

Sahasri Singar Academy

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CA Intermediate Group 2 – Paper 8

Financial management

&

Economics for Finance

Sec B - Economics for Finance



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Chapter 1: Determination of National Income

Unit I: National Income Accounting

Part A

2 Activities:

Economic | Non – Economic

2 Goods

Final | Intermediate

Final - 1. Consumption | Investment

2. Used for more than a year

Intermediate - 1. Resale | Further Production

2. Used in the same year

Note:

1. GDP: Final Goods

2. Inventory Investment: Goods produced this year, but sold later

4 Economical Sectors:

Household | Firms (or Org) | Government | Rest of the World (or External)

2 Enterprises:

Departmental | Non – Departmental

Departmental: Government | Ex: Transport, Police,

Non – Departmental: Other than departmental, separated from Government

Ex: Steel Manufacturing, Oil Exploration, EB, FIs

4 Territorial Sectors:

Primary : Agriculture, Fishing, Forestry, Mining,

Secondary : Heavy & Light Manufacturing, Oil Refinery, Energy
Production,

Tertiary (Service) :

- Market (Trade, Transport, Real estate, Personal Services,

- Non – Market (Human health, Social Work,)

Quaternary : Technology Developers, Professional Bloggers

3 Basic Incomes:

Labour | Capital | Mixed

Labour - Wages & Salaries, Fringe Benefits, Employer's Contribution to Social Security

Capital - Profit, Interest, Dividend, Royalty

Mixed – Farmers, Sole Proprietorship, Professionals

3 Incomes (as Macroeconomic aggregates / parameters):

National Income | State Income | District Income

Domestic Income (Public & Private Sector)

Personal Income | Disposable Personal Income

Disposable National Income (GNDI & NNDI)

Public Income | Private Income

3 Approaches / Sides / Methods - NI A/Cs:

Product (w.r.t. Value Addition)

Income (w.r.t. distribution of proceeds from sales to different factors)

Expenditure (w.r.t. Final Sales of G&S)

2 Values:

“ex – post” values | “ex – ante” Values

“ex – post” values – Realised Values (i.e. actual or accounting values)

“ex – ante” Values – Anticipated Values (i.e. intended or planned values)

Measures (product side)

Gross : GDP | GNP

Net : NDP | NNP

Note:

Types of GDP

Nominal GDP – For Current Year

Real GDP – w.r.t. Base Year | Inflation Adjusted | Comparisons @ different time periods

Table A (GDP @ MP)

		Resident / Citizen / Firm	
		Indian	Foreign
Production / Income	India	GDP Market Value ALL FINAL Economic Goods & Services Gross of Depreciation Produced within DOMESTIC TERRITORY of a country	
	Foreign	NFIA (GNP = GDP + NFIA)	-

National Income, NNP (FC) = FID + NFIA

Note:

1. NFIA – Net factor Income from Abroad

= \sum Foreign Income by Indian person in Foreign - \sum Foreign Income by Foreign person in Foreign

= Net Compensation of Employees + Net income from Property and Entrepreneurship + Net retained earnings

2. FID - Domestic Income (Factor income earned in Domestic Territory)

4 Factors of Production:

Land | Labour | Capital | Entrepreneurship (combines other factors)

Land - yields Rent

Labour - yields Salaries & Wages

Capital - yields Interest

Entrepreneurship (combines other factors) - yields Profit

Table B 1 (GDP @ FC & MP)

	Compensation of Employee (C) (i.e. Salary)	xxx		
+	Operating Surplus(O) (Rent + Profit + Interest)	xxx		
+	Mixed Income of Self – Employed (M)	xxx		
+	Depreciation / CFC (D)	xxx		
	GDP (FC) = C + O+ M+ D		xxx	NDP (@ FC) = GDP (@ FP) - D
+	All * Indirect Tax (I)	xxx		
-	All * Subsidy (S) * Internal Inputs, Labour, Capital (Already included in FC) (Avoids Duplication)	xxx		
	NIT = I – S		xxx	
	GDP (MP) = GDP (FC) + NIT		xxx	NDP (@ MP) = GDP (@ MP) - D
+	NFIA		xxx	
	GNP		xxx	

Table B 2 (All parameters in short)

	GDP (FC)	xxx	NDP (@ FC) = GDP (@ FC) - D
+	NIT = I – S	xxx	
	GDP (MP)	xxx	NDP (@ MP) = GDP (@ MP) - D
+	NFIA	xxx	
	GNP	xxx	

Note:

1. For Gross → Net: Deduct Depreciation
2. For DP → NP: Add NFIA

Table B3: National Income (To arrive GDP(MC) to NI)

	GDP (MP)		xxx
-	Depreciation	xxx	
	NDP (MP)		xxx
-	NIT	xxx	
	NDP (FC)		xxx
+	NFIA	xxx	
	National Income – NNP (FC)		xxx

3 Types of Prices:

Market Price | Factor / Cost Price | Basic Price

Table C

				paid / received
	GDP (FC)		xxx	
+	Production Tax	xxx		Land Revenues, Stamps and Registration Fees, Tax on Profession, Factory License Fee, Tax – Local authorities, Pollution Tax,
-	Production Subsidy	xxx		w.r.t Railways, Village and Small Industries
	GDP (BP)		xxx	* only related to intermediate inputs (others are deducted)
+	Product Tax	xxx		Excise Duty, Sales Tax, Service Tax & Import and Export Duties
-	Product Subsidy	xxx		w.r.t Food, Petroleum and fertilizers
	GDP (MP)		xxx	

3 Methods to evaluate NI: (i.e to arrive GDP (MP), NI then follows from Table B3)

Value Method | Income Method | Expenditure Method

Status in India: Calculation of Net Value Added for

Agri Sector – Value Added Method

Small Scale Sector – Income Method

Construction Sector - Expenditure Method

1. Value Added Method: [Product / Industrial Origin / Net Output Method]

Suitability:

Importance: Unduplicated contribution by each industry to the total output

Table D – Value Added Method

	Sales		xxx
+	Closing Stock	xxx	
	Opening Stock	xxx	
+	Changes in stock	xxx	xxx
-	Intermediate Consumption	xxx	
	GVA / GDP (MP)		xxx
	National Income (Follows from Table B3)		xxx

Note:

1. Value of Output = Gross Value of Output (w.r.t Labour & Capital)

2. Include:

- Own account Production of fixed assets by Government, Enterprises & Households
- Imputed value of production of goods for self – consumption
- Imputed rent of owner - occupied houses

3. Hints for calculation Purpose: Consider

- Every main economic sectors (Primary | Secondary | Manufacturing | Quaternary)
- The net products contributed by each and every sector & Sub-sector are included

2. Income Method: Factor Income / Factor Payment / Distributed Share

Suitability: For developed Countries where people properly file their IT returns
 Includes: Factor Payments of Residents & Non – Residents within the territory

$$\text{NNP(FC) / NI} = \text{NDP (FC) + NFIA}$$

or

Table E (Same to Table B1)

	Compensation of Employee (C) (i.e. Salary)	xxx	
+	Operating Surplus(O) (Rent + Profit + Interest)	xxx	
+	Mixed Income of Self – Employed (M)	xxx	
+	Depreciation / Consumption of Fixed Capital (D)	xxx	
	GDP (FC) = C + O+ M+ D		xxx
+	All * Indirect Tax (I)	xxx	
-	All * Subsidy (S) * Internal Inputs, Labour, Capital (since already included in FC)	xxx	
	NIT = I – S		xxx
	GDP (MP) = GDP (FC) + NIT		xxx
	National Income (Follows from Table B3)		xxx

Note:

Inclusions	Exclusions
<p>Imputed value</p> <ul style="list-style-type: none"> - Rent for self – occupied houses or offices - Services provided by owners of production units (family labour) - Profits of Private Sector Business <p>Labour Income:</p> <p>Wages & Salary, Bonus, DA, Commission, Brokerages, Employer’s contribution to PF, imputed value of compensation</p> <p>Non – Labour Income:</p> <p>Rent(Actual & Imputed), Royalty, Interest on loans availed for productive services, dividends, undistributed profits of corporations b/f tax, Profits of unincorporated enterprises and of Government enterprises</p>	<p>Transfer Payments (pension, Social Insurance) (as not received for any services in the current Year)</p> <p>Receipts of Sale of 2nd hand goods (as no new flow of goods)</p> <p>Windfall gains (Lotteries) (Not receipts from any productive activity)</p> <p>Corporate Profit (Not to be separately included as already included as part of company profit) [Profit = Corporate Tax + Dividend + Retained Earnings]</p> <p>Capital Gains</p> <p>Financial assets & payments out of past savings</p> <p>Interest paid on Public Debt, Consumption Loans, by one firm to another</p>

Note:

Hints for calculation Purpose: Includes

Income from people in jobs and in Self - Employment (e.g. wages & salaries)

Profits of private sector business

Rent income from the ownership of land

3. Expenditure Method (w.r.t. Aggregate Demand):

Income Disposal Approach / Outlay Method

Suitability: Growing facility in the use of the commodity flow method of estimating expenditures, an increasing proportion of the NI is estimated using this method

$$\text{GDP (MP)} = \text{Sum of Final Expenditure} = \sum \text{Final Expenditure}$$

Table F:

	Private Final Consumption Expenditure – C	xxx	
+	Government / Public Consumption Expenditure – G	xxx	
+	Gross Domestic Capital Formation - I	xxx	
+	Net Exports, (X - M)	xxx	xxx
	GDP (MP) = C + G + I + (X - M)		xxx
	National Income (Follows from Table B3)		xxx

Note:

If Net Imports given, then it is to be deducted (because Net Imports = M-X)

Overall Note:

- All the method should arrive equal value
- 3D View
- Measurement Errors (all the methods complement each other)
- Different Methods gives different insights into structure of our economy

Value Added Method - w.r.t. 4 Territorial Sectors

Income Method - w.r.t. FoP

Expenditure Method - w.r.t. 4 Economic Sectors

Table G: PI & DPI

	National Income (NI)	xxx
+ Income Received but not Earned	Transfer payments to the households from firms & Governments Current Transfer from Firms, Govt & Rest of the world (Ex: Net private donations, Fees & Fines paid to Federal State & others) Interest on National Debt	xxx
- Income Earned but not received	Undistributed (Corp) Profits Net interest Payments made by households to Frims & Governments Corporate (Profit) Tax Income from Property & Entrepreneurship accruing to Govt administrative departments Income from Domestic Product accruing to Govt Saving of Non-departmental enterprises, Private corporate sector Contribution of employees to social security	xxx
	Personal Income (PI)	xxx
-	Personal Income Tax (Direct Tax,) Non - Tax Payments (Compulsory payments to Governments like PF,)	xxx
	Disposable Personal Income (DPI)	xxx

Note:

1. Transfer Payments: Social Security | unemployed compensation | Welfare Payments
2. PI excludes: Retained Earnings | Corporate Tax | IDT (business)
3. Social Transfers (Pension, Relief subsidy)
4. DPI
 - Consumption + Saving
 - w.r.t Individuals | available for consumption
 - NNDI & GNDI reflects the amount of G & S the domestic economy has at its disposal

Table H: NNDI & GNDI

	Net National Income (NNI) (i.e. NNP)	xxx
+	Net Taxes on income and wealth receivable from abroad	xxx
Net Current Transfers from the rest of the world (Receipts – Payments)	Net social Contributions & benefits receivable from abroad	
	Net National Disposable Income (NNDI)	xxx
+	Depreciation (CFC)	xxx
	Gross National Disposable Income (GNDI)	xxx

Note:

1. $GNI / GNP - Dep = NNI$

2. Current Transfers – Current Transfers other than the Primary Income

Domestic Income:

Public Sector | Private Sector

Public Sector – Includes *(Income from Property & Entrepreneurship accruing to government administrative departments & Savings of non – departmental enterprises)

Private Sector: **Table I**

	NDP (FC)	xxx
-	Income from Property & Entrepreneurship accruing to Government administrative departments	xxx
	Savings of non – departmental enterprises	xxx

Private Income

- The income which accrues to a private sector from all sectors within & outside the country

- Includes Factor & Transfer Income

Table J: (Follows from Table I)

	NDP (FC)		xxx
-	Income from Property & Entrepreneurship accruing to government administrative departments	xxx	
	Savings of non – departmental enterprises	xxx	
	Factor Income from NDP accruing to private Sector		xxx
+	NFIA	xxx	
+	National Debt Interest	xxx	
+	Current Transfers from Government	xxx	
+	Other net transfer from the rest of the world	xxx	
	Private Income		xxx

Note:

Non – Departmental Enterprises: Separated from Government

Examples: Steel Manufacturing | Oil Exploration | Electricity Generation | FIs,

Misc...

Stock – A Quantity of a commodity that is constant at a point of time (Static)

Flow – Variables measured over a period of time

PQLI – Better indicator of Economic welfare than NI

NI should include loss of natural resources

Purchasing Power Parity (PPP) Method rather than US \$

National Income

- A Macro Economic Aggregate
- Equals to the Value of Aggregate Supply

$GDP\ Deflator / Price\ Index = (Nominal\ GDP / Real\ GDP) * 100$

$(NI\ (@\ Constant\ Price = NI\ (@Current\ Price / (P1/P0))$

$Inflation\ Rate = (GDP\ Deflator\ @\ nth\ year - GDP\ Deflator\ @\ n-1\ th\ year) / GDP\ Deflator\ @\ n-1\ th\ year * 100$

More on GDP:

Includes	Excludes
Service fee	Transfer Payments
Capital Goods (Business Plant and Equipment Purchased)	Financial Transactions
Inventory Investment	Non-reported output (illegal activities)
	w.r.t. Intermediate Goods

The System of Regional Accounts in India

- An integrated database on the innumerable transactions taking place in the regional economy
- Helps in in decision making at regional level

@ State Level

Prepared by State Income Units, State Directorates of Economics & Statistics (DESS)

Assisted by CSO, advises on conceptual and methodological problems

Supra – Regional Sectors:

- Sectors that cut across state boundaries
- Economic contribution combined as a whole, as cannot be assigned to one state and allocated on the basis of relevant indicators
- Sectors includes: Railways, Communications, Banking and Insurance, Central Government Administration

$\text{GDP per capita / per capita income} = \text{Real GDP} / \text{Total Population}$

$\text{per capita State income} = \text{NSDP} / \text{Mid - Year projected State Population}$

Note:

1. NSDP = State Income
2. State Income is not duplicated

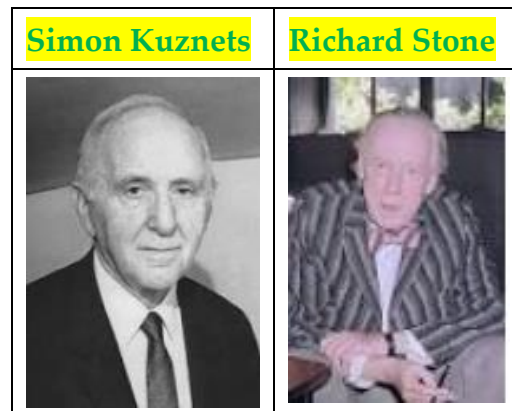
Part B

Introduction:

- Performance of a country depends on the output of the G&S
- Like Accounting Conventions, Conventions for measuring & analysis the economics performance exist

National Income (NI) Accounting:

Pioneered by



- An important macroeconomic aggregate
- Forms the basis of modern macroeconomic analysis
- provides detailed measures of the value & composition of national output and incomes generated in the production of that output

Usefulness and Significance of National Income Estimates

1. Analyses & Evaluates the short run performance

Indicates the level of economic activity, development & aggregate demand for G&S of a country

2. Distribution pattern determines the pattern of the demand | Forecasts the product's future demand

3. Economic welfare depends to a considerable extent on the magnitude and distribution of national income, size of per capita income and the growth of these over time.

4. Shows the composition and structure of national income in terms of different sectors of the economy, the periodical variations in them and the broad sectoral shifts in an economy over time.

Makes temporal and spatial comparisons of the trend and speed of economic progress and development.

With this, Government can fix various sector-specific development targets for different sectors of the economy and formulate suitable development plans and policies to increase growth rates.

5. Provides a quantitative basis for macroeconomic modelling and analysis, for assessing and choosing economic policies and for objective statement as well as evaluation of governments' economic policies. These figures often influence popular and political judgments about the relative success of economic programmes.

6. Throws light on income distribution and the possible inequality in the distribution among different categories of income earners. It is also possible to make comparisons of structural statistics, such as ratios of investment, taxes, or government expenditures to GDP.

7. International comparisons in respect of incomes and living standards assist in determining eligibility for loans, and/or other funds or conditions under which such loans, and/or funds are made available. The national income data are also useful to determine the share of nation's contributions to various international bodies.

8. Combined with financial and monetary data, national income data provides a guide to make policies for growth and inflation.

9. National income or a relevant component of it is an indispensable variable considered in economic forecasting and to make projections about the future development trends of the economy

Different Concepts of NI:

SNA: Concepts & definitions | To provide a comprehensive, Conceptual & accounting framework

Definition:

- A measure of the total flow of 'earnings of the factor-owners' which they receive through the production of goods and services
- The sum total of all the incomes accruing over a specified period to the residents of a country and consists of wages, salaries, profits, rent and interest.

GDP

- A measure of production activity: Production Boundary - Reference from SNA, classification as per NIC

Measurement of NI in India

NAS:

- Compiled by National Accounts Division, CSO, MOSPI
- Annual & Quarterly
- Key source – material for all macraeconomic data of the country

Mandate to use GDP (Current Prices):

- Fiscal Responsibility & Budget Management Act 2003, MoF
- To determine Fiscal Targets

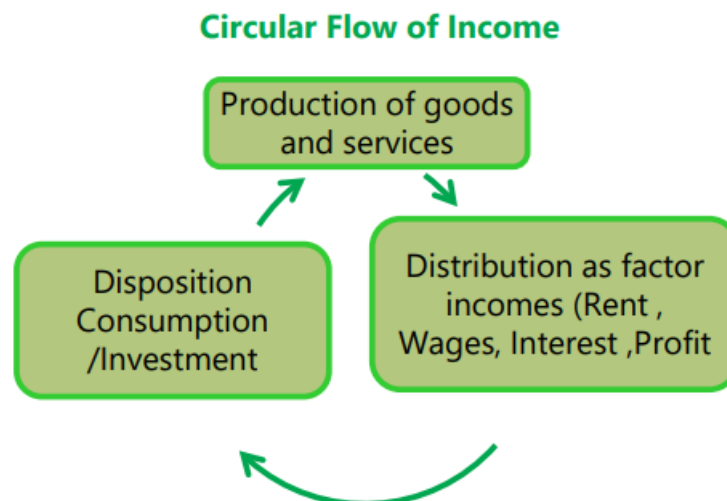
Revision:

By MOSPI: Base Year from 2004-05 to 2011-12

By CSO, Jan 2015: Sector wise estimates of GVA@ BP instead of FC

The Circular Flow of Income – 3 Phases

- Continuous circulation of
Production | Income / Distribution | Generation | Expenditure / Disposition
- Flows simultaneously
- Results to 3 different methods



More on Expenditure Method:

Final Consumption Expenditure

(a) Private Final Consumption Expenditure (PFCE)

$$\sum (Volume\ of\ Final\ G\&S\ to\ Households\ \&\ Non - Profit\ Institutions\ *) \times MP$$

* serving households acquired for consumption and not for use in production

Includes:

Primary Products (produced for own consumption by the households)

Payments for domestic services which one household renders to another

The net expenditure on foreign financial assets / net foreign investment

Excludes:

Land and residential buildings purchased or constructed by households (since included in Gross Capital Formation)

(b) Government / Public Final Consumption Expenditure

Includes: Money Spent for Collective Services (since these services are not sold in the market)

Excludes: Transfer Payments (Pensions, Scholarships, Unemployment Allowance)

2. Gross Domestic Capital / Investment Formation:

- Country's Total expenditure (not consumed but added to the nation's fixed tangible assets & stocks)

Includes:

Acquisition of fixed assets:

Machinery and equipment - Final expenditure & own account production

Expenditure on construction, changes in inventories, acquisition of valuables such as, jewellery and works of art

Accumulation of stocks: In the form of changes in stock of raw materials, fuels, finished goods and semi-finished goods awaiting completion

3. Net Exports:

Difference between Exports & Imports, [X - M]

Nature: Negative / Positive

GDP & Welfare: Why GDP is not a perfect measure?

GDP excludes:

1. Different income distributions and different levels of overall well being for the same level of per capita income
2. Quality improvements in systems and processes due to technological as well as managerial innovations which reflect true growth in output from year to year
3. Productions hidden from government authorities, either because those engaged in it are evading taxes or because it is illegal (drugs, gambling etc.).
4. Non - market production (with a few exceptions) and Non-economic contributors to well-being

Example: Health of a country's citizens, education levels, political participation, or other social and political factors that may significantly affect well-being levels.

5. The disutility of loss of leisure time. We know that, other things remaining the same, a country's GDP rises if the total hours of work increase

6. Economic 'bads'

Example: crime, pollution, traffic congestion etc which make us worse off.

7. The volunteer work and services rendered without remuneration undertaken in the economy, even though such work can contribute to social well-being as much as paid work.

8. Many things that contribute to our economic welfare such as, leisure time, fairness, gender equality, security of community feeling etc.

9. Both positive and negative externalities which are external effects that do not form part of market transactions

10. The distinction between production that makes us better off and production that only prevents us from becoming worse off, for e.g. defence expenditures such as on police protection.

Increased expenditure on police due to increase in crimes may increase GDP but these expenses only prevent us from becoming worse off.

However, no reflection is made in national income of the negative impacts of higher crime rates. As another example, automobile accidents result in production of repairs, output of medical services, insurance, and legal services all of which are production included in GDP just as any other production.

Limitations / Challenges / Complexity / Conceptual Difficulties

- (a) Lack of an agreed definition of NI
- (b) Accurate distinction between final goods and intermediate goods
- (c) Issue of transfer payments
- (d) Services of durable goods
- (e) Difficulty of incorporating distribution of income
- (f) Valuation of a new good at constant prices
- (g) Valuation of government services
- (h) Inadequacy of data and lack of reliability of available data
- (i) Presence of non-monetised sector
- (j) Production for self-consumption
- (k) Absence of recording of incomes due to illiteracy and ignorance
- (l) Lack of proper occupational classification
- (m) Accurate estimation of consumption of fixed capital

Annexures

A1 – Abbreviations

CFC	-	Consumption of Fixed Capital
CSO	-	Central Statistical Organisation / Office
DP	-	Domestic Product
DPI	-	Disposable Personal Income
FC / FP	-	Factor Cost / Factor Price
FIs	-	Financial Institutions
FID	-	Factor Income earned in Domestic Territory
G & S	-	Goods & Service
GDP	-	Gross Domestic Product
GNDI	-	Gross National Disposable Income
GNP	-	Gross National Product
NDP	-	Net Domestic Product
NFIA	-	Net Factor Income from Abroad
NI	-	National Income
NIC	-	National Industrial Classification
NIT	-	Net of Indirect Taxes
NNDI	-	Net National Disposable Income
NNP	-	Net National Pro-duct
NP	-	National Product
NSA	-	National Accounts Statistics
NSDP	-	Net State Domestic Product
M	-	Import
MoF	-	Ministry of Finance
MP	-	Market Price
MOSPI	-	Ministry of Statistics and Programme

PPP	-	Purchase Power Parity
PQLI	-	Physical Quality of Life Index
SNA	-	UN System of National Accounts
X	-	Export
X – M	-	Net Exports

**A2 - John Maynard Keynesian
[Father of Macro – Economics]**

