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BA Economics Honours | Semester 1 | Calicut University

Microeconomics Foundations

Course Code: ECO1MN105 • Module 1

Module I: Supply and Demand

The model of supply and demand represents the universal cornerstone of microeconomic analysis. Formulated in its modern geometric elegance by Alfred Marshall, the framework demonstrates how competitive market interactions between decentralized buyers and sellers establish market-clearing equilibrium prices and quantities, allocate scarce societal resources, and respond dynamically to external shocks and government interventions.

Unit 1: The Theory of Demand

Demand represents the quantity of a good or service that consumers are both willing and able to purchase at various alternative prices during a given time period, *ceteris paribus* (holding all other determinants constant).

The Demand Function and Law of Demand

The general market demand function for good X is expressed algebraically as:

Demand Function

$$Q_d^x = f(P_x, Y, P_y, T, E, N)$$

Where: Q_d^x = Quantity demanded of good X, P_x = Own price, Y = Consumer income, P_y = Price of related goods, T = Tastes, E = Price expectations, and N = Market population size.

Where P_x represents the own-price of the good, Y is consumer disposable income, P_y denotes the prices of related goods (substitutes and complements), T reflects consumer tastes and preferences, E embodies price expectations, and N is the size of the consuming population. The **Law of Demand** states that, holding other factors constant, an inverse relationship exists between the price of a good and the quantity demanded ($\frac{\partial Q_d}{\partial P} < 0$). This inverse relationship generates a downward-sloping demand curve, driven by two simultaneous microeconomic forces: the *substitution effect* (as price falls, the good becomes relatively cheaper than alternatives) and the *income effect* (as price falls, consumer real purchasing power expands).

Summing Individual Demand Curves to Derive Market Demand

The market demand curve is derived through the **horizontal summation** of all individual consumer demand curves in the marketplace. For n consumers, market demand at price P^* is:

$$\textbf{Market Demand:} \quad Q_D(P) = sum_{i=1}^{n} q_i(P)$$

Unit 2: The Theory of Supply

Supply represents the quantity of a commodity that competitive producers are willing and able to offer for sale at various price levels during a specified time period, *ceteris paribus*.

The **Law of Supply** posits a direct, positive relationship between the market price of a good and the quantity supplied ($\frac{\partial Q_s}{\partial P} > 0$), producing an upward-sloping supply curve. Higher market prices incentivize existing firms to expand output by hiring more variable inputs, and attract new entrepreneurial entrants into the profitable sector. Market supply is the horizontal summation of the marginal cost curves of all individual competitive firms lying above their average variable cost curves.

Unit 3: Market Equilibrium and Government Interventions

Market equilibrium occurs at the unique price-quantity intersection (P^*, Q^*) where the quantity demanded by consumers precisely equals the quantity supplied by producers ($Q_d = Q_s$). If the market price lies above equilibrium ($P > P^*$), a **surplus (excess supply)** emerges, exerting downward competitive pressure on prices. If the price lies below equilibrium ($P < P^*$), a **shortage (excess demand)** develops, bidding prices upward until the market clears.

Government Price Controls

- **Price Ceiling (Maximum Legal Price):** A statutory price set legally below the free market equilibrium price to protect consumers from exorbitant prices (e.g., rent control on urban apartments, price caps on essential pharmaceutical medications). While benefiting consumers who secure the good, a binding price ceiling creates persistent **shortages** ($Q_d > Q_s$), generates non-price rationing mechanisms (queues, waiting lists, seller favoritism), encourages illegal black markets, and creates significant **deadweight loss**.
- **Price Floor (Minimum Legal Price):** A statutory price set legally above the market equilibrium price to protect producers' incomes (e.g., agricultural Minimum Support Prices - MSP, statutory minimum wages for labor). A binding price floor generates persistent **surpluses** ($Q_s > Q_d$), requiring government agencies to purchase and store excess stocks at public expense.

Unit 4: Elasticities of Demand and Supply

Elasticity measures the quantitative responsiveness or sensitivity of one economic variable to changes in another.

1. Price Elasticity of Demand (e_p)

Measures the percentage change in quantity demanded resulting from a 1% change in the good's own price:

Price Elasticity Formula

$$e_p = -\frac{\%DeltaQ_d}{\%DeltaP} = -\frac{dQ}{dP} \cdot \frac{P}{Q}$$

Where: e_p = Price elasticity of demand, ΔQ_d = Change in quantity demanded, ΔP = Change in price, and (dQ/dP) = First derivative of the demand curve.

Elasticity ranges across five distinct categories: perfectly inelastic ($e_p = 0$), inelastic ($0 < e_p < 1$), unit elastic ($e_p = 1$), elastic ($e_p > 1$), and perfectly elastic ($e_p = infty$). Under Marshall's *Total Outlay Method*: if demand is elastic ($e_p > 1$), price and total revenue move in opposite directions; if inelastic ($e_p < 1$), price and total revenue move in the same direction.

2. Income Elasticity of Demand (e_y) and Cross-Price Elasticity (e_{xy})

- **Income Elasticity ($e_y = \frac{\%DeltaQ}{\%DeltaY}$):** Positive for *normal goods* ($e_y > 0$), further subdivided into necessities ($0 < e_y < 1$) and luxuries ($e_y > 1$). Negative for *inferior goods* ($e_y < 0$), where demand falls as income rises.

- **Cross-Price Elasticity ($e_{xy} = \frac{\%DeltaQ_x}{\%DeltaP_y}$):** Positive for *substitute goods* ($e_{xy} > 0$, e.g., tea and coffee), negative for *complementary goods* ($e_{xy} < 0$, e.g., automobiles and petrol), and zero for unrelated goods.

Elasticity Type	Numerical Value	Economic Classification	Practical Managerial / Policy Significance
Price Elasticity (e_p)	$e_p > 1$	Price Elastic Demand	Lowering price increases firm total revenue.
Price Elasticity (e_p)	$e_p < 1$	Price Inelastic Demand	Imposing excise taxes yields high fiscal revenue with low deadweight loss.
Income Elasticity (e_y)	$e_y > 1$	Superior / Luxury Good	Industry expands rapidly during macroeconomic booms.
Income Elasticity (e_y)	$e_y < 0$	Inferior Good	Demand contracts as consumer living standards improve.
Cross-Price Elasticity (e_{xy})	$e_{xy} > 0$	Substitute Goods	Firms must monitor competitors' pricing closely.

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

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Empirical Methodology, Identification Strategies, and Econometric Estimation

Empirical validation of economic models necessitates the rigorous treatment of endogeneity, omitted variable bias, and measurement error. Whether analyzing consumer behavior, firm cost structures, fiscal multipliers, or monetary transmission mechanisms, applied researchers utilize instrumental variables (IV), difference-in-differences (DiD), synthetic control methods, and regression discontinuity designs (RDD) to isolate causal relationships from mere statistical correlation.

Consider the structural estimation of policy impacts across decentralized economic agents. When evaluating macroeconomic interventions or microeconomic regulatory changes, parameters estimated from observational datasets must account for expectations formation and structural parameter stability in accordance with the Lucas Critique. Consequently, contemporary applied economics bridges micro-foundations with aggregate macroeconomic phenomena through dynamic stochastic general equilibrium (DSGE) modeling and micro-econometric panel estimations.

Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

Analytical Dimension	Orthodox / Classical Perspective	Heterodox / Institutional Framework	Empirical Policy Manifestations in India
Market Efficiency	Markets clear instantaneously; price mechanism allocates resources optimally without systemic friction.	Markets are prone to structural failures, information asymmetry, and coordination coordination failures.	Targeted regulatory oversight, public investment in infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
Distributional Equity	Factor rewards reflect marginal productivity; distribution is secondary to allocative efficiency.	Power asymmetries, bargaining power, and historical wealth accumulation shape distribution.	Progressive fiscal transfers, land reforms, and affirmative human capital investments.
Technological Progress	Exogenous technological shocks arriving randomly (Solow neoclassical growth model).	Endogenous technological innovation driven by R&D, human capital, and intellectual property institutions.	National Innovation Foundation, Startup India, and public digital infrastructure (India Stack / UPI).

Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

Policy Synthesis and Analytical Evaluation

Policy formulation in dynamic economic environments must therefore synthesize foundational deductive reasoning with robust inductive empirical inquiry. Economists must continuously evaluate the balance between market incentives and regulatory governance, ensuring that institutional frameworks promote both productive efficiency and distributive social justice.

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