

# 10. Prices and Cost of Living

## Improve your learning

### 1. Question

Why there is a need to regulate prices?

#### Answer

The continuous rise in the general price level in the economy is called inflation. Inflation affects every economic unit of the economy- consumers, firms, business units, and the government. There is a need to regulate the price level to protect the weak and financially vulnerable sections of society from the rise in general prices.

The rise in the price level is a sign of the fall in the money value i.e. more units of money should be given for purchasing the same commodity. This affects every section of the society especially the small income earners. Thus for maintaining a steady price in the economy, targeting and maintaining inflation is essential.

Fixed incomes earners like pensioners, daily wage earners, manual workers and small vendors, workers in small enterprises and in private low-income jobs are all badly affected by the continuous rise in prices. Income of the consumers adjusted to present inflation is the real income. Their money income does not change during inflation. So they are forced to cut down their consumption which again reduces their standard of living as they have to pay more for everything.

### 2. Question

How are prices fixed by a seller or producer?

#### Answer

The sellers fix the price of their commodities on the basis of their cost of production and the demand for the commodity in the market. The cost of production is an important component determining the price of the commodity. It includes both production and selling cost, i.e. cost of advertising, cost of transportation and selling the commodity. Thus it determines the cost of production to a large extent. When the cost of production is high, the price of the commodities will be higher and vice-versa. The prices are also fixed on the basis of the demand for the commodity in the market. Demand is the number of commodities that the consumers are ready to purchase at different prices. This also determines the total quantity demanded by different consumers in the market. When the demand is high, the price would be set lower and vice-versa. Thus these are the main determinants of the price of commodities.

### 3. Question

Differentiate cost of living from the standard of living.

#### Answer

COST OF LIVING	STANDARD OF LIVING
<ul style="list-style-type: none"> <li>• It is the cost that will be incurred to maintain a certain level and ease of living in a particular region.</li> </ul>	<ul style="list-style-type: none"> <li>• It is the measure of how any particular region is wealthy and comfortable in their material wealth and necessities.</li> </ul>
<ul style="list-style-type: none"> <li>• It is measured using Cost of Living and Purchasing Power Parity Indices.</li> </ul>	<ul style="list-style-type: none"> <li>• It is measured in a combination of many factors like poverty level, real income, housing facilities, employment, education, and life expectancy.</li> </ul>
<ul style="list-style-type: none"> <li>• It can vary within a particular country or region.</li> </ul>	<ul style="list-style-type: none"> <li>• It is calculated for a particular country or region.</li> </ul>

#### 4. Question

Who is affected most by an increase in the cost of living?

#### Answer

The cost of living is the amount of money needed to maintain a certain basic level of living and consumption in a particular country or region. It includes basic expenses such as housing, food, taxes, and health care. Increase in cost of living can be paired with inflation in the economy. The rise in the general price level in the economy is called inflation. Inflation affects every economic unit of the economy- consumers, firms, business units, and the government. Fixed incomes earners like pensioners, daily wage earners, manual workers, small vendors, workers in small enterprises and in private low-income jobs are all badly affected by the continuous rise in prices. Income of the consumers adjusted to present inflation is the real income. Their money income does not change during inflation. So they are forced to cut down their consumption which again reduces their standard of living as they have to pay more for everything.

#### 5. Question

Which groups can get higher income when there is inflation?

#### Answer

The rise in the general price level of the economy is called inflation. Inflation affects every economic unit of the economy- consumers, firms, business units, and the government. But the intensity of the phenomenon is different for everyone. For some groups, this rise in price levels is always compensated. Employees of the Central and State Government officials get an additional payment called Dearness Allowance or DA in compensation for the rise in prices. When prices rise by a certain amount, their salary and benefits also increase as the government compensates them for this rise in prices by paying them more DA. Therefore their income also increases, along with inflation. People doing business will reduce the higher cost of living, by prices of goods they sell. This is highly possible if the person is the only seller of the commodity. People providing services such as dry cleaners, barbers, lawyers or doctors increase their charges and remuneration as the prices increase. Thus, they are also less affected by the inflationary tendencies of the economy. The extremely rich persons, working in the corporate sector are also not affected by rising prices. They also enjoy most of the benefits that a government employee enjoys when the price rises. Also because of the high consumption standards, they are not much affected when the price of the necessities rise.

## 6. Question

How is a Wholesale Price Index (WPI) different from a Consumer Price Index (CPI)?

### Answer

WHOLESALE PRICE INDEX (WPI)	CONSUMER PRICE INDEX (CPI)
<ul style="list-style-type: none"> <li>• It measures the change in price levels of both consumer goods and the capital goods.</li> </ul>	<ul style="list-style-type: none"> <li>• It measures the change in prices of a selected range of consumer goods.</li> </ul>
<ul style="list-style-type: none"> <li>• It measures the prices changes at the wholesale price levels.</li> </ul>	<ul style="list-style-type: none"> <li>• It measures the prices changes at the retail price levels.</li> </ul>
<ul style="list-style-type: none"> <li>• It estimates the inflation rate at the first stage of the transaction.</li> </ul>	<ul style="list-style-type: none"> <li>• It estimates the inflation rate at the final stage of the transaction.</li> </ul>
<ul style="list-style-type: none"> <li>• It measures the prices paid by manufacturers and wholesalers.</li> </ul>	<ul style="list-style-type: none"> <li>• It measures the prices paid by the end consumers.</li> </ul>

## 7. Question

How is food inflation different from Consumer Price Indices?

### Answer

FOOD INFLATION	CONSUMER PRICE INDEX
<ul style="list-style-type: none"><li>• It measures the rise in the price of food items.</li></ul>	<ul style="list-style-type: none"><li>• It measures the change in prices of a selected range of consumer goods.</li></ul>
<ul style="list-style-type: none"><li>• It measures the prices changes at the wholesale price levels.</li></ul>	<ul style="list-style-type: none"><li>• It measures the prices changes at the retail price levels.</li></ul>
<ul style="list-style-type: none"><li>• It includes rice, wheat, pulses, vegetables, sugar, milk, egg, meat, food, and manufactured food materials.</li></ul>	<ul style="list-style-type: none"><li>• It includes not just food and beverages, but also housing, clothes, transportation and other facilities used by the public.</li></ul>

## 8. Question

What are the uses of CPI?

### Answer

CPI measures the change in prices of a selected range of consumer goods. It measures the changes in retail price levels. CPI is widely used as an economic indicator. It is the most widely used measure of inflation and indicates the effectiveness and efficiency of the government's economic policy. The CPI gives the idea to the governments, businesses, and citizens an idea about the price changes and fluctuations in the economy. It acts as a controller of the actions to make informed decisions about the economy.

The business enterprises and governments use CPI to measure and adjust for inflation expectations. The CPI shows the average change in prices on a monthly basis. Many business firms use it to predict the expected price levels in the future. This enables them to adjust their production process accordingly. The adjustments enable them to adjust their present and future earnings accordingly.

Labour unions and corporations also use the CPI to achieve higher wages and other financial and physical benefits. Proper measurement of CPI ensures them to adjust

their cost of living according to their benefits received. This also enables them to adjust their future standard of living accordingly. For the pensioners and other fixed income earners also, inflation helps to adjust their standard of living accordingly.

### **9. Question**

List five issues that are considered while measuring CPI.

#### **Answer**

CPI measures the change in prices of a selected range of consumer goods. It measures the changes in retail price levels. CPI is widely used as an economic indicator. But there are many problems in measuring inflation using CPI. Some of the basic issues are:

- It measures the average price of the basket of goods which are most commonly used by consumers. But the basket always remains incomplete as the new goods are to be included and the old commodities have to be eliminated.
- It includes the cost of only private goods and services and fails to consider the public goods and services.
- It assumes that consumers are continuing to buy the same commodities irrespective of the changes in price. It does not accept the reality that as certain goods become expensive, consumers substitute them with relatively less expensive commodities.
- It does not provide accurate measures of the prices and buying habits of the rural areas and does not provide data for different age groups.
- It does not consider substantial improvements and discoveries in the quality of goods and services.

### **10. Question**

Read the sixth paragraph under the heading of Role of Government in Regulating Prices and answer the question: How does APM affect the government revenue? Discuss.

#### **Answer**

Administrative Price Mechanism (APM) is the price fixed by the government for essential commodities to prevent hoarding and to facilitate their availability within a reasonable price range. It largely includes commodities like LPG, kerosene, diesel, CNG, and others. Controlling the prices by the government and subsidising its availability to the public affects the total revenue of the government. In this price control mechanism, the government fixes the price, and the commodities are partly or fully subsidised and sold by the government. This reduces the total revenue of the government. If the price is being controlled and the commodities are distributed via the private sector, the government would have to pay the private sector the excess of the subsidised amount. This results in a reduction in the revenue of the government. This can mostly be observed in the case of modern welfare governments.

### **11. Question**

Take five goods or services used by your family and construct a Consumer Price Index for your family based on these five goods or services.

#### **Answer**

1	2	3	4 = 2*3	5	6	7 = 5*6
Goods/Service	Last month's price this month (Rs.)	Last month's quantity	Expenditure last month (Rs.)	This month's price (Rs.)	This month's quantity	Expenditure this month (Rs.)
Milk	20	15 litre	300	22	15 litre	330
Petrol	80	6 litre	480	72	6 litre	432
Rice	50	30 kg	1500	46	35 kg	1610
Medicine	100	2 nos	200	105	2 nos	210
Mobile services	159	3 nos	447	229	3 nos	687
Total expenditure			2927	Total expenditure		3269
CPI: $342/2927*100 = 11.68\%$						
By how much has your total expenditure changed compared to last month? $3269-2927 = 342$						

## 12. Question

Write true or false against the statement

- a. Inflation increases the standard of living of the people.
- b. Value of money is shown by the changes in purchasing power.
- c. Change in cost of living does not affect the standard of living of pensioners.
- d. Central government workers are compensated for inflation by a rise in DA.

**Answer**

a. No, the statement is false. Inflation is the continuous rise in the general price level of the economy. The rise in the price level is a sign of the fall in the money value i.e. more units of money should be given for purchasing the same commodity. This affects every section of the society especially the small income earners. Their money income does not change during inflation. So they are forced to cut down their consumption which reduces their standard of living as they have to pay more for everything.

b. Yes, the statement is correct. Value of money is the total units of the commodity the consumer is able to purchase using his given money and income. Changes in purchasing power determine the value of money. When the commodities are a high price, the value of money and the purchasing power falls resulting in a reduction in the consumption of the commodity and vice-versa.

c. No, the changes in the cost of living will definitely affect the living standards of the fixed income groups like pensioners. The change in the cost of living can be attributed to changes in the rate of inflation in the economy. Fixed incomes earners like pensioners, daily wage earners, manual workers and small vendors, workers in small enterprises and in private low-income jobs are all badly affected by the continuous rise in prices. Income of the consumers adjusted to present inflation is the real income. Their money income does not change during inflation. So they are forced to cut down their consumption which again reduces their standard of living as they have to pay more for everything.

d. Yes, the Central government workers are compensated for the rise in rice due to inflation by raising their Dearness Allowance (DA). Employees of the Central and State Government officials get an additional payment called Dearness Allowance or DA in compensation for the rise in prices. When prices rise by a certain amount, their salary and benefits also increase as the government compensates them for this rise in prices by paying them more DA. Therefore their income also increases, along with inflation.

e. No, WPI measures the change in price levels of both the consumer goods and the capital goods. It measures the prices changes at the wholesale price levels and estimates the inflation rate at the first stage of the transaction. It measures the prices paid by manufacturers and wholesalers.

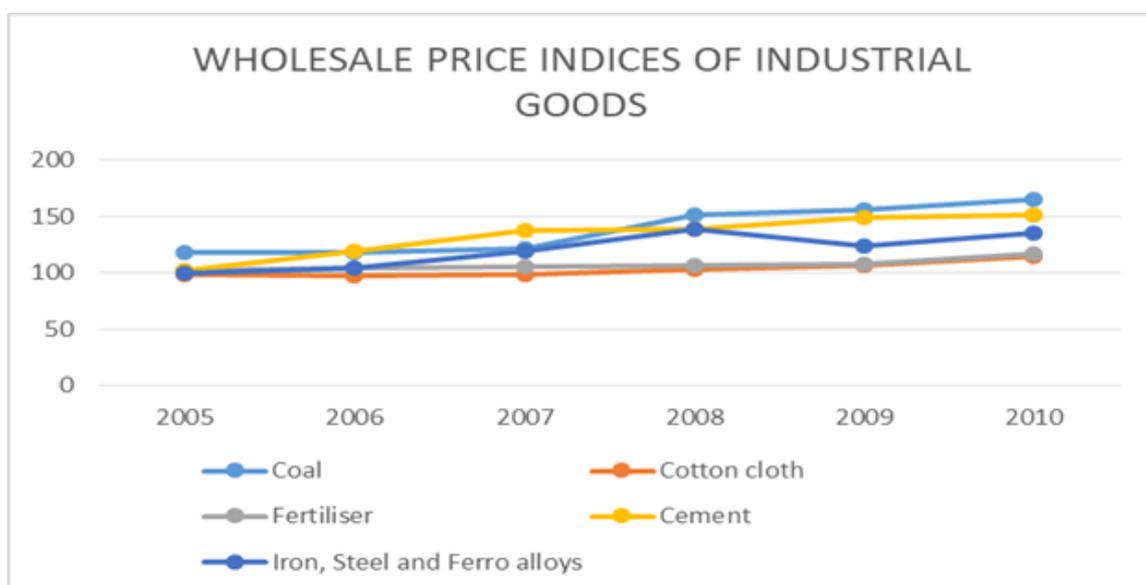
**13. Question**

The following table shows the Wholesale Price Indices of industrial goods. Prepare a line diagram and answer the questions that follow:

Year	Coal	Cotton cloth	Fertiliser	Cement	Iron, Steel, and Ferroalloys
2005	118	99	102	102	100
2006	118	97	104	119	105
2007	122	99	106	138	119
2008	151	103	107	139	139
2009	156	107	108	149	124
2010	165	115	117	151	136

- Which commodity's price rose sharply over the years?
- What could be the reasons for a slow rise in cotton cloth and fertilisers?
- Does the government play any role of any of the commodities? How?

**Answer**



a. The price of coal has risen sharply over time. It was constant and stable in 2005 and 2006. But it rose to 165 very rapidly during 2010.

b. During the six years, cotton cloth rose from 99 to only 115 and fertilisers from 102 to 117. This is mainly because of the character of the industry. Both cotton clothes and fertilisers are primary good industries whose demand does not rise rapidly. Also, the other commodities are basic good industries providing raw materials for other industries. Thus, industrial expansion results in their growth.

c. Yes, the government plays an active role in the above-mentioned industries. All the above industries produce basic goods for the use of other industries. Thus promoting those industries will help in the expansion and development of other related industries. Thus government involves in the functioning of the industries. They can be wholly or partly subsidized by the government.

#### **14. Question**

Write a letter to your Tehsildar on proper maintenance of Public Distribution System by indicating your suggestions?

#### **Answer**

The District Collector,

Ranchi District,

Jharkhand 835213.

Subject: PDS problem in Ranchi district.

Respected Sir,

I would like to draw your attention towards the dysfunctional state of the PDS system in the district.

The needy and the poor beneficiaries are not granted their share of ration on time. The ration shops are not opened regularly. Sometimes the items are itself not available and if available the quality of the items are not good.

Kindly look into the matter and take remedial steps towards it.

Thank You.