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AAT 1 National Accounting

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CHAPTER 06

National Income Accounting and Role of the Government

Macro Economics

It is the branch studying the behavior of an economy as whole and it covers national level economics phenomena such as unemployment, national income, inflation price level, economic growth rate, GDP and balance of payment etc.

There are certain relationships with regard to national production, national income & national expenditure.

The major macro-economic objectives:

1. **Full employment.**

   An economy achieves full employment level when all the resuor4ces in the economy are utilized in the full with maximum efficiency. Therefore it is necessary to increasing employment opportunities.

2. **Price stability.**

   It is necessary to manage the economy without inflationary or deflationary pressures. Average price level in the economy is stable when economy experiences very lower rate.

3. **Balance of payment equilibrium.**

   It is important to manage without any crisis when exchange across boundaries

4. **Equity or social justice or fair distribution of income**

   Ensuring fair level of income distribution among its population, a country is able to achieve equality

5. **Economy growth.**

   It means continuous improvement in capable of producing goods and services in order to satisfy the want of the member of society compared from one period to another period.

6. **Sustainable development.**

   Enhancing level of production while protecting the quality of environment and also ensuring that benefits of developments are distributed among public. All aspects of development in EONIMC, ENVIRONMENT AND SUSTAINABLE DEVELOPMENT. Therefore it includes improvement of tri components they are economic, environment and social of an economy should be developed over the period of time.

   ### Macro-economic variables

   1. Aggregate output
   2. Employment
   3. price level
   4. balance of payment

Macro-Economic management policies

1. Monetary policy
2. Fiscal policy
3. Supply side policy
4. Foreign trade policy
5. Direct control
6. Income policy

1. **Monetary policy**

   The following are the main instrument of implementing monetary policy,

   a. Money supply
   b. Rate of Interest

   Here it is possible to influence the macroeconomic variable such as consumption, output, savings, price level etc.

2. **Fiscal Policy**

   The following are the main instrument of implementing fiscal policy.

   a. Taxation
   b. Government Revenue
   c. Government Expenditure
   d. Government Department

3. **Supply side policy**
   The following facilities are given encourage production process

   a. Tax reliefs
   b. Privatization
   c. Development of infrastructure such as communication, transportation harbor etc.
   d. Improvement of technology

4. **Foreign trade policy**
   The following instruments are used in foreign trade policy,

   a. Tariffs
   b. Imports quotas
   c. Export subsides
   d. Adjustment of foreign exchange rate
   e. Dumping
   f. Prohibition of some imports

5. **Direct Control**

   The following instruments are used in direct control policy,

   a. Price control policy.
   b. Minimum wage determination.
   c. Restriction of land ownership.
   d. Prohibition of production & distribution of certain goods.

6. **Income policy**

   Business cycle and its impact

   The upward and downward movement of real GDP over time is known as business cycle.

Macro-Economic Agents

1. Household sector
   - Owners of production factors
   - Factor earners by supplying its own production factors
   - Purchasing good and services from business firms
   - Paying tax to the government
   - Saving factor

2. Business firm sector
   - Private and government institutions
   - Production of goods and services
   - Receiving factors of production from household sector
   - Part of profit pay as dividends
   - Partly pay as tax
   - Remainder will be retained with the institution for investments

3. Government Sector
   - Provide social welfare such as law enforcement. National security , education, health and highways
   - Providing consumer subsidies and producer subsidies

4. Foreign sector
   - Imports and exports
   - Capital inflows and settlements

Circular flow of an Economy

1. Simple economy
   a. With savings
   b. Without savings

2. Closed economy
3. Open economy

a. Without savings

b. Open economy

NOTE:

1. Two sector economy (simple economy with savings)
2. Three sector economy (closed Economy)
3. Four sector Economy (open Economy)

<u>In the Equilibrium Level</u>

Withdrawal Approach – Injection Approach

(W=J)

1. S= I
2. S+T=I+G
3. S+T+M=I+G+X

Aggregate Income – Aggregate Expense

(Y=E)

1. Y=C+I
2. Y=C+I+G
3. Y=C+I+G+(X-M)/NX

If transfers exists we say net tax (NT) instead of tax (T) it means NT=T-TR

National income accounting

It means the total value of goods and services produced in and economy within the certain time period and this is calculated through the preparation of national income accounts

Institutional units

There are five main institutional units exist within a total economic area.

- The non-financial corporations sector (NFC)

  Various corporations and companies whose main aim is production for the market are included in this sector. Production companies in both government and private sector include under this.

- The financial corporations sector (FC)

  Corporations and companies whose principal activity is providing financial services include under this category. Financial intermediation and provision of other special goods and services are the functions of this sector. Corporations in both government and private sector include under this.

- The government sector (GS)

  Various government institutions that provide services aiming private and collective consumption without aiming market include under government sector. Examples: - Education, health, defense, protection of environment

- The non-profit institutions serving households sector (NPISH)

  Institutions that provide services for households freely or at a price less than the market price are included in this sector. Workers or members of these institutions dedicate their labor voluntarily.

  Examples:-Charities, religious organizations, political parties

- Households sector (HH) Household units that engage in production aiming own consumption or aiming market are included in this sector. Both consumers and producers exist within this sector. The clergy and prisoners are also included in this sector.
- Rest of the world (ROR)

  Apart from the above mentioned five residential institutional units there is another institutional units that includes non-residential households and corporations. It is called the rest of the world (ROR).

Production boundary

It is necessary of identifying what production is covered and what production is not covered in the national income accounting

The following are production economic activities and included in national income accounting

- All goods and services that are produced for institutional units other than for the institution produced.
- All goods that are retained by their producers with themselves having produced them for their own final consumption or for purchasing of capital.
- The own-account production of housing services by owner occupiers.
- Domestic and personal services performed by paid domestic staff.
- Producing of agricultural crops for own consumption, storing of those, gathering of fruits and obtaining of foods from forests, chopping and gathering of wood, hunting and catching fish.
- The processing of agricultural products, the production of grain by threshing, the production of flour by milling, the preparation of meat and fish for preservation, bottling and drying of fruits, making curd, weaving of baskets, bags and mats; etc.
- Weaving cloth, dress making, making furniture.
- The supply of water (mini projects to supply water through small streams and water falls).

In this way, the goods production activities taken place within a household are included in the production boundary but the services performed by a member of a household for their own consumption are not considered as economically productive activities.

- The preparation of foods for members of a household.
- Looking after the children.
- The care of old and infirm people of a household.
- Activities such as decorating and cleaning of a house

Unobserved economic activities

1. <u>Hidden economic activities</u>

   Are those legal economics activates that are not captured in formal statistical enquiries.

Several reasons affecting to hide these economic activities purposely.

- To avoid payment of tax
- To avoid the payment of social security contributions
- To avoid having to meet certain legal standards Example:- Payment of minimum wages, laws relating to maximum work hours
- Disinclination towards complying with other administrative regulations

2. <u>Illegal economic activities</u>

There are two forms of illegal economic activities.

- The production and distribution of goods and services forbidden by law.

  Example: - Alcoholic, drugs, prostitution, transportation of goods prohibited
- Some legal goods and services produced and distributed by unauthorized people.

  Example: - Unlicensed medical practitioners

Productive economic activities which are included in gross domestic production

All the goods and services are produced

Domestic serviced obtained from one's own dwelling

Labor sacrificed for wages

Items produced for one's own consumption

Goods and serviced produced and provided utilizing voluntary labor

Productive economic activities not included in Gross Domestic Product.

- Unpaid household work.
- Freely obtained natural resources (Land, water, air etc.).
- Natural resources grown without the intervention of man (such as forests).
- Education and leisure.
- Change in value of resources due to natural growth or change in prices.

Nonproductive transactions excluded in national income accounting.

- Transfer payments
- Transactions relating to financial papers
- Transactions relating to second hand products

Main uses of national accounting is shown below.

- To assess the duty of an economy
- To measure economic growth

- To estimate per capita GDP
- For international comparisons
- To identify functional relationships between economic actors
- To reveal resource stock and resource utilization
- To obtain information for economic management
- To forecast behavior of macroeconomic variables

Three Approaches of National Income Accounting

There are three types of approaches normally use under the national income accounting.

1. Production approach
2. Income Approach
3. Expenditure Approach

A. Production Approach

To estimate the value of the national output by eliminating the multiple counting error two approaches are being used.

1. Final product approach
2. Value addition approach

- If national output is estimated either by using final product approach or value addition approach it should provide the same value.
- The value of goods and services which have passed the final stage of production process or in other words goods and services that can be consumed or invested without processing further is called the final product approach.
- Although the final product approach is used to eliminate the problem of multiple counting error it also has problems.
- This happens due to the difficulty of identifying consumer goods and intermediate goods separately.

Example: - Although sugar is considered as a final good it can be an intermediate good for a confectionary producer.

- The most suitable approach to estimate the value of national output avoiding these weaknesses of final product approach would be the value addition approach.
- The financial value of goods and services produced is identified as the gross value of output. (GVO)
- Goods and services purchased from outside to the production process are identified as intermediate inputs.

- Gross value added (GVA) means the value received after deducting the value of intermediate inputs (Intermediate consumption) from the gross value of output (GVO).
- Gross value added can be estimated in two ways.
  a. Product source
  b. Income source
- Gross value added is estimated using product source by deducting all the values of inputs purchased from outside from the value of output.

- Gross value added is estimated using income source by adding all factor incomes received for all production factors engaged in the production process and by adding the cost of depreciation for the utilization of fixed capital.

A. Production Approach

1. Agriculture Sector

• Agriculture, livestock ,forestry	xxx	
• Fishing	<u>xxx</u>	
		<u>xxx</u>

2. Industrial Sector

• Mining & Quarrying		xxx
• Manufacturing	xxx	

• Electricity ,gas, water	xxx	
• Construction		xxx
		xxx

3. Service sector

• Whole sale & retail		xxx
• Hotel & restaurant		xxx
• Transportation & communication		xxx
• Banking ,insurance, real state	xxx	
• Ownership & dwelling	xxx	
• Private sector service	xxx	
		xxx

Gross value added at basic price	xxx	
(+)Taxes on product		xxx
(-)Subsidy on product		(xxx)
GDP at market price		xxx
Net primary income from ROW	xxx	
GNI at market price	xxx	
Net secondary income from ROW	xxx	
Disposable GNI at market Price	xxx	

B. Income Approach

1. Employment compensation		xxx	
2. Gross operational surplus			
i. Net operational surplus	xxx		
ii. Fixed capital consumption	xxx	xxx	
3. Mixed income		xxx	
4. Other taxes and subsidies on product		xxx	
Gross value added at basic price		xxx	
(+)Taxes on product			xxx
(-)Subsidy on product			(xxx)
GDP at market price			xxx

Net primary income from ROW	xxx		
GNI at market price	xxx		
Net secondary income from ROW	xxx		
Disposable GNI at market Price	xxx		

C. Approach

1. Final consumption expenditure			
i. Household consumption expenditure	xxx		
ii. Nonprofit institutions expenditure		xxx	
iii. Government consumption expenditure	xxx	xxx	
2. Gross domestic capital expenditure			
i. Fixed capital formation	xxx		
ii. Change in inventory		xxx	
iii. Change in value		xxx	xxx
GDE at market price			
(+) Net exports (X-M)			
GDP at market price		xxx	
Net primary income from ROW	xxx		
GNI at market price	xxx		
Net primary income from ROW	xxx		
Disposable GNI at market Price	xxx		

Drawbacks in National Income Accounting

1. Multiple counting error.
2. It does not take House wives service.
3. It does not take illegal economic activities.
4. It does not take black market activities.
5. Difficulties in collection of accurate & realistic data.
6. It is not adjusted to Externalities. (Ex: Environmental Pollution)