Economic Theory: Microeconomics Notes

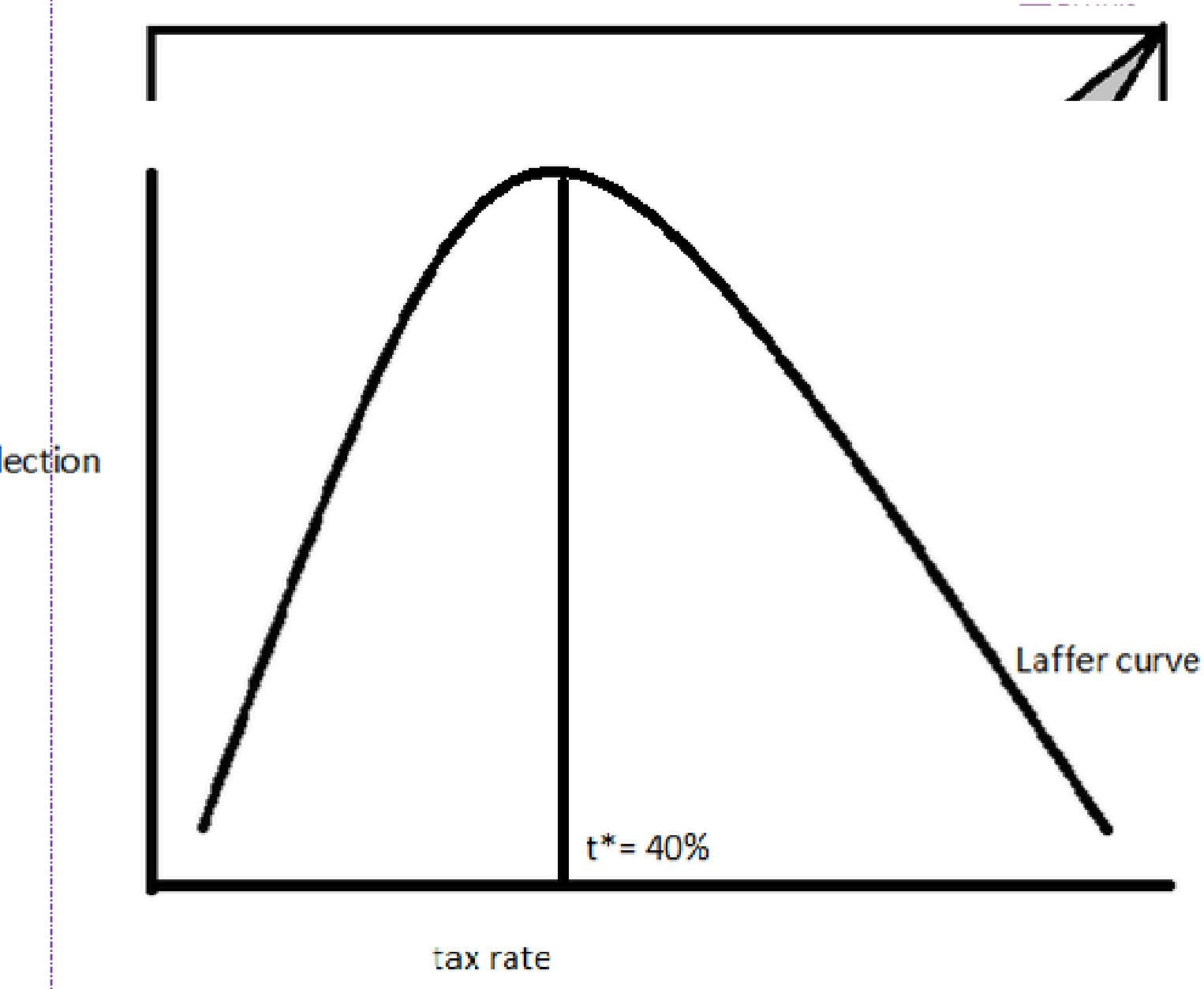
IMPORTANT CURVES

1. **LORENZ CURVE**:

- Lorenz curve is a graphical representation of income distribution in society.
- It was given by Max O Lorentz in 1905. It is used to analyze inequality prevailing in the population.
- In this graph, the cumulative percentage of national income is plotted against the cumulative percentage of households.
- The degree to which the curve sags away from the line of perfect equality is the measure of inequality in society.
- It is given by Gini's coefficient.
- **Gini's coefficient:** It is the proportion of the shaded region with respect to the area corresponding to the line of perfect equality. Higher the value more is the inequality in society.

1. **LAFFER CURVE**:

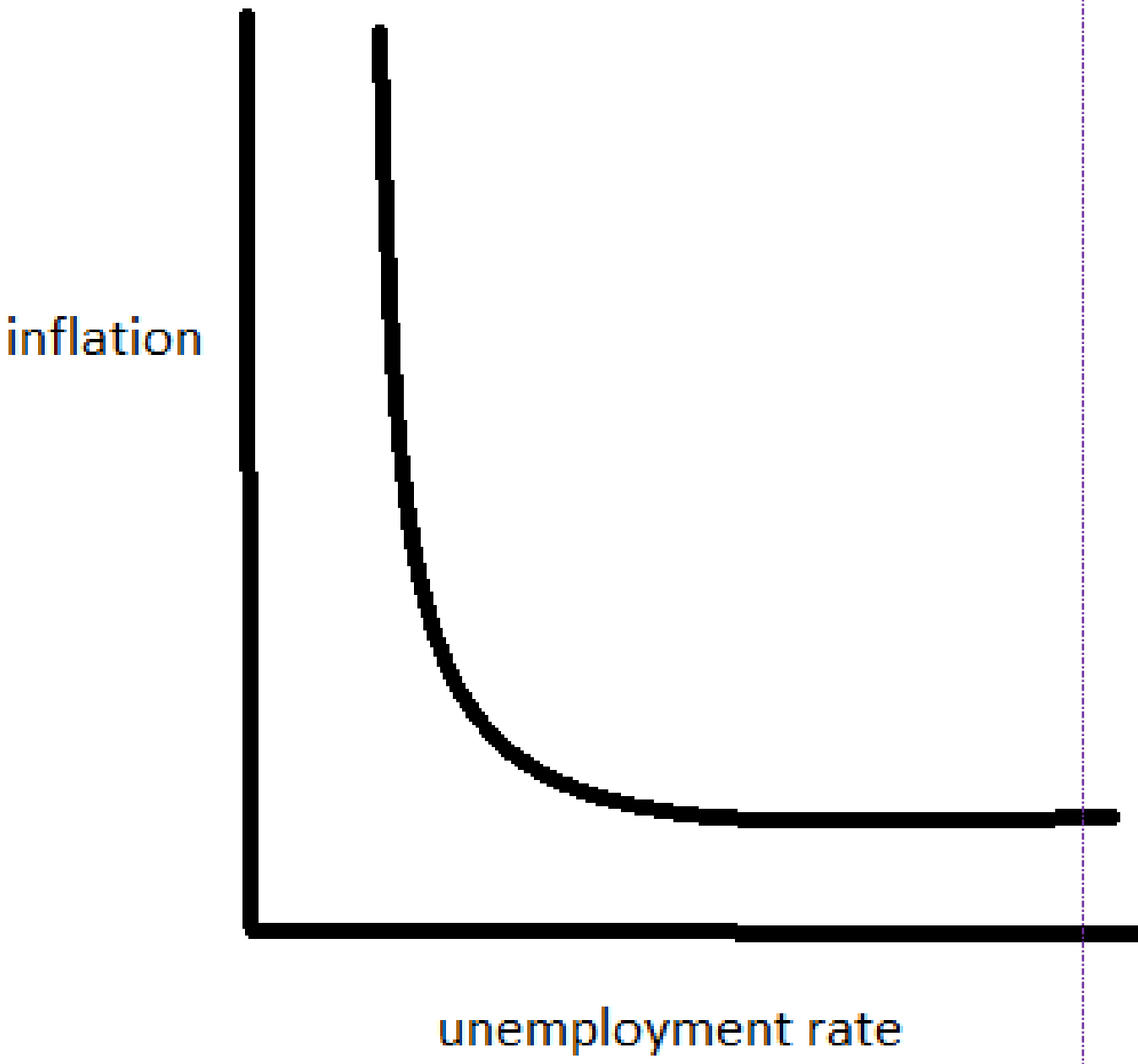
- Laffer curve represents the relationship between tax collection and levied tax rates by the state authorities.
- It states that as the tax rate increases from the low level, tax collection also increases but as the tax rate increases beyond a critical limit, tax collection starts falling.



- This can be due to lower profitability and higher incentive to cheat associated with higher taxes.

1. **PHILLIPS CURVE**:

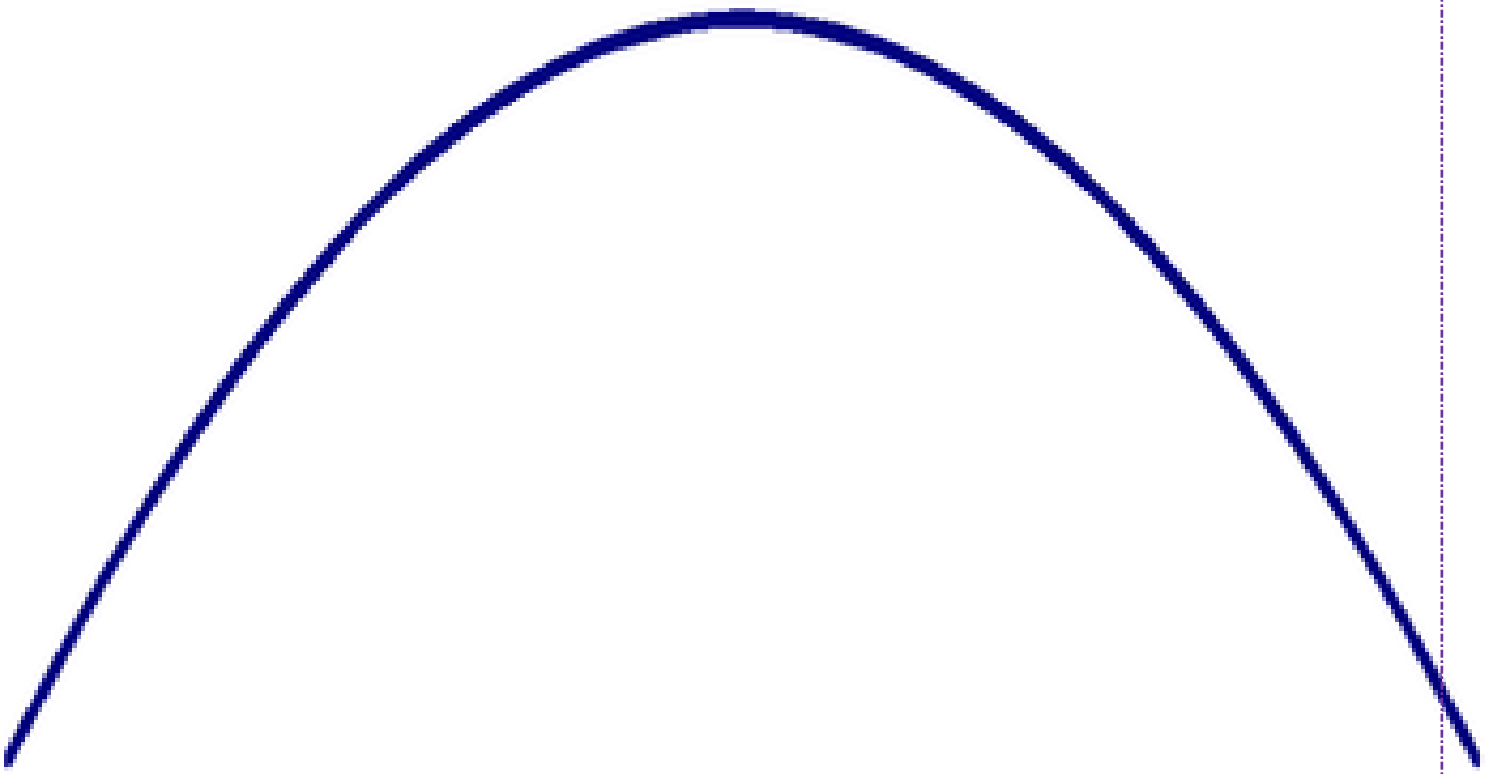
- It was given by A. William Phillips, a New Zealand economist.
- According to this, there is an inverse and stable relationship between inflation and unemployment. As one falls, other increase.



- There is also a term which defines the simultaneous existence of high inflation and high unemployment i.e. low growth with high inflation, which is known as stagflation.

1. **KUZNETS CURVE**:

- Kuznets curve is based on a hypothesis forwarded by an economist Simon Kuznets.
- According to the hypothesis, when a country starts developing, economic inequalities first increases for a period of time but after a threshold when a certain average income is attained, economic inequalities begin to decrease.
- It is thus represented as an inverted U-shaped graph as shown below.

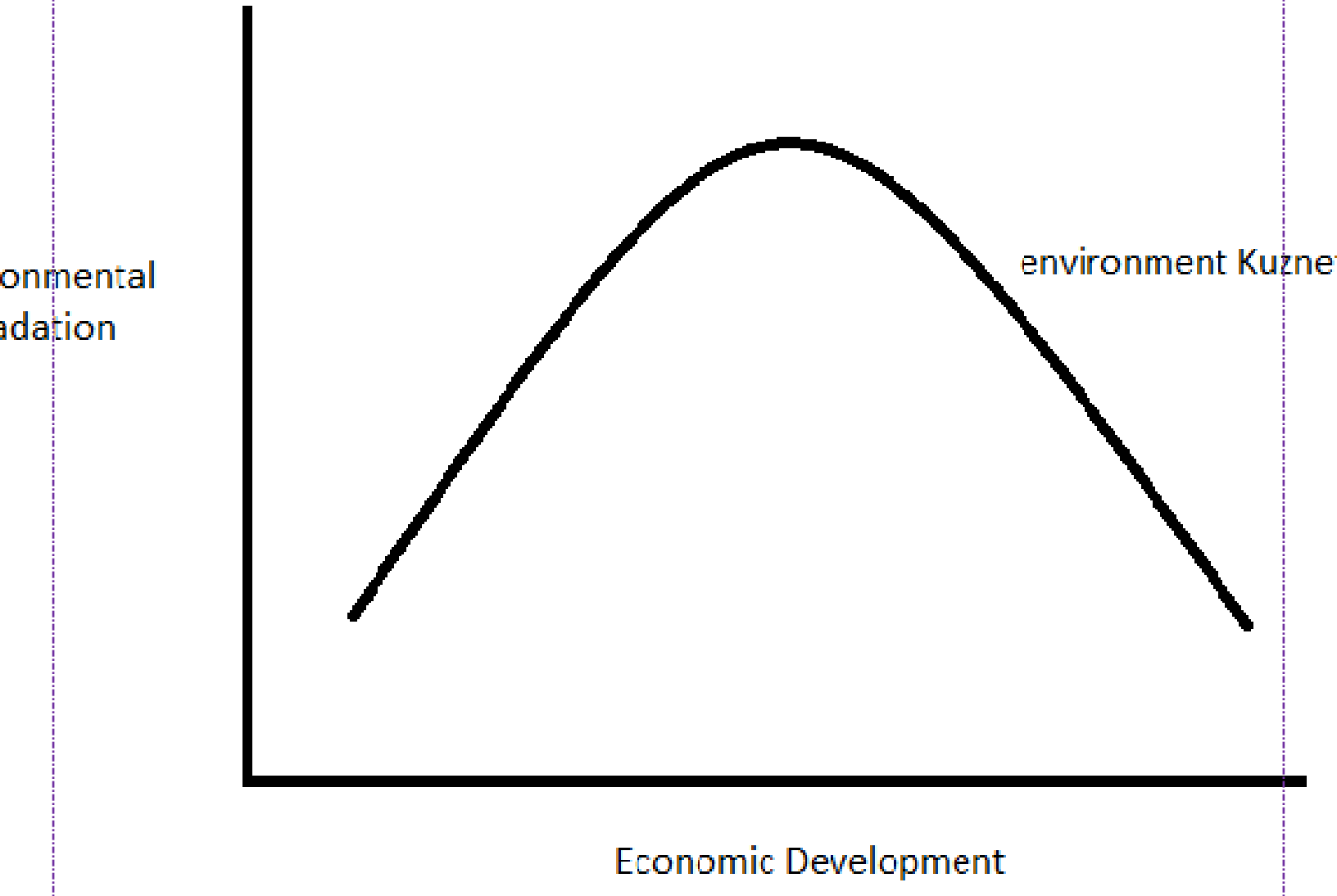


Income per Capita

- Similar in the line is the Environment Kuznets curve.

1. **ENVIRONMENT KUZNETS CURVE**:

- It shows the relationship between economic progress on one hand and environmental degradation over a period of time caused in lieu of that economic progress.
- It says, as the economy starts the journey of development, pollution in first phase increases but with further development of the economy, pollution rates begin to decline.



- And eventually, both economic progress and environment maintenance go hand in hand.

When economic stages of growth are plotted on the x-axis and environmental degradation on the

y-axis, the environment Kuznets curve is given by inverted U shape.

GRESHAM'S LAW

- Gresham's Law states that 'bad money drives out good'.
- It means if in a country there are two currencies, the overvalued currency (cheaper one) will drive the undervalued (precious/expensive one) out of use.
- This is because people start hoarding the undervalued currency as a store of value and eventually, that will be eliminated from circulation.
- This law was named after an English financier, Sir Thomas Gresham (1519-1579).

OPPORTUNITY COST

- Value of the loss incurred on account of the next best alternative/choice forgone, in availing the best alternative/choice available rather than the next best, is known as the opportunity cost of the chosen alternative.
- In simple words, it refers to the value one decides to give up in availing any opportunity.
- Or in other words, what have you lost while opting for an option is the opportunity cost of your choice.

Sr. No.	Articles	Opportunity cost
1.	Free goods like clean air, abundant freshwater, etc.	No
2.	Common goods (in abundant)	No
3.	Common goods (scarce)	Yes
4.	Government expenditure in defence	Yes
5.	Government freebies to citizens	Yes
6.	Public goods like roads, railways, infrastructure, etc.	Yes

- The opportunity cost is considered to be zero for naturally occurring abundant resources like free unpolluted air, water etc. and also for common goods like grazing land, oceans etc.
- For government expenditures, the Opportunity cost is never zero because the authorities always have choices to make.
- So, whatever is chosen, there would exist something forgone as well. Like if the government decides to build a bridge, the government could have spent that price onto increasing more personnel to ensure safety.
- In the case of freebies, for consumers/ citizens, there is no opportunity cost because it is transferred from them to the government.

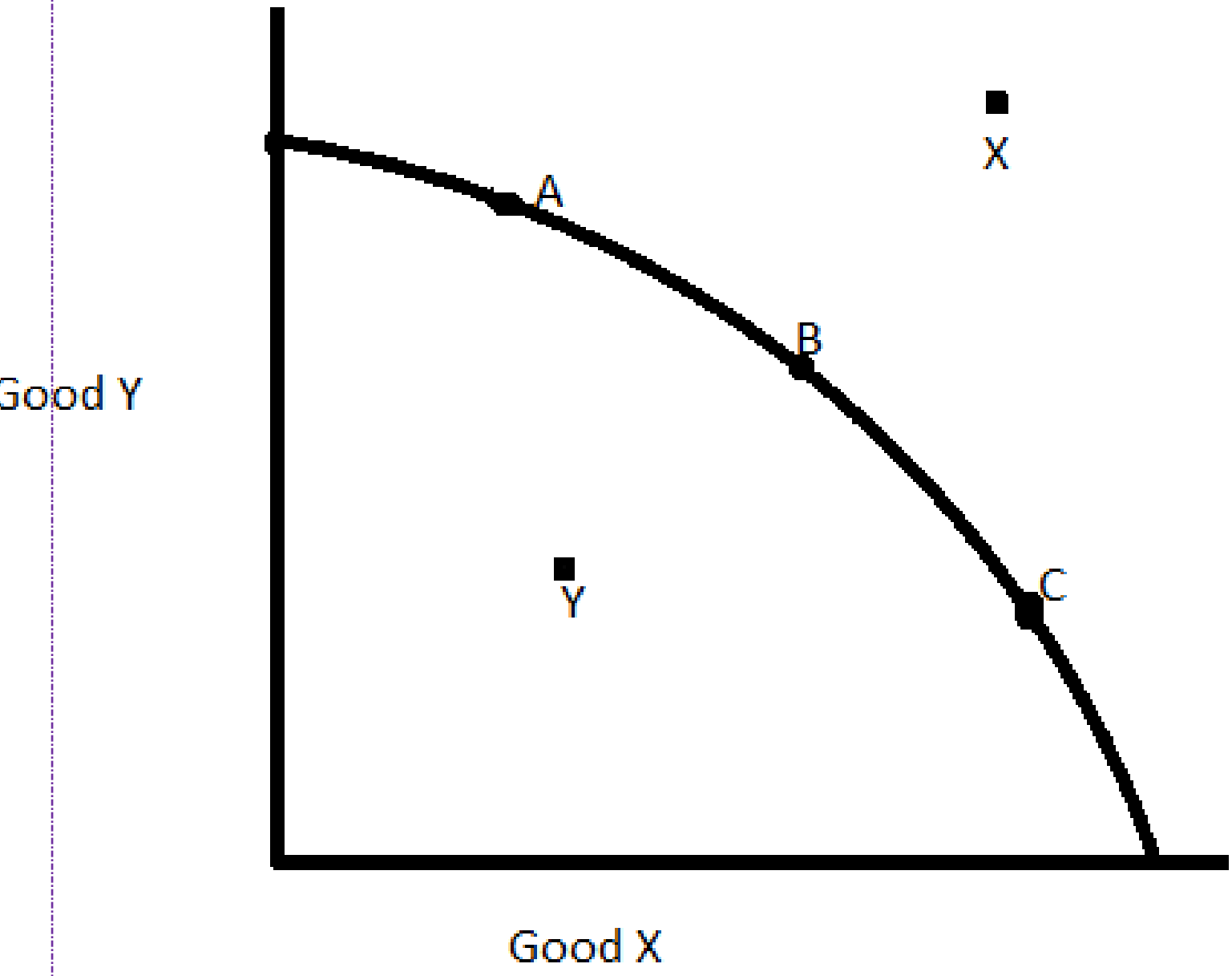
PRODUCTION POSSIBILITY CURVE:

- With the available amount of resources and technology, the various alternative combinations of production of a set of two goods are plotted to give a production possibility curve.
- It is also known as Production Possibility Frontier or Transformation curve.
- The curve helps in deciding “what to produce”.
- Thus, the curve provides all the production possibilities available, out of which the most economically or physically viable one could be chosen to maximize profit and minimize the losses attached.

Different points on a curve

Point X represents underutilization of resources;
point Y represents infeasible option i.e. non-feasibility of the chosen combination (beyond the capacity);
while points A, B and C represent the full utilization of resources.

If the resources and technology available increases, the curve shifts towards the right and if resources and technology fall short, the curve shifts towards the left.



SUPPLY-DEMAND CURVE:

Supply curve:

- It represents the relationship between the price and quantity of a product produced which

the seller is ready to supply in the market, keeping other variables to be constant.

- Herein quantity of the product is plotted horizontally on x-axis and price of the same product on the y-axis.
- It is generally a straight line sloping upward from left to right as shown in the graph. This is so because price and quantity of a product are directly related, i.e. if the price of a product is increasing in the market, its quantity in the market will also increase in the same manner (increase in price acts as an incentive for the suppliers to produce more).
- With the change in variables, the supply curve can shift in either direction. If it shifts towards the left, it implies a decrease in the quantity of product supplies in the market and rightward shift implies an increase in quantity supplies with respect to the price of the product.

Demand curve:

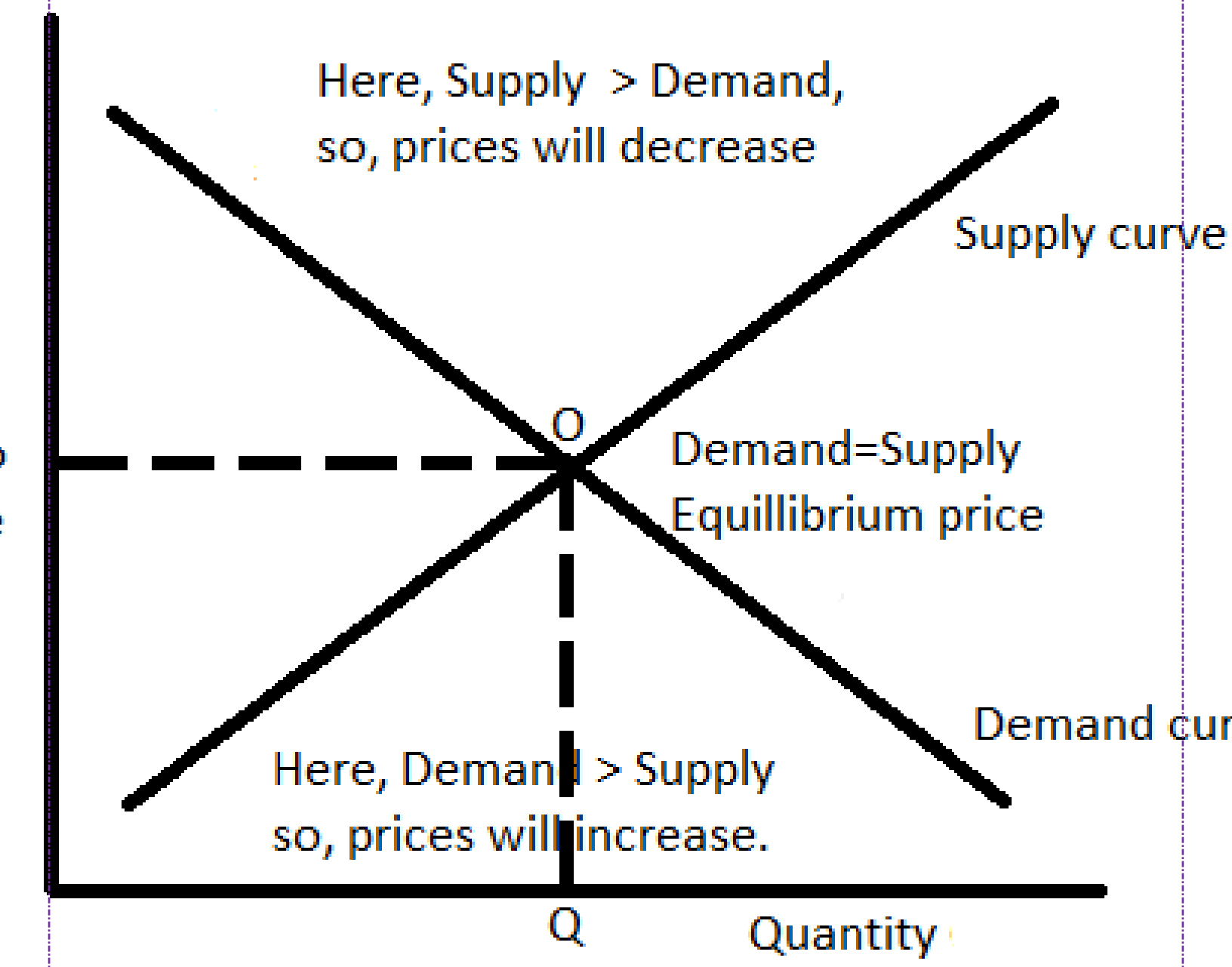
- It represents the relationship between the price and quantity of the product demanded by the consumers, keeping all other variables to be constant.
- It generally represents a downward sloping straight line from left to right as shown in the graph below.
- This is so because price and quantity of the product demanded are inversely related to each other, i.e. if the price of a commodity falls, its demand rises.
- Conforming to the supply curve, if it shifts leftwards, it implies a decrease in demand and if rightwards, it implies an increase in demand of a product.

In the graph below:

At point **O**, there exists an equilibrium price since supply=demand.

Above point **O**, since supply exceeds the demand, the price of product declines.

Below point **O**, as the demand of the product is more than the supply, the price of product further increases.



Keynesian Theory

Keynesian Economics

- It was developed by the British economist John Maynard Keynes during the 1930s. It was an attempt to understand the Great Depression.
- It suggested increasing government expenditures and lower taxes to stimulate demand and pull the global economy out of the depression.

Keynesian Theory of Employment

- This theory rejected the notion of full employment and instead suggested full employment as a special case and not a general case.
- It said if there is an increase in national income, there would be an increase in the level of employment and vice versa.
- According to this theory, the level of employment is dependent on national income and output and factors of production remain unchanged while determining the level of employment.

Laissez-faire Theory

- This theory opposed any government intervention in business affairs.