Ans: The line joining the minimum cost combinations is called the expansion path, because it shows, how the factor combination with which the firm produces will alter as the firm expands its level of output. Thus the expansion path may be defined as the locus of the points of tangency between the equal product curves and the iso-cost lines.
9. What is the meaning of Substitution. Ans: Substitution means replacing one commodity in place of the other. For example, if the price of coffee is increased, the customers may like to substitute tea for coffee.
10. What is meant by money cost. Ans. Cost represented in terms of money, in order to produce the goods and services. The costs spent on the machines, or capital, labour (wages) etc. in terms of money – are some of the examples.

**Section – B**

**II. Discuss the role and responsibilities of a managerial economist.**

In general, the factors which influence the business over a period to come fall under the following categories

1. External factors: Some relevant questions have to be solved, like
  - a. What are the present trends in national and international economics.
  - b. what phase of the business cycle lies innediately ahead.
  - c. Where are the market and customer opportunities likely to expand or contract most rapidly.
  - d. What are the expectations about the prices of availability of raw materials.
  - e. What are the possibilities of demand and prices of finished products.
  - f. Is competition likely to increase or decrease.
  - g. Will the availability and cost of credit tend to increase or decrease demand.

h. What changes are expected in government policies and control. i. What are the demand prospects in new and the established markets. How will the change in consumption pattern and fashion tend to affect the demand of the firm's product.

2. Internal factors: Some of the questions have to be solved like,

a. What will be the reasonable sales and profit targets for the next year. b. What will be the most appropriate production schedules and inventory policy for the next five or six months. c. What changes in wage and price policies should be made now. d. How much cash will be available in the coming months and how it should be invested.

3. Specific factors: A further idea of the role of managerial economists can be had from the specific functions which he performs for business management and management consultants. These specific functions are as under:

a. Sales forecasting b. Market research c. Economic analysis of competing firms d. Pricing problem of the industry. e. Evaluation of capital projects. f. Advice on foreign exchange. g. Economic analysis of agriculture. h. Analysis of underdeveloped economies. i. Environmental forecasting. j. Investment analysis and forecasts.

4. To provide economic intelligence managerial economist may also render general intelligence services to the management through economic informations of general interest.

5. Responsibilities

a. To make reasonable profits on capital employed. b. Successful forecasts. c. Knowledge of sources of economic informations d. His status in the firm.

### **III. Discuss the equi-marginal utility with the help of a table and diagram:**

The law of Equi-Marginal Utility provides a tool with the aid of which it is possible to analyse consumer behaviour. The theory of consumer behaviour explains how a consumer allocates his given money income among many goods and services which are available to him in the market at given prices. In addition to it, the law of diminishing marginal utility provides a basis for explaining the law of demand.

Assumptions:

1. The consumer is rational.
2. The consumer has clear-cut preferences for various goods and services available in the market.
3. The consumer has a given or fixed money income, that is he is under a budget constraints.
4. The goods and services available in market have price tags on them.

Table

**The Equi-Marginal Principle**

| Unit of Product | Product A: Price = Rs. 5<br>Marginal Utility | Product B: Price = Rs 5<br>MarginalUtility |
|-----------------|--|--|
| 1               | 10   | 7  |
| 2               | 8  | 5  |
| 3               | 5  | 4  |
| 4               | 3  | 2  |
| 5               | 2  | 1  |

Explanation of the table.

The utility maximisation rule can be written symbolically thus: **MU of A = MU of B = .....MU of N**

where MU is marginal utility and A,B, ..... N are number of commodities.

The utility maximisation rule is that a consumer will get highest level of satisfaction when he allocates his money income in such a way that the last rupee spent on product A, the last rupee spent on product B and so forth yield equal maarginal utility.

**In short, MU of A/Price of A = MU of B/ Price of B= ..... MU of N/ Price of N**

Because marginal utility of last rupee spent on A equals the marginal utility of A divided by price of A.

The same is the case with B and so forth.

Diagram.

Conclusion.

**IV. Why does a demand curve slope downwards from left to the right.**

Law of demand expresses the relationship between price and quantity demanded of a commodity.

According to the law of demand the demand of a commodity extends with fall in its price and contracts with rise in the price, other things being cosntant. There are several reasons for the demand curve sloping downwards to the right.

1. Law of Diminishing Marginal Utility.
2. Income effect
3. Substitution Effect
4. Different Uses.
5. Change in the number of buyers.

**V. What are the different ways of measuring price elasticity of demand.**

The demand of a commodity is closely related to its price. Price elasticity of demand quantity the change in demand as a result of change in price. The degree of responsiveness of demand for a commodity to a change in its price is known as price elastivity of demand or elastivity of demand as it is generally known. In other words, price elasticity of demand is the ratio of proportionate change in the quantity demanded

of a commodity to proportionate change in its price. Thus, it represents the rate of change in demand as a result of change in price of the commodity. The formula:

Elasticity of Demand = Proportionate change in quantity demanded/Proportionate change in price.

Types or degrees of price elasticity of demand:

1. Unit elasticity
2. Relatively elastic demand
3. Relatively inelastic demand
4. Perfectly inelastic demand
5. Perfectly elastic demand

Measurement:

1. Proportionate Method
2. Total Expenditure Method
3. Point method

Conclusion.

## **VI. Discuss the uses of importance of price elasticity of demand**

Following are the main determinants of elasticity of demand:

1. Nature of commodity
2. Range of Substitutes
3. Number of uses of a commodity
4. Possibility of Postponement of Purchase
5. Importance of the commodity in consumers budget
6. Range of Prices
7. Income level
8. Time
9. Joint demand

Importance of Price elasticity of demand:

1. Determination of price policy.
2. Price Discrimination.
3. Shifting of Tax Burden.
4. Taxation and subsidy policy.
5. Importance of international trade.
6. Importance in the determination of factors prices.
7. Determination sale policy for super markets.
8. Pricing of joint supply products.
9. Effects of use of Machines on Employment.
10. Public Utilities.

11. Explanation of paradox of poverty.
12. Output Decisions.

Conclusion.

### **VII. Explain the laws of production both short run and long run with the help of diagrams.**

There are two types of production function – (i) short term production function and (ii) long term production function.

Short term production function refers to production in the short run where there are some fixed factors and some variable factors. In the short run, production will increase when more units of variable factors are used with the fixed factor. Law of variable proportion comes under short run production.

Long run production function refers to production in the long run where all factors become variable. In the long run production can be increased by increasing units of all the factors simultaneously and in the same proportions. Laws of returns to scale comes under long run production function.

Law of variable Proportions:

Since not all inputs can vary in the short run, the proportion at which inputs are combined vary. Thus, the name returns to variable proportions is given to one input-output relationship depicted by the short run production function. The long run production function describes the input-output relationship when all inputs can be freely varied when all inputs to be freely varied.

This law is also known as the law of non-proportional returns or the law of the diminishing marginal return. Most of the earlier economists talked of the law of diminishing returns in the field of production. Famous Malthusian theory of production and the celebrated Ricardian theory of rent are based on the law of diminishing returns.

The level of output of a firm depends on the combination of different factors of production. Such as land, labour, capital and entrepreneur. In order to bring about a change in the level of production, the quantities of various factors engaged in production will have to be changed. An increase in production can be had only when either the quantity of all factors is increase simultaneously or when the quantity of some of the factors is increased, while other remains constant. Since all factors are not easily available in the required quantities, it becomes necessary to keep the scarce factor constant and increase in the quantity of other factors.

The law of variable proportions is widely observed law of production which takes place in the short run. In the short run, production can be increased by using more of variable factors. The law was formulated by Joan Robinson.

The law of variable proportions states that when total output or production of commodity is increased by adding units of a variable input while the quantities of other inputs are held constant, the increase in total production becomes after some point smaller and smaller.

Assumptions of the law

1. State of technology remains the same.
2. All units of the variable factors are homogeneous.
3. There must always be some fixed input which cannot be increased in the short term.
4. Only one factor is variable and the other factors are kept constant.
5. It is possible to vary the proportions in which the various inputs are combined.

Diagram of the three stages.

1. Increasing returns to the factor
2. Diminishing returns to the factor
3. Negative returns to the factor

Explanation of the diagram.

Laws of Returns to Scale:

The term returns to scale refers to the response of total output to changes in all inputs by the same proportions. The laws of returns to scale refers to the effects of scale relationship.

It states that when all factors of production are increased in the same proportion, the output will increase but the increase may be at increasing rate or constant rate or decreasing rate.

Three stages of returns to scale

1. Stage I – Increasing returns to scale
2. Stage II – Constant returns to scale
3. Stage III – Decreasing returns to scale.

Conclusion:

### **VIII. What is an envelope curve? How do you derive it?**

In the long run, all factors are variables. This means that the firms in the long run have to choose the nature and amount of plant and equipment, as well as the size of their labour force. While making the choice, the firm tries to avoid being technically inefficient, that is, not to use more of all inputs than are necessary. Besides being technically efficient, it also wishes to be economically efficient. It means that from among the many technically efficient options, it chooses the one that produces a given level of output at the lowest possible cost.

The long run cost curve is a planning curve which guides the entrepreneur in his decision to plan the future expansion of his output. In the long run the firm can build any desired scale of plant as all resources are variable. It can change the quantities of all inputs and thus change the scale of production. There is no average fixed cost curve in the long run. Our concern is with long run average cost curve, long run total cost curve and the long run marginal cost curve only.

The long run average cost curve (LAC) is derived from short run cost curves. Each point on LAC corresponds to a point on a SAC. At that point SAC is tangent to LAC.

It shows the least possible cost per unit of producing various outputs when the firm has time to build any desired scale of plant.

In the traditional theory of the firm the long run average cost curve, LAC, is U-shaped and it is often called the “envelope curve” because it envelopes the SAC curves. The U-shaped of the LAC in the traditional theory is based on the laws of returns to the scale of plant. Because of the economies of scale made possible by the large size of the plant – the optimum plant size. This size fully exploits the economies of scale.

**Assumptions:**

1. Each plant is designed to produce optimally a single level of output.
2. Plant is totally inflexible
3. There is no reserve capacity, not even to meet seasonal variation in demand.
4. State of technology is given
5. Factor prices are given.

Conclusion.

