**AIMAN COLLEGE OF ARTS AND SCIENCE FOR WOMEN**

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**BUSINESS ECONOMICS**

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**UNIT: V SEMESTER:II**

National Income – Concept – Measurement - Inequalities of income - Fiscal Policy Method. Public Finance – Definition – scope – importance

**NATIONAL INCOME**

National Income means the total income of the people of the nation in a year. The net aggregate performance of the economy in a year is the National Income. It is the aggregate money value of all goods and services in a country during the year.

**Definition of National Income:**

According to Prof.Pigou “National Dividend is the part of the objective income of the community including income derived from abroad, which can be measured in money.”

According to J.R. Hicks, “The National Income consists of a collection of goods and services reduced to a common basis by being measured in terms of money.”

**CONCEPTS OF NATIONAL INCOME:**

**1. Gross National Product (GDP)**

GDP is the basic social accounting measure of total output of goods and services produced in a year. It is defined as “the total value of all final goods and services produced in a year.”

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| **GNP = GDP + NFIA** |

GDP – Gross domestic product; NFIA – Net Factor Income from Abroad

**2. Net National Product (NNP)**

It refers to the net production of goods and services in a country during the year. NNP means market values of all final goods and services after providing for depreciation. It is called National Income at market price.

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| **NNP or NI at Market Price = GNP - Depreciation** |

**3. National Income (NI)**

It is also known as NI at factor cost. This is the total of all income payments received by the factors of production like land, labour, capital and organization.

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| **NI = NNP – Indirect taxes + Subsides – Profits accruing to the Government** |

**4. Personal Income (PI)**

PI is the sum of total of income actually received by person from all sources in the form of current transfer payments and factor incomes. It is a receipt concept.

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| **PI = NI – Corporate Income Taxes – Undistributed Corporate Benefits –**  **Social Contributions + Transfer Payments** |

**5. Disposable Personal Income (DPI)**

DPI is the sum of the consumption and saving of the individuals. The whole of PI is not available to individuals for consumption as they have to pay personal direct taxes. That part of PI, which is left behind after payment of personal direct taxes is called DPI.

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| **DPI = PI – Personal Direct Taxes + Transfer Payments** |

Generally, individuals spend a large portion of the DPI on consumption. A part of it may be saved. Thus

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| **DPI = Consumption + Savings** |

This concept is useful in finding money burden of personal direct taxation.

**6. Per Capita Income (PCI)**

The average income of the people of a country in a particular year is called per capita income.

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| **National Income**  **Per Capita Income = -----------------------**  **Total Population** |

The concept of |PCI is very useful as it is the single most commonly used measure of average income and the standard of living of the people of a nation.

**MEASUREMENT OF NATIONAL INCOME**

There are three basic methods of measuring national income.

**1. Census/Production or output method**

By this method, the total products produced in the economy are calculated for the year and the value of this flow is equated to the market price avoiding double counting. According to this method, the economy is divided into different sectors such as agriculture, mining, manufacturing, small enterprises, commerce, transport, communication, direct services, foreign transactions and other services.

**GNP = The net value of production of all the industries and sectors of the economy + the net income from abroad.**

**NNP or NI = GNP – depreciation.**

National Income by product method can be calculated in two ways.

a) Final Product Method:

According to this method, the total value of final goods and services produced in a country during a year is calculated at market prices.

b) Value Added Method:

This method measures the contribution of each producing enterprises of the economy. The difference between the values of materials outputs and inputs at each stage of production is the value added. If all such differences are added up for all industries in the economy, we are at the GDP.

**2.Income Method/ NI by Distributive shares**

This method measures the national income after it has been distributed and appears as income earned or received by individuals of the country. NI is obtained by summing up the incomes of all individuals in the country.

**Income method involves the following steps:**

i) The economy is divided on the basis of income groups, such as wage/salary earners, rent earners, profit earners and so on.

ii) Income of each of these groups is calculated.

iii) Income of all the earners added, including incomes from abroad and undistributed profits.

iv) From(iii) income earned by foreigners&transfer payments made in the year are subtracted.

**3. Expenditure Method/Income Disposal Method/Consumption and Investment Method**

This method arrives at national income by adding up all the expenditures made on goods and services during a year. Income can be spent either on consumer goods or investment goods. The GDP is found by adding up –

i) Personal consumption expenditure

ii) Gross domestic private investment

iii) Net foreign investment (exports – imports)

iv) Government Purchases

**It involves the following steps:**

i) Identification of economic units incurring final expenditure,

ii) Classification of final expenditure,

iii) Estimation of final expenditure.

**IMPORTANCE OF NATIONAL INCOME**

**1. Economic Policy:**

National income figures are an important tool of macroeconomic analysis and policy. It estimates are the most comprehensive measures of aggregate economic activity in an economy.

**2. Economic Planning:**

National income statistics are the most important tools for long-term and short-term economic planning. The Planning Commission in India also kept in view the national income estimates before formulating the five-year plans.

**3. Economy’s Structure:**

National income statistics enable us to have clear idea about the structure of the economy. It explains how income is produced, how it is distributed, how much is spent, saved or taxed.

#### 4. Inflationary and Deflationary Gaps:

#### National income and national product figures enable us to have an idea of the inflationary and deflationary gaps. For accurate and timely anti- inflationary and deflationary policies, we need regular estimates of national income.

#### 5. Budgetary Policies:

Modern governments try to prepare their budgets within the framework of national income data and try to formulate anti-cyclical policies according to the facts revealed by the national income estimates.

#### 6. National Expenditure:

National income studies show how national expenditure is divided between consumption expenditure and investment expenditure. It enables us to provide for reasonable depreciation to maintain the capital stock of a community.

#### 7. Distribution of Grants-in-aid:

National income estimates help a fair distribution of grants-in-aid by the federal governments to the state governments and other constituent units.

#### 8. Standard of Living Comparison:

National income studies help us to compare the standards of living of people in different countries and of people living in the same country at different times.

#### 9. International Sphere:

National income studies are important even in the international sphere as these estimates help us to fix the burden of international payments equitably amongst different nations.

#### 10. Public Sector:

National income figures enable us to know the relative roles of public and private sectors in the economy. If most of the activities are performed by the state, we can easily conclude that public sector is playing a dominant role.

**DIFFICULTIES IN THE MEASUREMENT OF NATIONAL INCOME :**

Theoretical and Practical difficulties generally arise while estimating national income.

**I) THEORETICAL DIFFICULTIES :** This is also known as conceptual difficulties.

**1) Transfer payments:**

Individuals get pension, unemployment allowance, but whether these should be included in NI is difficult problem. The transfer payments are ignored from national income.

**2) Income of foreign firms:**

         According to IMF view-point, income of a foreign firm, should be included in the national income of the country, where the firm actually undertakes production work. However, profits earned by foreign firms are credited to the parent concern.

**3) Unpaid services:**

National income is always measured in money, but there are a number of goods and services which are difficult to be assessed in terms of money.

**4) Incomes from illegal activities:**

Income earned through illegal activities such as gambling, black marketing, theft, smuggling etc., is not included in national income.

**5) Treatment of government sector**: Government provides a number of public services like defence, public administration, law and order etc. Measuring the market value of such government services is difficult; as the real value of these services is not known.

**6) Production for self consumption:**

Goods produced for self consumption such as food grains, vegetables and other farm products do not enter in the market.

**7) Changing price levels:**

The difficulty of price changes arises in the national income estimate, when the price level in the country rises, the national income also shows an increase even though the production might have fallen and when price level falls.

**II) PRACTICAL DIFFICULTIES / STATISTICAL:**

In practice, a number of difficulties arise in the collection of required statistics in estimating national income, some of these are.

**1) Problem of double counting:**

The greatest difficulty in calculating the national income is of double counting. It arises from the failure to distinguish properly, between a final and an intermediate product.

**2) Existence of non-monetized sector:**

There is a large non-monetized sector, in-the developing economy like India. Agriculture, still being in the nature of subsistence farming in the developing countries, a major part of the output is consumed at the farm itself and a part of production is partly exchanged for other goods and services. Such production and consumption cannot be calculated in national income.

**3) Lack of occupational specialization:**

There is the lack of occupational specialization, which makes the calculation of national income by product method difficult.

**4) Inadequate and unreliable data:**

Adequate and correct production and cost data are not available in a developing country, such data relate to crops, fisheries, animal husbandry, forestry, the activities of petty shopkeepers, construction workers, small enterprises etc.

**5) Capital gains or losses:**

Capital gains or losses, which accrue to the property owners by increases or decreases in the market value of their capital assets or changes in demand, are not included in the GNP.

**6) Depreciation:**

The calculation of depreciation on capital consumption is one more difficulty. There are no uniform, common or accepted standard rates of depreciation applicable to the various capital assets.

**7) Valuation of inventories:**

Raw materials, intermediate goods, semi­-finished and finished products in the stock of the producers are known as inventory. Any mistake in measuring the value of inventory, will distort the value of the final production of the producer.

**8) Illiteracy and Ignorance:**

Majority of the small producers in developing countries are illiterate and ignorant; and are not in a position to keep any account of their productive activities. So they cannot give information about the quantity or value of their output.

**INEQUALITY OF INCOME**

Inequality of income is an extreme disparity of income distributions with a high concentration of income usually in the hands of a small percentage of a population. When

inequality of income occurs there is a large gap between the wealth of one population segment compared to another.

**CAUSE OF INEQUALITIES OF INCOME**

**(i) Inheritance**

Some persons are born landless; others inherit a few acres and still others thousands of acres. So long as the system of inheritance lasts, inequalities are bound to be perpetuated.

**(ii) System of Private Property:**

Under the system of private property, a person is free to earn, free to save and free to own property. First a man earns and acquires property; and then his property starts earning. That is why some earn less and others more. Differences in property lead to differences in incomes.

**(iii) Differences in Natural Qualities:**

Persons who are endowed by nature with superior intelligence, better physique and greater capacity for hard work must surpass others in the race of life. Some inherit a feeble mind in a feeble body, and they naturally lag behind.

**(iv) Differences in Acquired Talent:**

A child of average ability, if properly nursed, brought up and educated, will more than make up for the lack of natural gifts. There is no doubt that if one undergoes technical training of the right type after a course of general education, his efficiency will improve. Commercial education may also improve efficiency and raise a person’s income-making capacity. Differences in personal efficiency are thus an important cause of inequality of incomes.

**(v) Family Influence:**

It is generally recognized that the job that a person gets is very largely determined by the family influence. Ordinary graduates manage to get lucrative jobs through the influence of relations and friends, whereas brilliant graduates without helpful contacts may have to be content with low-paid jobs. That is why unequal incomes are earned by different persons.

**(vi) Luck and Opportunity:**

Some persons are lucky enough to get a good chance and they may make the most of it. It sometimes happens that a person comes to know of a vacancy and gets it.

**CONSEQUENCES OF INEQUALITY OF INCOME**

**(a) Class-conflict:**

It has created two sections in society—the ‘haves’ and the ‘have-not’s—which are ever on the war path. This has resulted in ever mounting social tensions and political discontent.

**(b) Political Domination:**

The rich dominate the political machinery, and they use it to promote their own exclusive interests. This results in corruption, graft and social injustice.

**(c) Exploitation:**

The rich exploit the poor. The consciousness of this exploitation leads to political awakening and then agitation and even political revolution. Thus inequality of incomes is an important cause of social and political instability.

**(d) Creation of Monopolies:**

Unequal incomes promote monopolies. These powerful monopolies and industrial combines charge unfair prices from the consumer? And crush the small producers.

**(e) Suppression of Talent:**

It is said that ‘slow rises merit by poverty depressed’. It is not easy for a poor man to make his way in life, however brilliant he may be. It is a great social loss that brainy people without money are unable to make their due contribution to social welfare.

**(f) Undemocratic:**

Democracy is a farce when there is a wide gulf between the rich and the poor. Political equality is a myth without economic equality.

**(g) Moral Degradation:**

The rich are corrupted by vice and the poor demoralized by lack of economic strength. Thus inequalities spoil the rich and degrade the poor. Human dignity is lost altogether.

**(h) Promotes Capital Formation:**

It is only when income is unequally distributed that there are people who are so rich that in their case saving is automatic. It is only a minority of the people who have the saving habit. To the rest if income comes, it is squandered away. Thus inequality of incomes helps capital formation in a country.

**MEASURES TO REDUCE INEQUALITY OF INCOMES:**

**(i) Fixing Minimum Wage:**

In India in 1948, the Minimum Wages Act was passed in pursuance of which minimum wages are being fixed for agricultural labour and labour in what are called the ‘sweated trades’. This is a step which will level up the incomes from below the poverty line. **(ii) Social Security:**

The social security scheme that we envisage must include provision of free education, free medical and maternity aid, old-age pension, liberal unemployment benefits, sickness and accident compensation, provident fund and schemes of social insurance, etc. In that manner, substantial benefits can be assured to persons whose incomes are low.

**(iii) Equality of Opportunity:**

The Government may devise and set up some sort of machinery which may provide equal opportunities to all rich and poor in getting employment or getting a start in trade and industry. The recruitment to all jobs may be made by an impartial Selection Board or Public Services Commission. In the same manner, to give start in trade and industry, the Government may give financial aid or loans at very reasonable rates repayable in easy installments to all those who wish to enter trade and industry.

**(iv) Steeply-graded Income Tax:**

One such device is the steeply progressive taxes on incomes. This will prevent, to some extent, a rich man from getting richer still. Other direct taxes like the super tax, excess profits tax, and capital gains tax and limitation of dividends, etc., may also be imposed.

**(v) High Taxes on Luxuries:**

All conspicuous consumption by the rich may be ruthlessly crushed by means of heavy taxation of the consumption of luxuries by them. This will take away from the rich the power to display their wealth.

**(vii) Ceilings on Agricultural Holdings and Urban Property:**

With a view the reducing inequalities between the big and small farmers, ceilings on agricultural land holdings can be imposed. This has been done in India and recently the ceilings have been to lowered to 10-18 standard acres. The main purpose of land ceilings is to bring about a wider and equal ownership and use of land.

**METHODS OF REDUCING INEQUALITIES OF INCOME**

There are two methods advocated to reduce inequalities of income. They are:

1) The drastic method called “leveling down” is a solution offered by Marxists. (with

political machinery)

2) The another method is called “leveling up” advocated by moderates. (through fiscal

measures.

**1) Marxist method / Levelling down method:**

Marxist advocated extreme steps in doing away with inequalities of income. **Firstly**, recognition of private property and law of inheritance are completely dispensed with. Every person is given an equal share of the community. Further there is no economic incentive to work hard. **Secondly,** distribute on the need basis-“each according to his ability and according to his needs” each will contribute his maximum towards national product and each will get maximum according to his need.

**2) Fiscal Policy method /Levelling up method:**

This method depends on government intervention in the redistribution of purchasing powers from the rich to the poor. This can be done by a two-way procees:

**i) Upgrading the poor:** as an initial step, social barriers are sought to be removed and everyone is given equal opportunity through legislation. The wages and salaries are raised to a level by minimum wage. A system of social insurance to meet any eventualities like unemployment, sickness and accident fund for old age would go a long way to increase the earning capacity of workers and low income groups.

**ii) Reduction of excess income of the rich:** A high progressive income tax and wealth should be able to reduce inequalities of income and wealth.

If we examine both the methods, leveling up method is more constructive. They believe that year after year, net social income may be considerably increased. Levelling down method is more destructive, it emphasizes only redistribution of income and not production of income. This method is effective during a short span of time.

**FISCAL POLICY**

Fiscal policy is an integral part or organ of public finance. In ordinary words, fiscal policy refers to a policy that affects macroeconomic variables, like national income, employment, savings, investment, price level, etc.

Fiscal policy is **“a policy under which the government uses its expenditure and revenue programmes to produce desirable effects and avoid undesirable effects on the national income, production and employment.”**

**OBJECTIVES OF FISCAL POLICY:**

**i) Economic Growth**

Fiscal policy aims at controlling long term disequilibrium and at maintaining equilibrium growth path. Economic growth is largely conditioned by capital formation. To step up economic growth, capital formation has to be raised. Fiscal policy through its tax instrument should encourage more savings and investment and discourage consumption.

**ii) Full Employment**

Attainment of full employment is a major short run goal of fiscal policy. An increase in government expenditure leads to a rise in the level of employment. Taxation policy also helps to attain the goal of full employment.

**iii) Price Stability:**

Another short run objective of fiscal policy is the attainment of the goal of price stability. Instability in price level, i.e., either inflation or deflation, produces some undesirable consequences. The government prepares its budget in such a way that both inflation and deflation are controlled.

**iv) Equity and Justice:**

Modern welfare governments provide social justice by providing equitable distribution of income and wealth. Fiscal policy is an important instrument that aims at reducing income and wealth gaps between people.

Thus, it is clear that fiscal policy is an important instrument to achieve the goal of higher economic growth and stability by influencing aggregate demand, to reduce the level of unemployment and inequality cannot be disputed.

**PUBLIC FINANCE**

Public finance is a study of the financial aspects of the government. It refers to incomes and expenditures of the government. Public finance in concerned with the ways of raising resources and spending them.

**DEFINITION**

**Prof. Dalton**  defined public finance as “ it is concerned with the income and expenditure of public authorities and with the adjustment of one another.”

**Prof. Findlay Shirrras** defined as “the study of the principles underlying the spending and raising of funds by public authorities.”

The objective of public finance is to run the State with safety, security, healthyand wealthy.

**IMPORTANCE OF PUBLIC FINANCE**

1) Provision of public goods: -For providing public goods like roads, military services and

street lightsetc. public finance is needed.

2) Public finance enables governments to tackle or offset undesirable side effects of a market

economy. For example, pollution.

3) Public finance helps governments to redistribute income. To reduce the inequality in the

economy, the governments can impose taxes on the richer people and provide goods and

services for the needy ones.

4) Public finance provides many a programme for moderating the incomes of the rich and the

poor. Such programmes include social security, welfare and other social programmes.

5) The acceptance of the principle of welfare state, the role of public finance has been

increasing.

6) Generation of employment opportunities, control of economic fluctuations like boom and

depression, maintaining economic stability etc. are some of the thrust areas of the

governments through fiscal operations.

**SCOPE AND IMPORTANCE OF PUBLIC FINANCE**

The importance of the public finance can be discussed under three heads. i.e.

1. The functions of the state,

2. The effects of fiscal operations on economic life and

3. Subject-matter of public finance

**1. FUNCTIONS OF THE STATE**

According to **Adam Smith**, the duties of “a complete sovereign rich nation” can be divided into following three categories -

(a) To provide security to nation against war and injustice of other nations.

(b) To maintain peace, justice and system among citizens, and

(c) To build and conduct such public functions and public institutes, which can be highly

beneficial for whole society, but they will not provide profit if started and conducted by

some private persons.

**The functions of Modern State**

After analyzing the functions of Modern State, the following services are required for welfare :

(a) To arrange expenditure for **Internal and External Security** and soldiers, police and other

security services.

(b) **Justice** or solution for controversies.

(c) Organization, control of economic industries and other such services such as regulation of

professional activities and Government ownership etc.

(d) To develop social and cultural welfare by education, social help, social insurance, health

control and other such activities.

(e) Irregularization of moral levels by controlling on manufacture and sale of medicines, sale

of wine, gambling and other anti social activities.

(f) Preservation of natural resources.

(g) To maintain and expand the unity of state by controlling on the means of transport and

communication and other such means.

(h) Government administration and aid to Government officials.

(i) Financial arrangement of Government and administration of fiscal control.

(j) Religion related functions from time to time.

**EFFECT OF FISCAL OPERATIONS**

Fiscal policy for bringing stability in their economy and it is considered the best option fulfillment for that objective from all other options of economic planning. As an organ of general programme of growth, taxation can be used for achieving following objectives:

(a) By banning consumption or by subsidizing it, the means of origin must be transferred

toward investment of consumption.

(b) To motivate and encourage saving and investment.

(c) To give resources to the hands of state from hands of public, by which public investment

can be possible.

(d) To minimize economic inequalities.

**SUBJECT MATTERS OF PUBLIC FINANCE**

The subject matters of Public Finance can be broadly classified in to five categories –a) Public revenue b) Public expenditure c) Public debt d) Financial administration and e) Economic stabilization

**Public Revenue:**

The income of the states is referred to as Public Revenue. It included the various ways of raising revenue by the public bodies like effects of taxation.

**Public Expenditure**

It deals with the principles and problems relating to the allocation of public spending. We study the fundamental principles governing the flow of public funds in to different channels, classification and justification of public expenditure; expenditure policies of governments and the measures adopted for welfare state etc.

**Public Debt**

The governments borrow when its revenue falls short of its expenditure. Public debt is a study of various principles and methods of raising debts and their economic effects. It also deals with the methods of repayments and managements of public debts.

**Financial Administration**

It deals with the methods of Budget preparation, various types of Budgets, war Finance, Development Finance etc. Thus, it refers to the mechanism by which the financial functions are carried on. It studies the organizing and disbursing of the finances of the State.

**Economic stabilization and Growth**

The use of Public revenue and Public expenditure to secure stability in levels of prices by controlling inflationary as well as deflationary pressures is studied. Similarly the income and expenditure policies adopted by the government so as to attain full employment, optimum use of resources, equitable distribution of income etc. are also studied.

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