LESSON 14

BASIC CONCEPTS OF NATIONAL INCOME

In present times, in all the countries various commercial activities like cattle rearing, agriculture, industry, trade, transportation, communication, banking etc. are practised. Economic activities mentioned above enable people to earn their livelihood. Some people earn income through physical efforts and some people earn income by mental efforts. Income is received through various sources. In countries where most of the people earn income through various sources has higher income as compared to the ones who have less sources of income. Countries having low income are considered poor where as the countries having higher income are considered rich. Today in ordinary language every country wants to get rich. The country's income is known an National Income.

With the help of national income the information of economic achievements of a country is known. It enable us to know the effective policies and programmes executed by the government of that country. National Income depicts flow in an economy of country.

Stock and Flow

The study of economic variables on basis of time are classified as stock and flow. When any economic variable is studied on a certain point of time, then it is called as Stock. On the contrary, when any variable is studied over a period of time, it is called as Flow. According to Shapiro-"Stock is a measure of quantity at a point of time and Flow is a quantity which can be measured over a period of given specific time."

These concepts can be simply understood with the help of an example. -

Assume the water level of a dam during a year is 20 feet, due to rainfall within three months it increases to 40 feet. During the whole year, water is used for drinking, agriculture and manufacturing. Due to which the level of water falls down to 25 feet on 30th June of the next year. Now there are three important things in this example - First, on 1st July the water level was 20 feet. Second in three months due to rain the inflow of water was 20 feet and outflow was 15 feet during the year. Third, on the last day of the next year i.e. 30th June the water level remained at 25 feet.

On the basis of three things mentioned above the stock of water on 1st July and 30th June was 20 feet and 25 feet respectively. 1st July and 30th June are points of time. Similarly, the period from 1st July to 30th June of next year is a period of time between these two points of time, inflow of water was 20 feet and outflow was 15 feet. In this way net inflow of water was 5 feet (20-15).

National Income is also a flow concept. This flow is related to a period of one year i.e from 1st April to 31st March which is known as Financial year in India. Similarly, the level of wealth at a particular point of time is called Stock. This type of flow of National Income is generated by economic activities. In a country people aquire flow of national income by performing productive economic activities and utlilisation of resources.

"The flow of National Income is in circulur form among the people of a country and producers who perform economic activities, this is compared to the circulation of blood in the body."

Circular Flow of income –

The Circular Flow of income means that the production of a country in form of income and expenditure flows in a circular form from one sector to another because the expenditure of one sector is the income of the other sector.

Idea of Circular Flow of income was initially given by a physiocrat, an agricultural economist, Francois Quesnay in 1758. Later Karl Marx again published Quesnary's economic table.

There are different sectors in an economy like family, consumer, businessmen (Producer) and government etc. All these various sectors like household (consumer) businessmen (Producer) are dependent on each another. Dependency can be understood with the help of Circular Flow of income. "Production of goods and services is possible because of productive activities of factors of production. According to Euler's Theorem total output is fully distributed among the factors of production. In this way distribution of production among factors of production is called Factor Income. People spend this factor income to buy goods and services. Thus, in a country, the income flows from buisness firm to households in exchange of productive activities, again this income retuns to buisness firms because of expenditure made by households on goods and services produced by buisness sector. This is refered to as Circular Flow of Income. Circular flow of income can be understood with the help of two sector model.

MODEL

A model is a simplified version of complex realities. with the help of clay and plastic models it is easy to understand the human body and its functions. Similarly, we can understand the Circular Flow of Income between household and business firms in a country with help of a model. Circular flow of income model assumes the following necessary conditions :-

1. Total production of a country is done by only business firms.
2. Business firms sell all the goods they produce, Unsold product and raw material is not left.
3. Government is present in a country. but it neither imposes taxes nor provides any subsidy.
4. The economy of a country is closed economy, where there are no exports and imports with any foreign country.

When the economy, of a country is an open economy there are five sectors in Circular Flow of Income household, business firms, capital market, government and rest of the world. In a simpler model of circular flow of income, there are two sectors:-

1. Household Sector
2. Business Sector

1. Household Sector, - This sector refers to such a sector, which is the owner of all the factors of production, (Labour, land capital etc.) In household sector, there is only consumption of goods, produced by business firms.

2. Business Sector, - Business sector refers to the sector which produces goods with the help of the factors of production, (Land, Labour and capital) supplied by the households. It sells goods and services to the households for consumption. This can be understood with the help of the figure 14.1.

In this way, in a country the factors of production flow from household to business firm sector. In exchange of services given by factors of production, business firms make payment in form of money. Again the household sector spends this money on the purchase

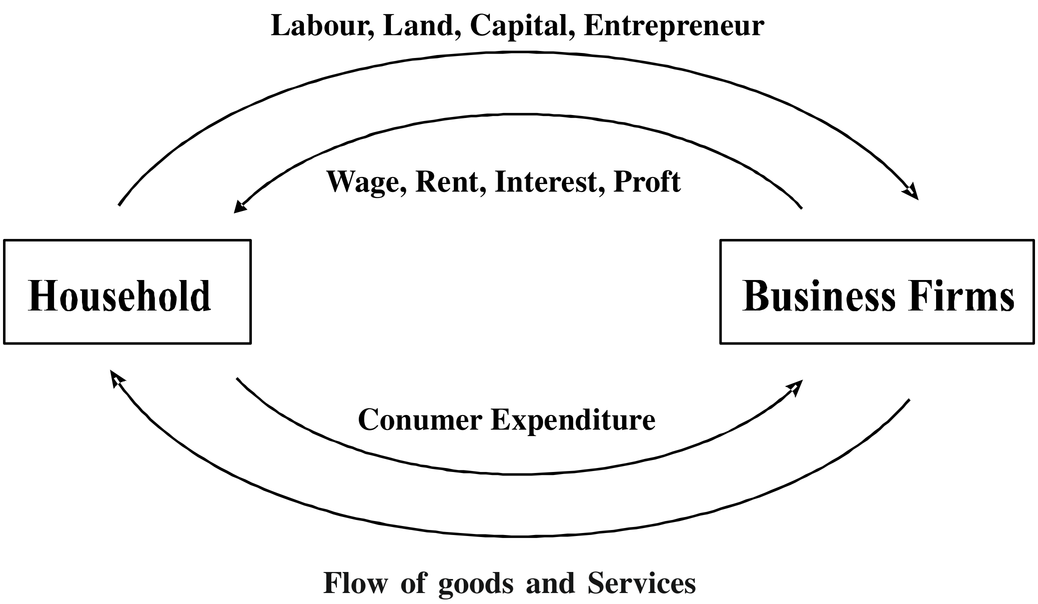

Fig – 14.1 Circular flow of Income in two sector economy

of goods and services produced by business firms. household sector in exchange of money receives goods and services from business firm for the consumption. In this way expenditure of household sector is the income of business firms and the expenditure of business firms is the income of household sector. This flow is of two types-

1. **Real flow-** The flow of factors of production from household sector to business firm sector and goods and services for consumption from business firm sector to household sectors is Real flow.
2. **Money flow -** The flow of factor payment from buisness firms to households and flow of consumption expenditure from the household to the business sector. Such money flows of transactions from one sector to another sector is a continious process in any economy of country.

From the above following conlusions can be drawn-

1. The amount of sale and purchase of goods and services is equal. In other words the income received by factors of production is equal to the expenditure on goods and services done by all the consumers.
2. Visualising the Figure 14.1 of Circular Flow of Income exhibits the flow in opposite direction from one sector to another. The flow of money is in opposite direction to the flow of goods and services.
3. The flow of money recieved as(payments) rewards to factors of production is in opposite direction to the flow of factor of production.

1. Consumer goods and Capital goods

Consumer goods- All those goods that are fully used up quickly after their purchase. In the society the people satisfy their wants by the consumption of consumable goods. Consumer goods are not used for production of other goods. Generally, the business firms keeps the stock of ready goods and services for sale. Consumer goods are final goods thus their value is included in measurement of national income. The examples of consumer goods are- eatables goods, clothes, vehicles, radio, television and books of your class etc. The cosumer goods and services include the durable and non durable goods, very often the durable consumable goods used by buisness firm are called capital goods.These goods are not used as raw material and in form of intermediate goods.

Capital goods - Capital goods are durable goods, which are used to produce other goods and services. In the production process capital goods are used to produce goods for many years. Examples of Capital goods are machines, tools, equipments, buildings, dams, canal and plants for generation of electricity etc. The development of a country depends on Capital goods.

2. Final goods and Intermediate goods

Final goods - Those goods which cannot be used as raw material for further production are known as final goods. These goods are directly used by the consumers, for examples food consumed by the consumer a pump set or tractor used by the producer(farmer). In other words goods and services used finally for consumption are Final good.

Intermediate goods - Intermediate goods are generally in the form of semi-finished product of raw materials. All types of semi-finished products can be included in this category. The Intermediate goods are used in production process in one or in many stages and transformed into Final goods. Example cotton, yarn are intermediate goods or semi-finished goods.

3. Gross Investment and Net investment

There are some important concepts related to Circular Flow of Income and National Income. Investment is an expenditure for production. When a producer spends in form of cash it is called Monetary Investment. Monetary Investment turns into real investment when it is converted into new machines, new building, new dams, new canals etc. Real Investment enhances the production and production efficiency. Investment are of two types Gross Investment and Net Investment.

The amount a producer spends on capital goods during a specified period (which is generally a year) is called Gross Investment. Examples of gross investment are new canals, new machines, new buildings, new dams, new equipments for generation of electricity and electricity lines etc. Maintenance expenditure which includes expenditure on old machines, old buildings, old dams, old canals etc. is also included in Gross Investment.

Gross Investment = Net investment + depreciation

Net investment - To calculate Net Investment we deduct depreciation of physical capital goods during a definite period(year) from Gross Investment. Production and productive capacity improves with increase in Net Investment.

Net investment = Gross investment - Depreciation

Depreciation -The wear and tear of capital goods is called Depreciation. There is decrease in the value of capital assets. Due to depreciation productive efficiency of machine. building, dams, canals and equipment for generation of electricity decrease (declines). Thus in this way with wear and tear depreciation of capital goods, there is a loss. Thus to calculate Net Investment we deduct the value of depreciation from gross investments.

Depreciation = Gross Investment - Net Investment

(D = GI - NI)

Concept of Domestic boundary and normal residents of a country:

Concept of Domestic territory :- It is consider as important in the measurement of National Income, it refers to the economic activities performed within the geographical boundary of a country. In this way, economic activities performed outside the geographical boundary of country are not included in Domestic Territory.

Concept of Normal Residents:-

A normal resident of a country can be defined as a person who resides in a country and has its citizen ship. Total income acquired by the economic activities of all the normal residents of country is included in National Income. Since we differentiate between the economic activities of residents and non residents there fore the concept of normal resident is very important in the measurement National Income

Coneept of Net Factor Income from Abroad

Import and export play an important role in measurement of National Income and also determines the volume and direction of national income. If import value of a country is greater than export value of a country it means net exports (X-M) is negative and vice-versa.

In present perspective net factor income from aborad (NFIA) is called as the difference between factor income from abroad by the normal residents and factor income of non residents in the domestic territory.

Concept of Net Indirect Taxes -

Valuation of production in a country is estimated at market price. To calculate the production at market price we need to add factor cost and indirect taxes. Indirect taxes like GST (Goods and Services Tax) is added to the factor cost and subsidy is deducted. In this way, net indirect taxes are calculated by deducting subsidy from gross indirect taxes .

Net Indirect Taxes = Gross Indirect taxes - Subsidy

In real world, instead of two sector circular flow of income we have four sector circular flow of income. In macro economics we study wide and aggregate aspect of level of national income, level of employment, level of saving, level of investment, general price level and fluctuation in ecnomic development. National income is generated by economic activities like animal industry, agriculture industry, trade and other business activities.

Important Points

- A Flow is a quantity that can be measured over a specific period of time, for instance National Income and Stock is a quantity measurable at a particular point of time.
- The concept of Cricular Flow of Income was given for the first time in the year 1758 by Francois Quesney, a physiocrat and an agricultural economist.
- In a simplified circular flow of income there are two sectors :

  A. Household Sector

B. Business Firm Sector

- In a country, factors of production flow from household sector to business firm sector and factor remuneration flows from business firms to household sector. In this way expenditure of household is the income of the business firm and expenditure of business firm is the income of household sector.
- All those goods and services which are fully consumed after the purchase are called consumer goods, that is consumer goods are consumed in a financial year itself.
- Factors which help in production and are durable are called capital goods. Capital goods helps in productions for many years.
- Intermediate goods are in the form of semi finished goods and raw material. Final products are obtained by processing of intermediate goods through many stages of production.
- Investment is an expenditure for production. When a producer spends in form of money, it is called monetary investment. Monetary investment gets converted into real investment, when it is invested in new machines, new building, new dams and new canals etc.
- Investment are of two types-

  (a) Gross Investment

  (b) Net Investmnt
- In a fixed time period (i.e. a year) expenditure on productive capital goods is called Gross Investment and when we deduct depreciation form Gross Investment it is called Net Investment.
- Obsolescence and wear and tear of capital goods is called Depreciation.
- The concept of domestic territory is geographical boundary of a country within which economic activities are performed.
- Income earned by normal resident through economic activities is considered in the measurement of national income.
- Net factor income from abroad = factor income from abroad by normal residents - factor income of non residents in the domestic territory.
- In real world, circular flow of income is in four sectors and not in two sectors.

Exercise Questions

Objective Type Questions :-

1. Net Indirect Taxes are calculated from the following-

   (A) Gross indirect tax - subsidy

   (B) Gross indirect tax - interest

   (C) Gross indirect tax - profit

   (D) Gross indirect tax + subsidy

2. Who gave the concept of circular flow of income?

   (A) Francois Quesney

   (B) Karl Marx

   (C) Simon Kuznetes

   (D) None of these

3. What is deducted from gross investment to obtain net investment?

   (A) Net interest

   (B) Investment

   (C) Depreciation

   (D) Profit

4. Which of the following is not an example of cusumption goods?

   (A) Vegetable

   (B) Clothes

   (C) Bread

   (D) Pumpset for irrigation.

5. Which of the following is not an example of Capital Goods?

   (A) Machine, building, and tractors

   (B) Dams and Canals

   (C) Electricity equipments and electric devices

   (D) Eatables and clothes

Very Short Answer Type Questions :-

1. What is flow ?
2. What is stock ?
3. What is circular flow of National Income?
4,. Which are the two sectors in circular flow of income model?
5. What do you mean by Intermediate Goods ?

Short Answer Type Questions :-

1. Differentiate between Stock and Flow.
2. Describe in brief the difference between Consumption goods and Capital goods.
4. Explain Gross and Net Investment.
5. Explain in brief the meaning of Depreciation.
6. Explain the concept of Normal Residents.

Essay Type Questions :-

1. Explain in detail the Circular Flow of Income with the help of a suitable Figure.
2. Write short notes on :-

   A. Consumption goods

   B. Capital goods

   C. Intermediate goods
3. Differentiate between :-

   A. Stock and Flow

   B. Gross and Net Investment

Answer Table

1	2	3	4	5
A	A	C	D	D