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## ENABLERS FOR SCORING CENTUM

## XII STD

## **ECONOMICS STUDY MATERIAL**

# PART I

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"Equanimity, hard work and intelligent timemanagement

are the secrets of success"

#### **CHAPTER 1 INTRODUCTION TO MACRO ECONOMICS**

Introduction -the subject economics is classified into two

branches

-micro and macro economics

Ragnar Frisch -a Norwegian Economist

-won the first noble prize in economics science

Coined the words -micro – meaning small

-macro – meaning large in the year 1933

Macro Economics -its modern form began with John Maynard

Keynes

-book "The General Theory of Employment,

Interest and Money" -published in 1936

Keynes -an explanation for fallout from the great

depression

-when goods remained unsold and workers

unemployed

-hence Keynes is regarded as the "Father of

Modern Macro Economics"

Meaning of Macro Economics -the word "Macro" is derived from the

Greek word "Makros" meaning large

Macro Economics -is the study of the economy as whole

-deal with aggregates such as national income, employment and output

-macro economics is also known as

"Income theory"

The subject matters -covered in macro economics are the areas

-employment, national income

-inflation, business cycle

-poverty, inequality

-saving and investment

-capital formation, infrastructural

development

-international trade

-balance of trade and balance of payment

-exchange rate and economic growth

<b>Importance</b>	of Macr	o Economics
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- -need for introducing a macro outlook
- -there is a need to understand the functioning of the economy
- -the aggregate level to evolve suitable strategies
- -to solve the basic problems prevailing in an economy
- -understand the future problems
- -needs and challenges of an economy as whole
- -important to evolve precautionary measures
- -macro economics provide ample opportunities
- -to use scientific investigation
- -to understand the reality
- -helps to make comparison analysis of economic indicators
- -better prediction future
- -to formulate suitable policies
- -to avoid economic crisis

#### Scope of Macro Economics

#### National Income

#### -it covers the major areas as follows

- -measurement of national income and its composition by sectors
- -the basic aspects of macro economic analysis
- -the trends in national income and its composition provide
- -long term understanding of the growth process of an economy

#### Inflation

- -refers to steady increase in general price level
- -estimating the general price level
- -by constructing various price index numbers
- -such as whole sale price index, consumer price index, etc., are needed

#### Business cycle

#### -almost all economic face the problem of business fluctuations and business cycle -cyclical movements in the economy need to carefully studied based on aggregate

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Cyclical movements -boom, recession, depression and recovery

Poverty and Unemployment -the major problems are poverty and unemployment

-this is one of the economic paradoxes

-a clear understanding about the magnitude of poverty and unemployment facilitate

-allocation of resources initiating corrective

measures

-development of an economy and factors Economic growth

determining them

-understand only through macro analysis

**Economic Policies** -macro economics is significant for evolving

suitable economic policies

-economic policies are necessary to solve

the basic problems

-to overcome the obstacles and to achieve

growth

-there is a danger a excessive generalisation of Limitations the economy as a whole

-it assumes homogeneity among the

individual units

-there is a fallacy of composition

-what is good of an individual need not be

good for nation and vice versa

-what is good for a country is not good for

another country

-at another time

-many non – economic factors determine

economic activities

#### **Economy and its types**

-A.J. Brown as "a system by which people The term economy has been defined by

earn their living"

J.R. Hicks defined -"an economy is a co – operation of producer and workers to make goods and services that satisfy the wants of the consumers"

Any economy referred -to any system or area where economic

activities are carried out

-each economy has its own character

-functions or activities also vary

The fundamental economic activities -production and consumption

-these two activities are supported by several

other activities

-the ultimate aim achieve growth

The exchange activity -supports the production and consumption

activities

The major economic activities -include transportation, banking, advertising,

planning, government policy

The major non-economic activities -environment, health, education,

entertainment, regulation, etc.,

In addition to supporting activities,

External activities are -import, export, international relations, emigration, immigration, foreign investment,

foreign exchange earnings, etc.,

#### Economics can be classified into different types based on

State of Development -Developed, underdeveloped, undeveloped

and developing economies

System of Activities -Capitalistic, Socialistic and mixed economies

Scale of Activities -Small and large economies

Nature of Functioning -Static and dynamic economies

Nature of operation -Closed and Open economies

Nature of advancement -Traditional and modern economies

Level of National Income -Low income, middle income and high

income economies

Economic systems -refers to the manner in which individuals

and institution	s are connected together
-it is the metho	dology of doing economic
activities to m	eet the needs of the society

There are three major types

-Economic systems

-Capitalist Economy – Capitalism -Socialist Economy – Socialism -Mixed Economy - Mixedism

Globalism

-the term coined by Manfred D Steger-2002

-connects nations together through

international trade

-aiming at global development

-this ideology is also termed as "extended

capitalism"

Capitalism and socialism

-two extreme and opposite approaches

Capitalism

-there is total freedom and private ownership

of means of production

Socialism

-there is no freedom for private

-there is public ownership of means of

production

Mixedism

-denotes the co – existence of capitalism

and socialism

Capitalist Economy

-Adam Smith is the "Father of Capitalism"

-Capitalist economy is also termed as a free

economy

-Laissez faire in Latin word

-Market economy where

-the role of the government is minimum and

market determines the activities

The means of production

-in a capitalistic economy and privately

owned

-manufacturers produce goods and services

with profit motive

The USA, West Germany, Australia

and Japan

-are best examples for Capitalist Economies

-large scale social welfare measures to

safeguard the downtrodden people from the market forces

#### **Features of Capitalist Economy**

Private ownership of property and law of inheritance

-the basic features of capitalism is that all resources namely land, capital, machines,

mine, etc., are owned private

-the property can be transferred to heirs

after death

Freedom of choice and enterprises -each individual is free to carry out any

occupation or trade at any place and produce

any commodity

-consumers are free to buy any commodity as

per their choice

Profit Motive -profit is the driving force

-each individual and organization ensure high

profit

Advance technology -division of labour and specialization are

followed

The golden rule -producer under capitalism is "to maximize

profit"

Free competition -both product and factor market

-the government or any authority cannot

prevent from buying or selling

-in the market

-there is competition between buyers and

sellers

Price Mechanism -is the heart of any capitalist economy

-all economic activities regulated through

price mechanism

-i.e. market forces of demand and supply

Role of Government -price mechanism regulates economic activity

-government has a limited role

The government provides basic services -such as defence, public wealth, education, etc

Inequalities of Income -two classes have and have nots

-haves – that is those who own property

-have nots - who do not own property and

work for their living

-rich become richer-poor become poorer

-here economic inequality goes on increasing

#### **Merits of Capitalism**

Automatic working -without any government intervention

Efficient use of resources -are put into optimum use

Incentives for hardwork -encouraged and entrepreneurs get more

profit for more efficiency

Consumers sovereignty -all production activities are aimed at

satisfying the consumer

Higher rates of capital formation -increase in saving and investment

Development of new technology -profit is aimed at producers invest on new technology and produce quality goods

#### **Demerits of Capitalism**

Concentration of wealth and income -few hands and thereby increases inequalities

of income

Wastages of resources -large amount of resources are wasted on

competitive advertising and duplication of

products

Class struggle -capitalism leads to class struggle as it divides

the society into capitalist and workers

Business cycle -free market system leads to frequent violent

economic fluctuations and crises

Socialist economy -the father of socialism is Karl Marx

Socialism refers -to a system of total planning public

ownership and state control on economic

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Socialism is defined -as a way of organizing a society in which

major industries are owned and controlled

by the government

A socialist economy -is also known as "Planned Economy" or

"Command Economy"

-all the resources are owned and operated by

the government

-public welfare is the main motive behind all

economic activities

It aims -at equality in the distribution of income and

wealth and equal opportunity for all

Russia, China, Vietnam, Poland and Cuba -are examples of socialist economies

What, How, Whom to produce -completely determined and controlled by

a central authority

#### Features of Socialism

Public ownership of means of production -all resources are owned by the government

-it means that all the factors of production

Central planning -is an integral part of socialist economy

-all decision are undertaken by the central

planning authority

Maximum social benefit -social welfare is the guiding principle behind

all economic activities

-investments are planned in such a way that the benefits are distributed to the society at

large

Non – existence of competition — there is absence of competition in the market

-state has full control over production and

distribution

-consumers will have a limited choice

Absence of price mechanism -the pricing system works under the control

and regulation of the central planning

authority

Equality of Income -another essential feature of socialism

-removal and reduction of economic

inequalities

-private property and the law of inheritance

do not exist

Equality of opportunity -socialism provide equal opportunity

-free health, education and professional

training

Classless society -no class conflicts

-in a true socialist society everyone is

equal as far as economic status

#### **Merits of Socialism**

Reduction of inequalities -no one is allowed to own and use private

property to exploit others

Rational allocation of resources -the central planning authority allocates the

resources in a planned manner

-wastages are minimised and investments

are made in a pre planned manner

Absence of class conflicts -as inequalities are minimum

-there is no conflict between rich and poor

class

-society functions in a harmonious manner

End of trade cycles -planning authority takes control over

production and distribution of goods and

services

-therefore economic fluctuations can be

avoided

Promotes social welfare -absence of exploitation

-reduction of economic inequalities

-avoidance of trade cycles

-increase in productive efficiency help to

promote social welfare

#### **Demerits of Socialism**

Red Tapism and Bureaucracy -as decision are taken by government

agencies, approval of many officials and

movement take time lead

Absence of incentive -the major limitation of socialism is that this system does not provide any incentive for efficiency -therefore productivity also suffers Limited freedom of choice -consumers do not enjoy freedom of choice -over the consumption of goods and services Concentration of power -the state takes all major decisions -private takes no initiative in making economic decisions -hence the state is more powerful and misuse of power can also take place -Communism **Economic systems Socialist** -pure planned economy -example - North Korea -China -Venezuela Capitalist -pure competition -pure free market economy -example – France -Sweden -USA -Japan **Mixed Economics** Mixedism -socialist learning -capitalist learning Mixed economy -system both private and public sectors co-exist -work together towards economic development -it is a combination of both capitalism and socialism -eliminate the evils of both capitalism and socialism

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-in these economies resources are owned by

individuals and the government

-example: India, Brazil

#### **Features of Mixed Economy**

Ownership of property and means of

production

-owned by both private and public

-public and private have right to purchase

use or transfer their resources

Co-existence of public and private sectors

-private industries undertake activities

primarily for profit

-public sector firms are owned by the

government

-to maximise social welfare

Economic planning -the central planning authority prepares

the economic plans

-national plans are drawn up by the

government

-both private and public sectors abide

-in general, all sectors of the economy function according to the objectives

priorities and targets laid down

Solution of economic problems

-the basic problems of what to produce, how to produce, from whom to produce

-how to distribute are solved through the price mechanism as well as state intervention

Freedom and control

-through private has freedom to own

resources

-produce goods and services

-distribute the same

-overall on the economic activities rests with

the government

#### **Merits of Mixed Economy**

Rapid economic growth

-the best advantages of mixed economy

-thus, both public requirements and private

needs are taken care of

Balanced economic growth

-mixedism promotes balanced growth

-it promotes balanced growth balanced

agriculture and industry

-consumer goods and capital goods

-rural and urban etc

Proper utilization of resources	-the government can ensure proper utilization of resources
	-the government controls most of the important activities directly -private sector indirectly
Economic equality	-the government uses progressive rates of taxation
	-levying income tax to bring about economic equality
Special advantages to the society	<ul> <li>-the government safeguards the interest of the workers and weaker sections</li> <li>-by legislating on minimum wages and rationing</li> <li>-establishing fair price shops and formulating social welfare measures</li> </ul>
Dem <mark>er</mark> its of Mixed Economy	
Lack of Co – ordination	-the greatest drawback of mixedism is lack of co-ordination -between public sector and private sector -both work with divergent motives -it creates many co-ordination related problems
Competitive attitude	-both government and private sectors -should work with a complementary spirit towards welfare of the society -but in reality they are competitive in their activities
Inefficiency	<ul><li>-most of the public sector enterprises remain inefficient</li><li>-due to bureaucracy, red tapism and lack of motivation</li></ul>

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business operations -innovative initiatives

-discourages the private entrepreneur in their

Fear of Nationalization

Widening inequality

-ownership of resources laws of inheritance

and profit motive

-people widens the gap between rich and

poor

#### **Features of Capitalism**

Ownership means of production

**Economic Motive** 

Solution of central problems

Government Role

Income determination

Nature of enterprise

Economic freedom

Major problem

-private

-profit

-free market system

-internal regulation only

-unequal

-private

-complete

-inequality

#### **Features of Socialism**

Ownership means of production

**Economic Motive** 

Solution of central problems

Government Role

Income determination

Nature of enterprise

Economic freedom

Major problem

-public

-social welfare

-central planning systems

-complete involvement

-equal

-government

-lack of freedom

-inefficiency

#### **Features of Mixedism**

Ownership means of production

**Economic Motive** 

Government Role

Income determination

Nature of enterprise

Economic freedom

Major problem

Solution of central problems

-both private and public ownership

-social welfare and profit motive

-central planning system and free market

system

-limited role

-less unequal

-both private and state

-limited

-inequality and inefficiency

## **Concept of Macro Economics**

Stock and flow variables

-variables used in economic analysis are

classified as stock and flow

-both stock and flow variables may increase

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or	decrease	with	time
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Stock -refers to a quantity of a commodity measured

at a point of time

In Macro Economics -money supply, unemployment level, foreign

exchange, reserve capital, etc

-ex: stock variables

Flow variables -measured over a period of time

-national income, imports, exports,

consumption, production, investment, etc

-ex: of flow variable

Economic models -simplified representation of real situation

-to describe economic activities-relationship and their behaviour

-most economic models are built with mathematics, graphs and equations to explain relationships between economic

variables

The commonly used economic models -the supply-demand models and circular

flow models and smith models

Circular flow of income -is a model of an economy showing

connections between different sectors of an

economy

-it shows flow of income, goods and services

and factors of production between economic

agents

Economic agents -such as firms, households, government and

nations

The circular flow analysis -is the basis of national accounts and

macro economics

There are three models -circular flow of income representing the

major economic systems

-two sector model

-three sector model

-four sector model

Two sector model -simple economy with household and firms

Three sector model	-mixed and closed economy with households, firms and government
Four sector model	-are open economy with households, firms, government and rest of the world (external sector)
Circular flow of income in two sector economy	-two sectors namely household and firm sector
Household sector	-is the sole buyer of goods and services -the sole supplier of factors of production -it spends its entire income on the purchase goods produced by the business sector -the household sector receives income from firm sector
Firms	-revenue from by selling goods and services to household sector -it hires the factors of production owned by the household sector
Two sector economy	-production and sales are equal -there will be a circular flow of income of goods
The outer circle	-represents real flow (factors and goods)
The inner circle	-represents the monetary flow (factors prices and commodity prices)
Real flow	-indicates the factor services flow from household sector to the business sector -goods and services flow from business sector the household
Two sector economy	-Y = C + I -where Y is Income -C is consumption -I is investment

Circular flow of income in three sector economy

-in addition to household and firms and

government sector

-purchase goods and services from firms

-receive factors of production from

household sector

Government also makes

-social transfers such as pension, relief,

subsidies households

-pays the firms for the purchases of goods

and services

Three forces -Y = C + I + G

-three sector model

Circular flow of income in a four sector economy

-in addition to househond, firms and government, fourth sector namely external sector

-the external sector comprises exports and

imports

-Y = C + I + G + (X - M)

-C + I + G domestic expenditure

-X – M net exports

#### **CHAPTER 2 NATIONAL INCOME**

National income -measure of the economic activities of a nation

-it denotes the country's purchasing power -the growth of an economy is measured by its

real national income grows

National income serves -as an instrument of economic planning

National income -one of the most significant macro economic

variables

Nobel laureate -Simon Kuznets

first introduced the concept of national income

National income -means the total money value of all final goods

and services produced in a country during a

particular period of time (one year)

Simon Kuznets -Creator of GDP 1932

Basic concepts of National Income

Gross domestic product -is the total market value

-of final goods and services

-produced within the country during the year

-calculated at market prices

-is known as GDP at market prices

GDP by expenditure -method at market prices = C + I + G + (X - M)

-C = Consumption goods -I = Investment goods

-G = Government purchases -X = Exports; M = Imports

-(X - M) is net export which can be positive or

negative

Net Domestic product (NDP) -is the value of net output of the economy

during the year

-country's capital equipment wear out or

become outdated

-each year during the production process

Net Domestic product -GDP – Depreciation

Gross National Product (GNP)

- -is the total measure of the flow of final goods and services
- -at market value resulting from current production in a country during a year
- -including net income from abroad

GNP includes five types of final goods and services

- -1.Consumption (C)
- -2..Gross Investment (I)
- -3.Goods and services produced (or) purchased by the government (G)
- -4.Net exports of goods and services, ie. the difference between value of export and import of goods and services known as (X M)
- -Net factor income from abroad
- -which refers to difference between factor income received from abroad
- -factor incomes paid to the foreign residents for factor services by them in the domestic territory
- -5.GNP at market prices means the gross value of final goods and services + Net factor income from abroad C + I + G + (X M) + (R P)
- -GNP at market price = GDP at market prices+ Net factor income from abroad

Net national product (NNP) at market prices

- -refers to the value of the net output of the economy during the year
- -NNP is obtained by deducting the value of depreciation (or)
- -replacement allowance of the capital assets from the GNP

It is expressed as -NNP = GNP - Depreciation allowance

(Depreciation is also called Capital consumption allowance)

NNP at factor cost -refers to the market value of output

-NNP at factor cost is the total of income

Personal Income

Personal income

Disposable income

Percapita Income

Percapita Income

Real Income

payment made to factors of production -money value of NNP at market price, we deduct the amount of indirect taxes and subsidies to arrive -at the Net National Income at factor cost -NNP at factor cost = NNP at market prices— (Indirect taxes + Subsidies) -is the total income received by the individuals of a country from all sources before payment of direct taxes in a year -is near equal to the national income -Personal income = National Income – (Social security contribution and undistributed corporate profits) + Transfer payments -is also known as disposable personal income -it is the individuals income after the payment of income tax -this is the amount available for household for consumption -Disposable Income = Personal Income – Direct tax -as the entire disposable income is not spent on consumption -Disposable Income = Consumption + Saving -the average income of a person of a country in a particular year is called percapita income -percapital income is obtained by dividing national income by population = National Income **Population** -nominal income is national income -expressed in terms of a general price level of a

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particular year

-is the buying power of nominal income

National income	e is the	final	value of
goods and servi	ces		

-produced and expressed in terms of money at current prices

Real income derived as follows National Income at Constant price

=National Income at current price  $\div P_1/P_0$ 

-P<sub>1</sub> – Price Index during current year

 $-P_2$  – Price Index during base year

GDP deflator

-is an index of price changes of goods and

services included in GDP

-it is a price index which is calculated by dividing the nominal GDP in a given year

-by the real GDP for the same year and

multiplying in by 100

-GDP deflator =  $\underline{\text{Nominal GDP}}$  X 100

Real GDP

Methods of measuring national income

-All goods and services produced in the country

-must be counted and converted against money

value during year

-whatever is produced in either used for

consumption or saving

-national output can be computed at any of three

levels

-viz. production, income and expenditure

Accordingly three methods

-1. Production or value added method

-2.Income method or Factor earning method

-3.Expenditure method

The following equation must hold

-Output = Income = Expenditure

GDP expenditure

-consumption

-government spending

-investment spending

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- -exports
- -imports
- -GDP (Known as aggregate demand)

#### GDP factor income

-income from people in jobs and in self employment eg. wages and salaries -profit of private sector business

-rent income from the ownership of land

#### GDP value of output

-value added from each of the main economic sectors

-these sectors are

-primary

-secondary

-manufacturing

-quaternary

## Because the three methods

Product method

-are circular in nature

-measures the output of the of the country

-it is also called inventory method

#### Gross value of output

- -from different sectors like agriculture, industry trade and commerce etc.
- -is obtained for the entire economy during a year
- -the value obtained is actually the GNP at market prices
- -to avoid double counting
- -the value of the final product
- -is derived by the summation of all the value added in the productive process
- -to avoid double counting
- -either the value of the final output should be taken estimate of GNP
- -or the sum of values added should be taken

## In India, the gross value of the farm output is obtained

-total production of 64 agriculture commodities is estimated

The output of each crop
-------------------------

- -is measured by multiplying the areas own by the average yield per hectare
- -the total output of each commodity is valued at market price
- -the aggregate value of total output measure the gross value of agricultural output
- -the net value of the agricultural output is measured by making deductions for the cost and depreciation from the gross value

**Precautions** 

- -the product method is followed in the underdeveloped countries
- -but it is less reliable because the margin of error in their method
- -In India, this method is applied to agriculture, mining and manufacturing including handicrafts
- -double counting is to be avoided under value added method
- -raw material or intermediate goods for the final production should not be included ex. cloth
- -the value of output used self consumption should be counted while measuring national income
- -In the case of durable goods, sale and purchase of second hand goods should not be included
- -factor earning method
- -this method approaches national income from the distribution side
- -national income is calculated by adding up all the income generated

#### Steps involved

Income method

The enterprises

-are classified into various industrial groups

Factor incomes are grouped under

-labour income, capital income, mixed income

Labour income

-wages, salaries, fringe benefits, employer's

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Capital Income -profit, interest, dividend or royalty

Mixed income -farming, sole proprietorship and other

professions

National income -is calculated as domestic factor income plus net factor incomes from abroad

$$-y = w + r + I + \pi + (R - P)$$

-w = wage; r = rent; i = interest;  $\pi = profits$ ;

R = exports; P = imports

-this method is adopted for estimating the contribution of the remaining sectors

-income from abroad are obtained from the account of the balance of the country

Precautions

Items not to be included

-transfer payments are not be included in estimations of national income

-these payments are not received for any services provided in the current year

-such as pension, social, insurance, etc.

-the receipts from the sale of second hand goods should not be treated as a part of national income

-windfall gains such as lotteries are also not be included

-corporate profit tax should not be separately included

-imputed value of rent for self occupied houses or offices

-imputed value of services provided by owners of production units

-outlay method

-the total expenditure incurred by the society in a particular year is added together

-it includes personal consumption expenditure, net domestic investment, government

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### The Expenditure method

on consumption as well as capital goods and net exports

$$-GNP = C + I + G + (X - M)$$

-C = Private consumption expenditure

-I = Private investment expenditure

-G = Government expenditure

-X - M = Net exports

**Precautions** 

Second hand goods -expenditure on second hand goods should not

be included

Purchase of shares and bonds -in the secondary market should not be included

Transfer payment -old age pension should not be included

Expenditure on intermediate goods -expenditure on seeds and fertilizers by farmers, cotton and yarn by textile industries

-not to be included to avoid double counting

-only expenditure on final product are to be

included

Factor cost -there are number of inputs are included into

production process

-land, labour, capital and entrepreneurship

-incur a cost for using these factors of

production

-these costs are ultimately added onto the price

of the product

The factor cost refers -the cost of production that is incurred by a firm

when producing goods and services

Example -cost of renting machine, purchasing machinery

and land, paying salaries and wages, cost of obtaining capital, and the profit margins added

by the entrepreneur

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The factor cost does not include	<ul><li>-the taxes that are paid to the government</li><li>-taxes are not directly involved in the production process</li></ul>
	-not part of the direct production cost
Subsidies received	-included in the factor cost as subsidies are direct inputs into the production
	080888
Market price	-once goods and services are produced they are sold
	-in a market place at a set market price
	-is the price that consumers will pay
	-when they purchase it from the sellers
Taxes charged	-by the government will be added on the factor price
Subsidies	provided will be reduced from the factor price
Subsidies	-provided will be reduced from the factor price to arrive at the market price
MP	=FC + Indirect taxes – SubsidiesEquation 1
FC	=MP – Indirect taxes + SubsidiesEquation 2
	1,11
National income (NNP <sub>FC</sub> )	=Gross value added by all the production
23da5a	enterprises within the domestic territory of the
	country – Depreciation – Net indirect taxes +
	Net factor income from abroad (or)
Value of output	= Price X Quantity sold
1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1	N.P.S.C. INDIANA CONTRACTOR OF THE PROPERTY OF
$\mathrm{GDP}_{\mathrm{MP}}$	=Private final consumption + Government final
	consumption expenditure + Gross domestic
	capital formation + Net exports
Importance of National Income analysis	-National income is of great importance for the
	economy of a country
	-national income is regarded as accounts of the
	economy
	-which are known as social accounts
	-to know the relative importance of the various
_	••

sectors of the economy and their contribution

- -to formulate the national policies such as monetary policy, fiscal policy and other policies
- -to formulate planning and evaluate plan progress
- -to build economic models both in short run and long run
- -to make international comparison inter regional comparison and inter temporal comparison of growth
- -to know a country's percapita income which reflects the economic welfare of the country
- -to know the distribution of income for various factors of production in the country
- -to arrive at many macro economic variables namely tax – GDP ratio current account Deficit – GDP ratio, Fiscal deficit – GDP ratio Debt – GDP ratio, etc.

Difficulties in measuring national income

- -Transfer payment
- -difficulties in assessing depreciation allowance
- -unpaid services
- -income from illegal activities
- -production for self consumption and changing price
- -capital gains
- -statistical problems

Transfer payments

- -form of pensions, unemployment allowance, subsidies, etc.
- -these are government expenditure
- -they are not included in the national income
- -because they are paid without adding anything to the production processes
- -interest on national debt is also considered transfer payments
- -past savings without any productive work

Difficulties in	n assessing	depreciation
allowance		

-accidental damages, repair and replacement charges from the national income is not an easy task

Unpaid services

-a housewife renders a number of useful services not paid for them

Income from illegal activities

-like gambling, smuggling, illicit extraction of liquor, etc. not included in national income

Production for self – consumption and changing price

-farmers keep a large portion of food and other goods produced on the farm for self consumption

-product method is measured by the value of final goods and services at current market prices

-price do not remain stable

-they rise or fall

-calculate the real national income at a constant price index

-capital asset such as a house, other property, stocks or shares, etc.

-sold at higher price than was paid for it the time at the time of purchase

-capital gains are excluded from national income

-to avoid double counting

-accurate and reliable data are not adequate

-farm output in the subsistence sector is not completely informed

-different languages, customs create computing estimates

-people in India are different to the official inquiries

-most of the statistical staff are untrained and inefficient

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Capital gains

Statistical problems

-national income estimates out country are not

	very accurate or adequate
	-there is at least 10% margin of error
	-underestimate or overestimate
	-GDP estimates for India varies from 2 trillion
	US dollar to 5 trillion US dollar
	alai. <sup>O19</sup>
National Income and social accounting	-national income is also being measured by the social accounting method
	-the social accounting framework is useful for economists as well as policy makers
	-it represents the major economic flows and
	various sectors of the economic systems
	i calai Ota
Social accounting and sector The economy is divided into the	-the economy is divided into several sectors
following sectors	-firms, households, government, rest of the
	world capital sector
Firms	-undertake productive activities employ the
	factors of production to produce goods and
	services
	TO THE PERSON OF
Households	-consuming entities and represent the factors of production
	-receive payment from firm
	-households spend money incomes received on
	the goods and services produced by the firm
The government sector	-public bodies at all level centre, state and local
220 80 (02200000000000000000000000000000	-in their work concerning social accounting
Edey and Peacock	-defined government as a collective "person"
Man. Man.	that purchase goods and services from firm
	-these purchases may be financed through
	taxation public borrowing or any other fiscal
	means
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Social goods	-the main function of the government
	-defence, public health, education, etc.
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Rest of the world sector	-relates to international economic transactions
	of the country
	pada5 <sup>310</sup>
Capital sector	-refers to saving and investment activities -it included the transaction of bank, insurance
	corporations, financial houses, other agencies
	of the money market -these are not included under "firms"
	-these agencies provide financial assistance to
	the firm activities
	MANN Y
Sectoral contribution to GDP	-the economy is divided into three namely, primary, secondary and tertiary sectors
	W.P30°C WWW.P30°C WWW.P30
National income and welfare	Assalai Org
National income	-is considered as indicator of the economic well
	being of a country
The economic progress of countries	-is measured in terms of their GDP percapita
	and their annual growth rate
	andasalal.
A country with a higher percapita	is symmetry and to anion amount an accompanie avallance
income	-is supposed to enjoy greater economic welfare
	and higher standard of living
Limitations	-composition of goods and services not favour economic welfare
	-ex. greater the proportion of capital goods over
	consumer goods
	-improvement in economic welfare will be
	lesser
	W.Pagaz
Higher GDP	-greater environmental hazards such as air,
Tilgifol ODI	water and soil pollution will be little economic
	1 0000

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welfare

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			_vai.Org
	- 1/N - 1	oduction of was goyment of children	oods not welfare n not promote economic
	welfar	re ovo	1258/3/O19
Physical Quality of Life Index (I		indicator of econo	/// //
		and literacy	iving, life expectancy at
National income and erosion of			MMM bs
national wealth		r GDP, larger natu ed or damaged	iral resources are being
National income in terms of US	119	rmer looks very lo	. ( )(9)
		chasing Power Pai ed India looks bett	rity (PPP) method is ter
Social environment cost	-consid	dered while enume	erating national income
Personal income		ncome received by ry before payment	y the individuals of a of direct taxes
Capital sector	-it incl	udes saving and ir	nvestment activities
Social accounts		nal income considerated by economic	ering the social cost activities
Transfer payments		1211	ments in the form of allowance, subsidies,
			dasalai Org

#### **CHAPTER 3 THEORIES OF EMPLOYMENT AND INCOME**

Unemployment -is the most vexing

Both Classical economists and Keynes -have explained the relationship between

employment and income

The classical economists -great faith in the law of markets

> -articulated by J.B.Say -the French economist

J.M. Keynes -greatest and most influential economists of

the mid 20th century

Meaning of full employment -refers to a situation in which every person

willing to work

-at the prevailing wage rate is employed

Keynes defines -full employment as the absence of involuntary unemployment

Lerner defines -that level of employment at which any further

increase in spending would result in

inflationary of wages and prices

Full employment equilibrium -efficiently employed to achieve maximum

level of output

Concept of full employment -generally refers to full employment of labour

force of a country

Unemployment and its types

Unemployment -who are willing to work and able to work but

cannot find suitable jobs

-both unemployment and underemployment India's rural economy

The major features of rural unemployment -existence of unemployment in the form of disguised unemployment and seasonal unemployment

In India -frictional, structural and open unemployment

exist in urban areas

**Types of unemployment** 

In India -nature of unemployment is different from

developed countries

Developing countries -largely structural unemployment

-which is due to slow rate of capital formation

Developed countries -the unemployment is purely temporary or

cyclical or frictional

Types of unemployment -Cyclical unemployment

-Seasonal unemployment

-Frictional unemployment

-Educated unemployment

-Technical unemployment

-Structural unemployment

-Disguised unemployment

Cyclical unemployment -exists during the downturn phase of trade

cycle

-during period of recession and depression,

income and output fall

-leading to widespread unemployment

-its caused deficiency of effective demand

-cyclical unemployment can be caused by

public investment or expansionary monetary

policy

Seasonal unemployment -during certain seasons of the year

-Ex: agriculture and agro based industries

-therefore people may remain unemployed

during off season

-happens from demand side also

	-Ex: Ice cream industry, holiday resorts, etc.
Frictional unemployment	-temporary unemployment -arises due to imbalance between supply of
This is because	labour and demand for labour -immobility of labour, lack of necessary skills, break down of machinery shortage of raw
	materials, etclose jobs and search of jobs are also included
	under frictional unemployment
Educated unemployment	<ul><li>-qualification does not match the job</li><li>-faulty education system</li><li>-lack of employable skills</li></ul>
	<ul><li>-mass student turnout</li><li>-preference for white collar jobs</li></ul>
Technical unemployment	-capital intensive requires less labourers -technological unemployment -invention and innovations lead to adoption of new techniques
	-existing workers are retrenched -labour saving devices are responsible for technological unemployment
Structural unemployment	-to drastic change in the structure of the society -lack of demand for the product (or)
	-shift in demand to other products cause this type of unemployment -unemployment results from massive and deep rooted changes in economic structure
Disguised unemployment	-when more people are there than what is actually required
	-even if some workers are withdrawn production does not suffer this type of unemployment is found in
	<ul><li>-this type of unemployment is found in agriculture</li><li>-a person contribution to output is less than</li></ul>
	what he can produce by working for normal

	4953l/dl.
Situation	-Marginal productivity of labour is zero or less or negative
Classical theory of unemployment	-different views of classical economists -on the issue of income and employment in the economy
Adam Smith wrote the book	-"An enquiry into the nature and causes of the wealth of nations" in 1776
Classical theory was developed by	-David Ricardo, J.S. Mill, J.B. Say and A.C. Pigou
Classical economists assumed	-economy operates at the level of full employment -without inflation in the long period
They also assumed	-wages and price of goods were flexible -competitive market existed in the economy (laissez – faire economy)
Say's law of market	-Jean Baptist Say (1767-1832) -French economist and an industrialist -Core of the classical theory of employment -he was influenced by the writing of Adam Smith and David Ricardo
J.B. Say enunciated the proposition that	-"Supply creates its own demand" -Hence there cannot be general over production (or) -the problem of unemployment in the economy
According to Say	-when goods are produced by firms in the industry -they pay reward to the factors of production -the households after receiving rewards of the
Pa	factors of production -spend the amount on the purchase of goods ge No. 36

	019
	and services produced by them -each product produced in the economy creates demand equal to its value in the market
	demand equal to its value in the market
Classical theory explains	-A person receives his income from production which is spent on the purchase of goods and
	services produced by others
For the economy as a whole	-therefore "total production equal total income"
Everante and Everant in Covin lavy	the statement that sumply areates even demand
Ex ante and Ex post in Say's law	-the statement that supply creates own demand (or) equivalently that the aggregate investment equals the aggregate saving always hold good
	in the ex post sense since it is simply an accounting identity
Say's law of markets	-however states that these two are equal in ex ante sense
	-the total quantity which people produce -ie. aggregate supply must be equal to the total
	quantity which they plan to buy -ie. aggregate demand
Assumptions of the Say's law of market	-No single buyer or seller of commodity or
	an input can affect price -full employment
	<ul><li>-people are motivated by self interest</li><li>-it determines economic decisions</li></ul>
The laissez faire policy	-is essential for an automatic and self adjusting process of full employment
	equilibrium
	-market forces determine everything right
Perfect competition	-in labour and product market
	-there is wage-price flexibility -money acts only as a medium of exchange
	-long run analysis

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or unemployment

-there is no possibility for over production

	-unutilized resources us employment	ed until reaches full
	<ul><li>-no government interver adjustment mechanism</li></ul>	101.0.0
	-interest rate flexibility investment equality	leads is saving and
	m vestment equality	
Implications of Say's law	there is no possibility for unemployment	M.Wan.
	-unutilized resources us -it is profitable to emplo	by them up to the
	point of full employme -willing to accept rewar productivity	
As automatic price mechanism	-operates in the econom -there is no need for gov	A
Interest flexibility	-brings about equality b investment	etween saving and
Money performs	-only the medium of exceedance economy as people will	- ///
Criticism of Say's law	019	
According to Keynes	-supply does not create -it is not applicable whe increase as much as pro-	ere demand does not
	<ul><li>-automatic adjustment p</li><li>unemployment</li><li>-unemployment can be a</li></ul>	
	the rate of interest -money is not neutral	removed by mercuse in
	money to not neutral	
Individual hold	-money for unforeseen of -while business keep car activities	_

		(a) 019
28	Say's law	-is based on the proposition that supply creates its own demand
		-there is no over production
		-Keynes said that over production is possible
		-Keynes regards full employment as a special case
		-because there is under employment in
		capitalist economies
		capitalist economics
r	The need for state intervention	in the case of consul even muchystics and
	The need for state intervention	-in the case of general over production and
		mass unemployment
		$m_{n_{\alpha}}$ , $m_{n_{\alpha}}$ .
]	Keynes theory of employment and income	-the general theory of employment, interest and money
		-published in 1936
		Man. Man.
]	Highly significant work	-turning point in the development of modern
	425	economic theory
,	The theory of Voynes	against the belief of elessical economists
	The theory of Keynes	-against the belief of classical economists that the market forces
		Mac
		-in capitalist economy adjust themselves to
		attain equilibrium
		SO S
]	Keynes	-not only criticized classical economists
		-but also advocated his own theory of
		employment
		WINN.
]	Keynes theory	-was a general theory as it tried to explain
-	- alai 019	all types of situations
		-ie. not only equilibrium level of employment
		but also the concept of full employment as
		well as possibility of under employment
Pa	000 - 1	1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1
J	Keynes theory of employment	-was based on the view of the short run
	, a, 019 , a, 1019	, at O19
20	According to him	-the factors of production such as capital
		goods, supply of labour, technology and
	Pag	e No. 39

efficiency	of labour i	unchanged
CITICICITE y	or radour t	anichani 5 ca

-while determining the level of employment

John Maynard Keynes

-most influencial economists of the 20<sup>th</sup>

century

-he was born in Cambridge in 1883

-Civil servant, a director of the Bank of

England

-leader of British delegation of negotiators at

the Bretton Woods Conference

Economic theory based -idea is known as Keynesian economics

-particularly in the field of macro economics

### **Effective demand**

The starting point of Keynes theory

-of employment and income is the principle

of effective demand

Effective demand

-denotes money actually spent by the people on

products of industry

-entrepreneurs receive is paid in the form of

rent, wage, interest and profit

-therefore effective demand equal national

income

An increase in the aggregate effective

demand -ir

-increase the level of employment

A decline in total effective demand

-lead to unemployment

Total employment

-determined total demand of country

According to Keynes

-theory of employment "effective demand

signifies the money spend on consumption of

goods and services and on investment"

The total expenditure

-is equal to the national income, which

### equivalent to national output

The relationship	between	empl	oyment
1 0 2 1			

and output of an economy

-depends upon the level of effective demand which is determined by the forces of aggregate supply and aggregate demand

-ED = Y = C + I = Output = Employment

Effective demand

-determines the level of employment in the economy

-when effective demand increases employment

will increase

-when effective demand decrease, the level of

employment will decrease

The effective demand

-will be determined by two determinants namely consumption and investment expenditure

The consumption function

-depends upon income of the people and marginal propensity to consume

According to Keynes

-if income increases, consumption will also increase but by less than increase in income

The rate of interest and marginal

efficiency of capital

-determine the investment levels

Rate of interest depends

-on money supply and liquidity preference

Keynes has given importance

-concept of liquidity preference

Liquidity preference

-is based on three motive

-transactive motive

-precautionary motive

-speculative motive

MEC depends on

-two factors namely prospective yield of capita asset and supply price of capital

## Aggregate demand function (ADF)

Keynesian model

-output is determined mainly by aggregate

demand

-is the amount of money which entrepreneurs expect to get by selling the output produced by

the number of labourers employed

Therefore it is expected income or revenue

-from the sale of output at different level of employment

Aggregate demand

- -following four components
- -1. Consumption demand
- -2.Investment demand
- -3. Government expenditure
- -4.Net export (Export Import)

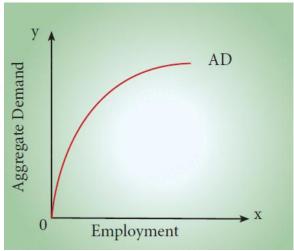
Desired demand in the economy

-is the sum total of desired private consumption expenditure, desired investment expenditure, desired government spending and desired net exports

The desired spending is called

-aggregate spending and can be expressed as

$$-AD = C + I + G + (X-M)$$



The above figure explains

Aggregate demand price increases or

decreases

-with increase or decrease in the volume of employment

. 1 (ANN) "	
Aggregate demand curve	-increases at and increasing rate in the
riggiogate demand curve	mercases at and mercasing rate in the

beginning and then increases at decreasing

rate

This shows that -as income increases owing to increase in

employment expenditure of the economy

increase at a decreasing rate

Aggregate Supply Function (ASF) -is increasing functions of the level of

employment

Aggregate supply refers -to the value of total output of goods and

services produced in an economy in a year

In other words, Aggregate supply -is equal to the value of national product

ie. national income

In other words, Aggregate supply refers -to the required amount of labourers and

materials to produce the necessary output

-production involves cost

# Aggregate supply price

Aggregate supply price -is the total amount of money that all

entrepreneurs in an economy

-expect to receive from the sale of output

produced by given number of labourers

employed

The term "price" refers -the amount of money received from the sale

of output

Components of aggregate supply are -1.Aggregate (desired) consumption expenditure (C)

-2. Aggregate (desired) private saving (S)

-3.Net tax payment (T)

Total payment to be received by the government – transfer payment, subsidy and interest payments to

to be incurred by the government

-4.Personal (desired) transfer payments to the the foreigners (Rf)

Eg: Donations to international relief efforts

Aggregate supply

-= C + S + T + Rf = Aggregate income generated in the economy

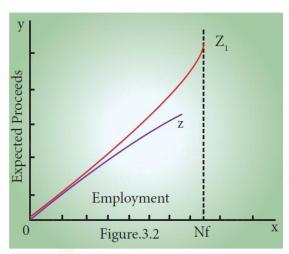


Figure 3.2 shows Aggregate Suppply curve

-the shape of the two aggregate supply curves drawn for the assumption of fixed money wage and variable wages

-Z curve is linear where money wages remains fixed

-Z1 curve is non – linear wage increase with employment

When full employment level

-Nf is reached it is impossible to increase output by employing more men

Aggregate supply curve

-become inelastic vertical straight line

The slope of aggregate supply curve

-depends on the relation between the employment and productivity

The capital stock

-often fixed

-hence the law of diminishing marginal returns takes place

-as more workers are employed

-based upon this relation

The aggregate supply curve -can be expected to slope upwards

Aggregate supply depends -on the relationship between price and wages

If prices are high -wages low

-the producers will try to employ labourers

If prices are low -wages high

-investment will be curtailed output will fall

-reduction in the productive capacity

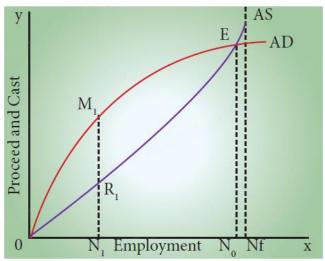
Aggregate supply -is an important factor is determining the level

of economic activity

## **Equilibrium between ADF and ASF**

Under the Keynes theory of employment

-simple two sector economy consisting of the household sector and the business sector understand the equilibrium between ADF and ASF



- -all the decisions concerning consumption expenditure
- -taken by the individual household while the business firms take decisions concerning investment
- -it is also assumed that

Consumption function

-is linear and planned investment is autonomous

There are two approach to determination of the equilibrium

- -level of income in Keynesian theory
- -1. Aggregate demand Aggregate supply approach
- -2.Saving Investment approach

Aggregate demand and aggregate supply approach

-is alone explained to understand the determination of equilibrium level of income and employment

- -the employment level is N<sub>o</sub>
- -the tendency to employ more labour will stop once they reach point E
- -at all level of employment beyond ON<sub>o</sub>
- -the aggregate demand curve is below the aggregate supply curve indicating loss to the producers
- -they will never employ more than ON<sub>o</sub> labour

Thus effective demand concept becomes

-a crucial point in determining the equilibrium level of output

-in the capitalist economy or a free market economy in the Keynesian system

-employment need not be the full employment level N1

-it is understand that the difference between

No – N1 is the level of unemployment

-becomes significant in explaining the

unemployment equilibrium

The concept of effective demand

-short – run equilibrium

-saving is a vice

Function of money

Keynesianism

Equilibrium level

-is a medium of exchange on the one side and

a store of value on the other side
-macro approach to national problems

-state intervention is advocated

Applicable to all situations -full employment and less than full

employment

-capitalism has inherent contradictions

Budgeting -should be adjusted through changes in income

The equitability between saving and

investment -is advanced through changes in income

Rate of interest -is determined by the demand for and supply

of money

-rate of interest is a flow

-demand creates its own supply

Classicism -long – run equilibrium

-saving is a social virtue

Function of money -is to act as a medium of exchange

-micro foundation to macro problems

-champions of laissez faire policy

-applicable only to the full employment

situation

-capitalism is well and good

-balanced budget

The equality between saving and

investment -achieved through changes of rate of interest

Rate of interest -is determined by saving and investment

-rate of interest is a stock

-supply creates its own demand

-rate of interest is a reward for saving