ICSE Board
Class X Economics
Sample Paper – 3 Solution

SECTION A

Answer 1

a) According to the law of demand, other things being equal, the demand for a good increases with a fall in price and the demand diminishes with a rise in price. However, if there is a positive correlation between price and quantity demanded, then it is paradoxical to the law of demand. The following demand schedule represents this situation:

Price	Individual demand
4	18
6	20
9	26
15	30

b) Factors determining the supply:

i. Price of the product: When there is an increase in the price of the product and if it is more than the marginal cost of production, it enables the firm to earn more profit by selling at a higher price. Hence, there will be an increase in the supply of a product.

ii. The prices of the factors of production: Given the other factors, if the prices of the factors of production increases, there will be a decline in the profit of the firm. Hence, the firm would reduce the quantity of supply at the current price level.

c) Differences between tax on income and tax on commodity:

i. A tax on income is paid directly to the Government by the person to whom it is imposed. Hence, the tax on income is known as direct tax. It cannot be shifted on to any other person. These taxes are levied according to the ability of the taxpayers.

ii. A tax on commodity is paid to the Government by one person but the tax burden is borne by another person. Hence, the tax on commodity is known as indirect tax. It can be shifted on to the other person. Ability of the taxpayers is assessed indirectly in this taxation.

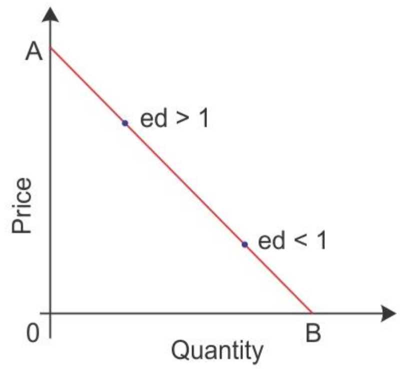
d) During inflationary situation, the variable income group gain the most with the income rise. In a business firm, the wage does not increase as fast as the level of price because the wage rate is contractually fixed. But there will be an increase in the prices of output sold in the market. It leads to an increase in the profits of producer which encourage the producer to produce more commodities. Thus, a mild dose of inflation is always good for economic growth.

e) Differences between demand deposits and fixed deposits:

i. Demand deposits can be withdrawn at any time, whereas the time deposits can be withdrawn only after the expiry of a specific period.
ii. There is no interest rate on demand deposits, whereas the time deposits carry higher interest rate.
iii. Demand deposits are chequable which can be withdrawn through cheques, whereas time deposits are not chequable.

Answer 2

a) Price elasticity of demand > 1 and price elasticity of demand < 1 are shown in the diagram below.



b) The law of supply states that other things being equal, the quantity of good supplied increases with an increase in the price level and decreases with a decrease in the price level of a good.
Exception to the law of supply is that sellers may be willing to sell more units at declining price for perishable goods.

c) Productive expenditure is the expenditure which increases the production of goods and services in the nation. These expenditures constitute physical assets such as machinery and human capital such as education, health etc.
Unproductive expenditure is the expenditure which does not increase the productivity. These expenditures constitute the maintenance of law and order in the nation.

d) During inflation, the profit income of the business category increases, while the real income of the common salaried people decreases. Hence, the pattern of income distribution in a society becomes much more unequal in nature.

e) The central bank is the apex bank which controls the whole banking system of a country. It has the sole authority to issue notes in the country. It acts as a banker to the Government and controls the supply of money in the country.

Answer 3

a) At a given price of a product, its demand curve shifts in a rightward direction in the following two cases:

i. Increase in the income of the consumer
ii. Increase in the prices of substitute items

At a given price of a product, its demand curve shifts in a leftward direction in the following two cases:

i. Decrease in the income of the consumer
ii. Decrease in the prices of substitute items

b) Technological progress creates a positive approach in the supply of a particular product. It decreases the cost per unit and increases the productivity of the given factor inputs of production. Thus, the producer enjoys more profit.

c) A situation where the Government has to incur new public debt for meeting interest obligations on old debt is called debt trap. One of the sources of public revenue is public debt. But the negative effect is that the Government may be lured to take recourse to borrowing whenever there is the requirement of money.

d) Fixed income groups: The hardest hit is the people who receive fixed income. People who live on past savings, fixed interest or rent, pensions, salaries etc. suffer during periods of rising price as their incomes remain fixed. The middle class who by hard work take care of their children's education, livelihood in the times of sickness and old age, and accommodate day-to-day expenses find it difficult to survive the times of serious inflation.

Borrowers: Debtors borrow from creditors to repay with interest at some future date. Changes in price level affect them differently at different time periods. During inflation, when the prices rise and the real value of money goes down, the debtors pay back less in real terms than what they had borrowed and thus to that extent they are gainers. On the other hand, the creditors get less in terms of goods and services than what they had lent and lose to that extent.

e) The bank rate is that discount rate at which the central bank rediscounts different bills of exchange submitted by commercial banks while obtaining loans from the central bank. The bank rate is used as the main instrument of monetary control during the period of inflation.

Answer 4

a) Normal goods are those goods that the demand for which increases as income of consumers rises. There is a positive relationship between income and demand for good.

b) When the Government imposes heavy taxes on the production of a particular commodity, the cost of production increases and price will remain constant. This results in reduction in profits. In such a situation, the producer will use the resources to produce those commodities on which the Government has levied less tax. Thereby the supply of that particular commodity decreases.

c) Progressive taxation is represented in slab 3 and 4. Hence, the tax rate increases with an increase in the income slab of the income earner.

d) Under the Banking Regulation Act, 1949, the RBI has been entrusted with extensive power to control the commercial banking system. RBI acts as the banker to the banks in four ways:

i. Custodian of the cash reserves of the commercial banks
ii. As the lender of last resort
iii. As clearing agent
iv. As supervisor

e) Primary functions of a commercial bank:

i. Accepting deposits from the public is the primary function of a commercial bank. A bank accepts deposits from individuals in society. In order to attract savings, banks accept three types of deposits—demand deposits, savings deposits and fixed deposits.
ii. A commercial bank advances loans to business people, farmers and consumers against approved securities. Cash credit, overdraft, short-term loans, discounting of bill of exchange, money at call etc. are the loans advanced by the commercial bank.

SECTION B

Answer 5

a) Different stages in the evolution of money:

i. Barter system is a system where goods were exchanged for goods in the olden days. Various commodities used as money is known as commodity money. It is the most primitive form of money. However, certain problems such as improper standardisation, indivisibility, storage difficulty etc. made this form of money an unsuitable medium of exchange.

ii. Mono-metalism and bi-metalism, i.e. valuable metals such as gold and silver, were used as medium of exchange. As society progressed, different sections of people agreed to consider some precious metals as common medium of exchange. The gold coin was introduced in India by King Kanishka of the Kushan Dynasty during the first century AD.

iii. The paper currency system is a system where coins and currency notes are used as the medium of exchange. Due to the expansion of trade and commerce and greater demand for money as a common medium of exchange, metallic money was replaced by paper money. The central bank of a country assumes supreme authority in issuing paper money of definite denominations and value. A medium of exchange which is generally acceptable and enforced by law is called fiat money. For example, rupee notes and coins are legal tender.

iv. At the final stage of evolution of money, demand deposits with commercial banks are considered bank money. Demand deposits are current account deposits with banks or other financial institutions which are payable on demand by cheques. Thus, cheques drawn on the demand deposits of commercial banks can be used as a medium of exchange.

b) Duties of consumers:

i. To protect against unsafe and dangerous products: While making the purchases, consumers should check for the standard quality certification marks such as ISI, Agmark, FPO, Eco-mark, Hallmark etc.

ii. To protect against deceptive and unfair trade practices: Consumers have to be protected against unfair trade practices about the quality, quantity, purity, standard and the price of goods and services.

iii. To acquire proper knowledge: Consumer's duty is to acquire knowledge and skills needed for taking action to influence factors which affect consumer decisions.

iv. To receive consumer education: Education is the most powerful tool for the promotion of consumer welfare. A consumer has to educate through programmes conducted by voluntary organisations with the aid of mass media.

Answer 6

a) Five causes of inflation:

i. Public expenditure increases: Spending by the Government is an important part of total spending in any modern economy. It is the total spending which determines the total demand. Thus, government expenditure is an important determinant of aggregate demand. Government expenditure has shown an upward trend in less-developed countries. In the beginning of the planning period in India, the amount of government spending has increased by leaps and bounds. This has created an inflationary situation in the economy.

ii. Hoarding: Excess demand is artificially created by hoarders. They stockpile goods and do not release to the market for sale. It leads to excess demand and inflation in the economy.

iii. Genuine shortages: Sometimes, the shortages may not be artificial but genuine. Due to some reason, the factors of production are limited in supply and production will be affected. Because supply will be less than demand, prices will rise.

iv. Population growth: Growth of population will increase the total demand in the market. If the supply of goods and services does not keep pace with demand, the pressure of excess demand will create inflation.

v. Increases velocity of circulation: The total use of money in the market is the amount of supply by the Government multiplied by the velocity of circulation of money. During the boom phase of a business cycle, people spend money at a faster rate. The velocity of circulation of money increases. This situation creates an inflationary condition in the economy.

b) Role of commercial banks in credit creation:

Bank deposits form the basis for credit creation. Banks accept deposits from the public by opening a deposit account known as the primary deposit. Banks do not hold the money in the account itself and the entire amount is not withdrawn from the account at the same time. So, they advance loans to business people and retain only a small portion of the total deposits in the bank. The central bank decides the amount to be held in the form of cash. This is called the cash reserve ratio.

These banks advance loans to business people only against collateral securities. The bank will not give cash but open a derivative account in the name of the individual or institution. Here the loans create a derivative deposit which is called a secondary deposit or derivative deposit. Thus, the secondary deposit is called the creation of credit.

Two limitations of the commercial bank to create credit:

Credit creation by the commercial bank is based on the primary deposit. Hence, there should be a large amount of cash, but the central bank has full control over the cash deposited by the individual. They decide the amount of cash to hold as reserves and the remaining amount for advancing loans.

Business people can avail loans from the bank only when they have good securities to submit against a loan. If the approved securities are not available to them, then the bank will not be able to create credit as loans.

Answer 7

a) An increase in the general price level of an economy with an increase in the average cost of production is called cost-push inflation. Cost-push factors are an increase in the wage rate, increase in the prices of raw materials etc. Therefore, the producers increase the prices of these goods and services after an increase in the cost of production in order to maintain the profit rates.

Factors responsible for the causes of cost-push inflation:

i. Rise in wages: Rise in wages is considered the determinant of cost-push inflation. Due to trade unions, workers have organised strongly to get higher wages. This rise in wage cost may lead to the imposition of higher product price by producers. Hence, when the average prices of different consumption goods increase, workers would again demand for higher wages.

ii. Increase in the price of basic materials: Basic materials such as steel, chemicals, oil etc. are used directly or indirectly in major industries. Thereby any increase in the prices of basic materials affects the entire economy and the prices tend to increase.

iii. Higher taxes: Increase in tax such as excise duties, sales tax, value added tax etc., where taxpayers can easily shift the burden of tax to others. It leads to an increase in the prices of different commodities.

b) Public expenditure promotes the economic development of the nation in the following two ways:

i. Its expenditure on infrastructural development improves the productive efficiency of industries and increases employment opportunities.

ii. It encourages private enterprises by initialising state-owned financial and banking institutions to provide cheap credits.

iii. It helps to increase the production of certain essential commodities to end private monopolies and the state starts public enterprises.

iv. It reduces income inequalities through welfare measures such as education, medical facilities etc.

v. The aggregate demand increases with the increase in public expenditure. Thereby the producer receives an incentive to increase the production level. Due to excess demand for these products in the market, the stocks of their goods exhaust completely. Hence, they increase production capacity to maintain the stock. There will be more demand for capital and labour to increase the level of production. Thus, it leads to an increase in the level of employment within the economy.

Answer 8

a) Three functions of the central bank:

i. Issuing of notes: The central bank of a country has an exclusive right of issuing notes. Under the original Act, there was provision for issuing currency notes according to the proportional reserve system. Here, the RBI can print or issue any volume of currency or notes by keeping a gold reserve worth Rs 115 crore and foreign exchange worth Rs 85 crore.

ii. Banker to the Government: The central bank is a banker, agent and financial advisor to the Government. As a banker, it manages accounts of the Government all across the country. It buys and sells securities on behalf of the Government as an agent to the Government. It helps the Government in framing policies to regulate the money market as an advisor to the Government.

iii. Lender of the last resort: The central bank also provides financial assistance to commercial banks by rediscounting eligible bills of exchange. When the commercial banks do not get loan facilities from any other source, they approach the central bank as a last resort. The central bank advances loans to such a bank against approved securities.

b) Internal and external debts, funded and unfunded debts, voluntary and compulsory debts, productive and unproductive debts, redeemable and irredeemable debts, transferable and non-transferable debts, and convertible and inconvertible debts are different types of public debts.

i. Internal and external debts: Internal debt means the Government borrowings within the country. Individuals, banks, business firms and others are the various internal sources from which the Government borrows. The various instruments of internal debt include market loans, bonds, treasury bills, ways and means advances etc. Over the years, the internal debt of the Central Government has increased from Rs 1,54,004 crore in 1990–91 to Rs 23,37,682 crore in 2009–10.

External debt means the Government borrowings from abroad. The external debts are multilateral borrowings, bilateral borrowings, loans from World Bank, Asian Development Bank etc. It helps for various developmental programmes. Over the years, the external debt of the Central Government has increased from Rs 31,525 crore in 1990–91 to Rs 1,39,581 crore in 2009–10.

ii. Productive and unproductive debts: A debt is called productive if the loan is financed for the projects which bring revenue to the Government; for example, irrigation, power projects etc. Productive debts are self-liquidating in nature; this means the principal amount and interest are normally paid out of the revenue generated from the projects to which the loans were used.

A debt is called unproductive if the loan is financed for war and other relief operations in case of emergency. Unproductive public loans are a net burden on the community. The Government will have to resort to additional taxation for their servicing and repayment.

iii. Redeemable and irredeemable debts: A redeemable debt is that which the Government repays after a fixed period of time. When the Government borrows money from the public, it sells securities to the public. They pay the interest at regular intervals. When the debt matures, the public surrenders the security to the Government and receives the principal along with the interest amounting anything due to them. Banks and other institutions are the holders of government securities.

Irredeemable debts are the loans for which no promise is made by the Government regarding their exact date of repayment. Such debt has no maturity period. The Government may pay interest regularly. Normally, the Government does not resort to such borrowings.

Answer 9

a) Prof Dalton defined public finance as 'it is connected with the income and expenditure of public authorities and with adjustment of one to another'. Tax revenue and non-tax revenue are two sources of income.

Differences between public and private finance:

i. For private finance, an individual adjusts the spending pattern according to his income level. However, for public finance, the Government determines the size of expenditure that it has spent on different segments and adjusts income to expenditure.
ii. Private individuals try to maximise their profits, whereas public authorities are motivated by the welfare of society.
iii. An individual spends less than his income to maintain a surplus budget. But the Government prefers to have deficit budget, especially in financing of economic development.
iv. Private finance transactions are maintained secretly, whereas public finance transactions are open to everyone in society.

b) Reasons for slow rate of capital formation in India:

i. Lack of ability to save: Due to poverty, poor people are unable to save more than the negligible part of their earnings. Hence, low rate of savings lead to low rate of capital formation in an economy.
ii. Lack of willingness to save: In certain parts of the country, there is still a feudal economic system. People who have the ability to save money are not willing to save and spend all their income.
iii. Insufficient mobilsation of savings: People are not mobilising the savings for capital formation. Most of their savings are kept in the form of gold and cash at home. These savings are not used productively due to poor banking knowledge and a poor banking network in the underdeveloped state.

Answer 10

a) Price elasticity of supply:

Price elasticity of supply is a percentage change in quantity supplied with respect to percentage change in price of the commodity.

e_s = Percentage change in quantity supplied/Percentage change in price

$e_s = \Delta Q / \Delta P * P/Q$

where P = initial price, ΔP = Change in price, Q = Initial quantity, ΔQ = change in quantity supplied

Price elasticity of supply = Price/Quantity * Change in quantity/Change in price

$e_s = 5/10 * 4/1 = 2$

Thus, the price elasticity of supply is greater than unity.

b) Differences between private and public debts:

i. The Government can frequently avail loans for long term. An individual or a private sector company is often not in a position to avail loans for long term.
ii. The Government can influence the interest rate through its monetary and fiscal policies. While an individual is unable to influence the rate of interest at which the loan is taken.
iii. Because people have more confidence in the Government than in private borrowers, they usually give loans to the Government more readily.
iv. Generally, the Government takes loans for the welfare of the people, whereas individuals take loans to maximise their profits and satisfaction.
v. The Government source of borrowing can be within the country as well as abroad, whereas the individual loans are within the country.