AAT LEVEL 01 – ECONOMICS

Chapter 04

National Accounting & Role of the Government

4.1 Macroeconomic Objectives

A country's economic management aims to achieve the following key objectives:

Price Stability	Managing the economy without inflationary or deflationary pressures. The average price level is stable when the economy experiences very low rates of inflation.
Full Employment	All resources in the economy are utilised with maximum efficiency. Labour unemployment is minimised by increasing employment opportunities.
BOP Equilibrium	Achieving Balance of Payment (BOP) equilibrium by managing the economy without BOP crises when exchanging goods/services across boundaries.(Exports & Imports)
Fair Distribution of Income	Ensuring income and wealth are distributed so that every citizen can fulfil their wants and needs, achieving equality.
Sustainable Development	Enhancing production while protecting the environment and ensuring benefits of development are distributed among the population.
Economic Growth	Continuous increase in a country's Gross National Product (GNP) over time.

4.1.1 Macroeconomic Policies

Policies and strategies employed in managing an economy of a country are considered as Macro Economic policies.

Key Policy Types:

Policy	Description
Monetary Policy	Used by Government & Central Bank to determine **money supply size and rate**, affecting interest rates, exchange rates and price levels.
Fiscal Policy	Changes to **government revenue, expenditure** and government debt. Includes decisions on taxation and government spending.
Supply Side Policies	Designed to **enhance productive capacities** (Aggregate Supply). Tools include privatisation, deregulation and tax reforms.
Income Policy	Controls economy-wide **wage rates and price levels**, mainly to curb inflationary pressures.
Foreign Trade Policy	**Influences international trade** using tools such as taxes, tariffs, export subsidies, import quotas and exchange rate manipulation.
Direct Controls	Government intervention in the free market — **controlling ownership, distribution of resources** and price levels.

4.2 Business Cycle

Draw the diagram in the recording.

Phases of the Business Cycle:

- Peak – The highest point of real GDP in a cycle
- Declining Period – GDP starts to fall from the peak
- Trough – The lowest point; GDP reaches its minimum
- Expanding Period – GDP begins to recover and grow

A fall in output for more than 6 consecutive months is called a RECESSION. A prolonged increase in output is called an ECONOMIC Decline.

4.3 Circular Flow of Income

Draw the diagram in the recording.

4.3.1 The Four Sectors

Sector	Role
Household Sector	Owners of production factors. Earn factor income, purchase goods/services, pay taxes and receive transfer payments. Identified as the savings sector.
Business Sector	Private & government institutions producing goods/services using factors of production from households. Pay dividends, taxes and retain profits.
Government Sector	Public institutions providing welfare services (health, education, defence). Provides consumer and product subsidies.
Foreign Sector	Deals with imports, exports, capital inflows and international settlements.

4.3.2 Markets

- **Factor Market** – Where factors of production (land, labour, capital, entrepreneurship) are bought and sold. Households supply; earnings are called factor income.
- **Goods & Services Market** – Where goods and services produced by businesses are sold to households and government.

4.3.3 Withdrawals / Leakages

Leakages	Part of household income that does NOT flow back to the business sector. Leakages have a CONTRACTIONARY effect on national income.

The three leakages are:

- Savings (S)
- Government Taxes (T)
- Imports (M)

Remember: S + T + M = Total Leakages

4.3.4 Injections / Additions

Injections	Any income that flows INTO the circular flow in addition to household-to-business flows. Injections have an EXPANSIONARY effect on national income.

The three injections are:

- Investments (I)
- Government Expenditure (G)
- Exports (X)

4.3.5 Simple / Closed Economy

A simple economy has only TWO sectors: Household and Business.

- Households supply all factors of production to business sector
- All income earned is spent on consumption — no savings, investments or capital goods
- Real flow: factors of production flow from household → business; goods/services flow back
- Financial flow: wages/rent/interest/profit flow to households; payments for goods/services flow to business

4.4 National Income Accounting

National Income Accounting	Measures the total value of goods and services produced in an economy within a given time period. Used to assess the overall performance of an economy.

4.4.1 Institutional Units (6 Types)

Unit	Description
1. Non-Financial Corporation (NFC)	Private & state organisations that produce goods/services for the market.
2. Financial Corporation (CFC)	Private & state organisations providing financial services — banking, insurance, leasing.
3. General Government (GG)	Public institutions providing services for private and collective consumption without profit motive (health, education, defence).
4. NPISH	Non-Profit Institutions Serving Households — supply goods/services free or below market price (religious orgs, trade unions, political parties).
5. Household Sector (HH)	Both consumers and producers. Includes those producing for own use and for the market. Clergy and imprisoned persons are also included.
6. Rest of the World (ROW)	Foreign sector — represents all transactions with foreign countries.

4.4.2 Economic Territory

Economic Territory	An area that comes under the effective control of the government, within which persons, goods and capital can move freely.

Sri Lanka's economic territory consists of:

- All domestic units located in the geographical area of Sri Lanka
- Sri Lankan embassies located around the world
- Territorial waters and aircrafts/ships controlled by Sri Lanka

4.4.3 Production

Production	An activity of combining factor inputs (labour, capital, raw materials) under the control of an institutional unit to produce goods or services.

Things occurring naturally without human intervention (rivers, rain, forests) are NOT considered economic production and not included to GDP calculations.

4.4.4 Production Boundary

Separating activities that qualify for national income accounts from those that do not is called drawing the production boundary.

INCLUDED in National Income:

- Domestic services provided by owner-occupied housing units
- Domestic and personal services rendered by paid domestic staff
- All goods retained by producers for final consumption or capital formation
- Goods/services produced to be supplied to other institutional units
- Producing & storing food crops, gathering firewood, hunting and fishing
- Processing agricultural products (rice milling, meat/fish processing, weaving)

NOT INCLUDED in National Income (private consumption activities):

- Cleaning, decorating, maintaining own dwelling
- Preparation and serving of food at home
- Caring for children, sick, elderly
- Transportation of household members and goods

4.4.5 Unobserved Economic Activities

Type	Description
Hidden Economic Activities	Legal activities not subjected to systematic calculation — deliberately hidden to evade taxes, avoid social security contributions or bypass regulations.
Illegal Economic Activities (Type 1)	Production/distribution of legally prohibited goods & services (drug trafficking, illegal tree felling, prostitution).
Illegal Economic Activities (Type 2)	Production/distribution without legal authority (practising medicine without registration, driving without a licence, sand mining without a permit).

What is Included / Excluded from GDP

Included in GDP	Excluded from GDP (Productive but not counted)
All goods and services produced	Studying and leisure
Domestic services from own dwelling	Natural resources obtained free (land, water, air)
Labour sacrificed for wages	Unpaid domestic services
Items produced for own consumption	Natural resources growing without human effort (forests)
Goods produced using	Change in value of resources due to price changes

voluntary labour	

Non-Productive Activities NOT included in GDP:

- Transfer Payments
- Payments related to financial instruments
- Payments made for selling used/second-hand items

Importance of National Accounts

- To assess economic performance
- To make comparisons with other countries
- To measure economic growth
- To understand the economic structure of the country
- To estimate per capita national income
- To forecast the behaviour of macroeconomic variables
- To identify functional relationships between economic factors

Limitations of National Income Accounts

- Non-inclusion of productive activities in the informal economy
- Non-inclusion of services provided by housewives
- Non-consideration of damage to the environment
- Non-consideration of changes in public service productivity
- Inclusion of defence/war expenditure under productive activities
- Non-inclusion of some long-lasting consumer goods (classified as investments)

4.5 Basic Price, Producer's Price & Purchaser's Price

Price Type	Formula / Explanation
Basic Price	**Price received by the producer.** (The price received by the producer excluding taxes on products, but including product subsidies.)
Producer's Price	**Price at which the products leaves the factory**. (Basic Price + Taxes on Production − Subsidies on Production)
Purchaser's Price	**Final price which the customer pays when purchasing the products.** (Producer's Price + Transportation charges + Wholesale/Retail margins − Subsidies to traders + Taxes on goods paid by consumers)

4.6 Government Failure

Government Failure	When government intervention to correct market failures creates further inefficiencies without providing desired outcomes, due to weaknesses in the public sector.

Reasons for Government Failure:

- **Political Selfishness** – Public officials acting in personal interests
- **Increase of Administrative Expenses** – Excessive spending on governmental activities
- **Avoiding Government Interference** – Individuals/institutions hiding from rules and regulations
- **Firmness in Government Operations** – Failure to adapt policies to changing environments

4.7 Role of Government in a Market Economy

1. Distribution of Resources Efficiently

- Encouraging consumption of welfare (merit) goods
- Supply of public goods
- Supply of quasi-public goods
- Restriction of supply of demerit goods

2. Equitable Distribution of Income & Wealth

- Land reforms
- Establishment of income and wealth distribution systems
- Setting restrictions on wealth accumulation

3. Macroeconomic Stability

Controlling inflation and unemployment through fiscal policy.

4. Sustainable Development

Maintaining a market system through balanced improvement of economic, social and environmental sectors.

4.8 Fiscal Policy & Its Instruments

Fiscal Policy	Changes to government expenditure, taxation and borrowings to achieve macroeconomic goals. Also known as Budgetary Policy.

Three Types of Fiscal Policy:

- **Contractionary Fiscal Policy** – Reduce government spending / increase taxes (to control inflation)

- **Expansionary Fiscal Policy** – Increase government spending / reduce taxes (to expand the economy)
- **Neutral Fiscal Policy** – Balanced; no net effect on the economy

Two Components of Fiscal Policy:

- Government Expenditure
- Government Revenue

4.8.1 Government Expenditure

Type	Description
Recurrent Expenditure (repeated expenses)	All government payments EXCEPT acquiring real assets used in production for more than one year and capital transfers.
→ Goods & Services	Day-to-day operational spending
→ Interest Payments	Interest paid on government debt
→ Recurrent Transfers & Subsidies	Subsidies and transfer payments to households/businesses
Capital Expenditure (One time expenses)	Spending on acquiring real assets (machinery, infrastructure) used in production for more than one year.

4.10 Government Budget, Taxes & Deficit

4.10.1 State Budget

State Budget	A report presented to Parliament annually, outlining expected government expenditure and means of raising revenue. It reflects the government's fiscal plan.

Three Types of Budget Balance:

Budget Type	Condition
Deficit Budget	Gov. Expenditure > Gov. Revenue
Excess (Surplus) Budget	Gov. Expenditure < Gov. Revenue
Balanced Budget	Gov. Expenditure = Gov. Revenue

Budget Deficit Financing Sources

1. Domestic Sources:

- **Market Sources** – Treasury bills and treasury bonds
  - **Banking system** – Loans from Central Bank and commercial banks (inflationary)
  - **Non-banking sources** – National savings bank, insurance companies, EPF (non-inflationary)
- **Non-Market Sources** – Internal government deposits and surplus funds of government institutions

2. Foreign Sources:

- **Foreign Loans** – Concessionary (low interest, grace period) or Non-concessionary/Commercial (high interest)
- **Foreign Aids – Grants**; can have inflationary effects when converted to domestic currency

Borrowing from banking system = Inflationary | Borrowing from non-banking sources = Non-inflationary | Non-market source borrowing = No money supply expansion

Effects of Continuing Budget Deficit & Public Debt

- Increase in market interest rates
- Shortage of domestic financial resources for private sector investment (Crowding Out Effect)
- Unfavourable effects when borrowing from Central Bank and commercial banks

4.10.2 Measures to Review the State Budget

Measure	Definition
Current Account Balance	Total Revenue (excl. grants) − Recurrent Expenditure
Total Account Balance	Total Revenue (incl. grants) − Total Expenditure (recurrent + capital)
Primary Account Balance	Total Revenue (incl. grants) − (Recurrent Expenditure excl. interest payments + Capital Expenditure)
Net Fiscal Deficit	Total Government Expenditure − Installment Payments − Total Revenue (incl. grants)

4.10.3 Types of Taxes

Tax Type	Description & Examples
Direct Tax	**Paid by the person/entity** legally liable. **Cannot be transferred to another party.** The taxable person bears the full burden. Examples: Income Tax, Property Tax.
Indirect Tax	The legally liable person **transfers the tax burden to another**

	person. Examples: VAT, Customs Duty.

4.10.4 Macroeconomic Measurements & Business Impact

Measurement	Impact on Business
Economic Growth (Real GDP growth)	Creates new business opportunities and expands existing business sectors.
Full Employment	Enables businesses to optimise human and physical resources; skilled manpower is available.
Equitable Income Distribution	Proper wealth distribution has direct impact on large-scale business sectors.
Price Stability	Low inflation directly impacts cost and profit of businesses.
Sustainable Development	Businesses should increase income while preserving ecological balance.
BOP Equilibrium	Allows businesses to carry out import and export activities smoothly.