

ECONOMICS

PART 1

CPA

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Section 2

STUDY TEXT

Revised: May 2021

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PAPER NO. 4 ECONOMICS

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to apply the fundamental principles of economics in decision making.

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Apply basic mathematical and graphical techniques to analyse economic relationships and interpret the results
- Apply the knowledge of economics in decision making
- Analyse economic problems and suggest possible policy related recommendations
- Apply knowledge of economics in international trade and finance
- Apply economic principles in the development and implementation of policies in agriculture and industry

CONTENT

4.1 MICROECONOMICS

4.1.1 Introduction to economics

- Definition of economics
- Basic economic concepts: economic resources, human wants, scarcity and choice, opportunity cost, production possibility curves/frontiers
- Scope of economics: Micro and macro economics
- Methodology of economics: positive and normative economics, scientific methods, economics as a social science.
- Economic systems: free market economy, mixed economy, consumers' sovereignty.

4.1.2. Demand, supply and determination of equilibrium

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- Factors influencing demand
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- Movement along and shifts of demand curves
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- Application of elasticity of demand in management and economic policy decision making

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- Factors influencing supply

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- Factors influencing elasticity of supply
- Application of elasticity of supply in management and economic policy decision making

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- Reasons for price fluctuations in agriculture

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4.2.3.1 Money

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MICROECONOMICS

TOPIC 1

INTRODUCTION TO ECONOMICS

DEFINITION OF ECONOMICS

Economics is a social science that has been in existence for about two centuries. Various economists have tried to define it differently. Three types of definition can be identified.

- a) Wealth definition
- b) Welfare definition
- c) Scarcity definition

a) Wealth definition

Adam Smith and his disciples J.B. Say, Walker, J.S. Mill defined economics as an **inquiry into the nature and courses of wealth of nations**. Such a definition has been criticized as follows.

- (i) The definition is very selfish: it restricts economics to the study of wealth alone. The definition does not state clearly how man comes into the study.
- (ii) Since economics is defined in terms of material commodity, it doesn't consider services e.g. services offered by doctors, teachers, etc.

b) Material welfare definition of economics

Alfred Marshall and his disciples, Pigou and Cannon defined economics as the **study of man's activities in the ordinary business of life**. It tries to study how man acquires and uses his resources aimed at improving the welfare of mankind. In this definition, it can be noted that on the one hand, economics is the study of wealth and on the other hand, and more important, a study of man.

Criticism of the definition

- (i) The definition excludes the study of services, that is, it only takes human material welfare.
- (ii) Speaks of study of man's activities during ordinary business of life. The question remains, how about during extra ordinary business life?

c) Scarcity definition of economics

Leonel Robbin (1933) improved upon the above definition and explained economics as the study of human behavior (**as a relationship between scarce resources which have alternative uses**)

The definition has characteristics that are currently addressed in economics namely

- Limited/scarce resources
- Alternative uses
- Unlimited wants

Scarcity: when we say that a resource is scarce, it means that it is there but cannot meet the demand. The scarce productive resource would include, land, labor, capital, entrepreneurship, and by extension technology used in the production process.

Alternative uses: some resources may be having more than one use. For example milk can make butter, cheese, chocolate etc.

Unlimited wants: human needs are unlimited and they are recurrent in that when you satisfy a need today, the same need has to be satisfied tomorrow. They are also competitive in that they compete for the limited resources.

Based on the above definition, economists today agree on a general working definition of the discipline. They conclusively define economics as **the study of how man can use his scarce resources to satisfy his needs.**

Thus, we study economics in order to solve economic problem, which is that of allocating scarce resources among competing and unlimited wants in such a manner that greatest satisfaction is derived. To do this, the society will have to make a choice on what combination of goods and services to produce and what therefore to sacrifice. The quality that one foregoes /sacrifice in order to consume more of another is what is known as opportunity cost.

BASIC ECONOMIC CONCEPTS

ECONOMIC RESOURCES

Economic resources are those scarce resources which help in the production of goods and services. They are classified under two main heads:

- i. Property Resources and
- ii. Human Resources

1.S Property Resources: In property resources, we include land and capital. The term land is used to describe all natural resources which are used in the process of production and yield income. These resources which are free gifts of nature include agricultural land, forests, mineral deposits, fisheries, rivers, lakes, oil deposits, etc.

The term capital refers to all man made resources which aid to production. Thus machinery, equipment, tools, factories, storage, transportation, etc., which are used in the production of new goods and supplying them to the ultimate consumers are capital resources.

2. SHuman Resources: Human resources include labor and entrepreneurial ability. Labor in economics refer to human effort, physical and mental which is directed to the production of goods and services. Thus factory worker, clerk, typist, teacher, doctor. Judge, physicist, etc., fall under the category of labor.

It may here be noted that it is the services of labor which are bought and sold for money and not the labor itself. As regards the supply of labor, it depends upon the (i) size of total population (ii) age composition of the population (iii) the availability working population (iv) the working hours devoted to production (v) the remuneration paid to the workers, etc., etc.

HUMAN WANTS

For us to lead our lives well, we require certain commodities and services. These goods and services satisfy our wants. Human wants can be referred to as the desires that human beings strive to satisfy by using goods and services. The satisfaction of these wants refers to the process of acquiring and using the required goods and services.

Characteristics of human wants

1. **Insatiable** – human wants are endless (each cannot be satisfied once and for all) and they are also unlimited in number (satisfying one requires the other.)
2. **Competitive** – the unlimited human wants are to be satisfied using limited human wants. This necessitates choice of the wants to satisfy and those to forego;
3. **They are recurrent** – Satisfaction levels vary in time such that a need that has been fully satisfied in one point of time requires satisfaction in another point. Several hours after eating to the full, one feels hunger again.
4. **Varied intensity and urgency** – the intensity of need is different for different people and also in different time, gender, age, season, location and culture.
5. **Require resources** – it takes resources to satisfy human wants. Resources are always much less than the wants they need to satisfy;
6. **Complimentary** – Satisfying some wants may create a need for another related want. For instance, acquiring a shoe may create a need for polish and socks, buying a car may require fuel.
7. **Universal** – most human wants are common to all human wants, though in varying quantities and qualities;
8. **Habitual** – Many consumers tend to develop a taste of commodities they use more frequently, especially certain brands and also certain addictive commodities.

Types of human wants

There are two main types – basic wants and secondary wants

a. Basic wants

These are the essential needs in life such that one cannot do without them. They include food, shelter and clothing. They are satisfied before the secondary wants. They have the following characteristics;

- One cannot do without them;
- They're felt needs;
- Cannot be postponed;
- They are satisfied before secondary wants.

b. Secondary wants

Secondary wants are requirements for comfortable and luxuriant live. Comforts provide good life, beyond mere survival. It includes such needs like Medicare, education and security. Luxuries include even much more flamboyant needs like a sleek car, a mansion, study abroad and such kinds of needs. At times some secondary want may be meant to save lives, for instance Medicare. In such circumstances, the needs become a basic want.

SCARCITY

To the economists all things are said to be scarce, since by “scarce” they mean simply “that there are not enough to fill everyone’s wants to the point of satiety”. Most people would probably like to have more of many things or goods of better quality than they possess at present: larger houses perhaps in which to live, better furnished with the latest labour-saving devices, such as electric washers, cookers, refrigeration; more visits to theatre or the concert hall; more travel; the latest models in motor cars; radios and television sets; and most women exhibit an apparently insatiable desire for clothes. People’s wants are many, but the resources for making the things they want – labour, land, raw materials, factory buildings, machinery – are themselves limited in supply. There are insufficient productive resources in the world, therefore, to produce the amount of goods and services that would be required to satisfy everyone’s wants fully. Consequently, to the economist all things are at all times said to be “scarce”.

CHOICE AND OPPORTUNITY COST

Because there are not enough resources to produce everything we want, a choice must be made about which of the wants to satisfy. In economics, it is assumed that people always choose the alternative that will yield them the greatest satisfaction. We therefore talk of Economic Man. Choice involves *sacrifice*. If there is a choice between having guns and having butter, and a country chooses to have guns, it will be giving up butter to the guns. The cost of having guns can therefore be regarded as the sacrifice of not being able to have butter. The cost of an item measured in terms of the alternative forgone is called its opportunity cost.

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TOPIC 2

DEMAND, SUPPLY AND DETERMINATION OF EQUILIBRIUM

DEMAND ANALYSIS

Introduction

In any economy there are millions of individuals and institutions and to reduce things to a manageable proportion they are consolidated into three important groups; namely

- Households
- Firms
- Central Authorities

These are the **dramatis personae** of the economic theory and the stage on which much of their play is acted is called the MARKET (see lesson three for definition of market).

Household

This refers to all the people who live under one roof and who make or are subject to others making for them, joint financial decisions. The household decisions are assumed to be consistent, aimed at **maximizing utility** and they are the principal owners of the factors of production. In return for the factors or services of production supplied, they get or receive their income e.g.

- Labour – wages and salaries
- Capital – interest
- Land – rent
- Enterprise – profit

The firm

The unit that uses factors of production to produce commodities then it sells either to other firms, to household, or to central authorities. The firm is thus the unit that makes the decisions regarding the employment of the factors of production and the output of commodities. They are assumed to be aiming at **maximizing profits**.

Central authorities

This comprehensive term includes all public agencies, government bodies and other organisations belonging to or under the direct control of the government. They exist at the centre of legal and political power and exert some control over individual decisions taken and over markets.

DEMAND ANALYSIS

DEFINITION

Demand is the quantity per unit of time, which consumers (households) are willing and able to buy in the market at alternative prices, other things held constant.

INDIVIDUAL VERSUS MARKET DEMAND

(i) Individual and market demand schedule

The plan of the possible quantities that will be demanded at different prices by an individual is called **Individual demand schedule**. Such a demand schedule is purely hypothetical, but it serves to illustrate the **First Law of Demand and Supply that more of a commodity will be bought at a lower than a higher price**.

PRICE (SH)	QUANTITY DEMANDED PER WEEK
20	3
18	3.5
16	4
14	5
13	6
12	7
11	8
10	9

Table : The individual demand schedule

Theoretically, the demand schedule of all consumers of a given commodity can be combined to form a **composite demand schedule**, representing the total demand for that commodity at various prices. This is called the **Market demand schedule**.

PRICE(SH)	QUANTITY DEMANDED PER WEEK
20	100000
18	120000
16	135000
14	150000
13	165000
12	180000
11	200000
10	240000
9	300000
8	350000

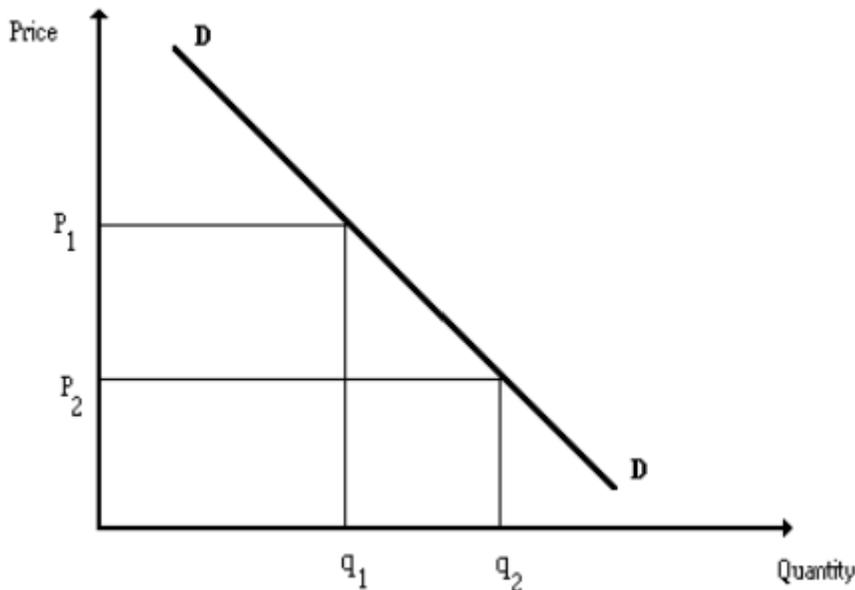
Table: The market demand schedule.

These prices are called **Demand Prices**. Thus, the demand price for 200,000 units per week is KShs 11 per unit.

(ii) The individual and market demand curves

The quantities and prices in the demand schedule can be plotted on a graph. Such a graph after the individual demand schedule is called **The Individual Demand Curve** and is downward sloping.

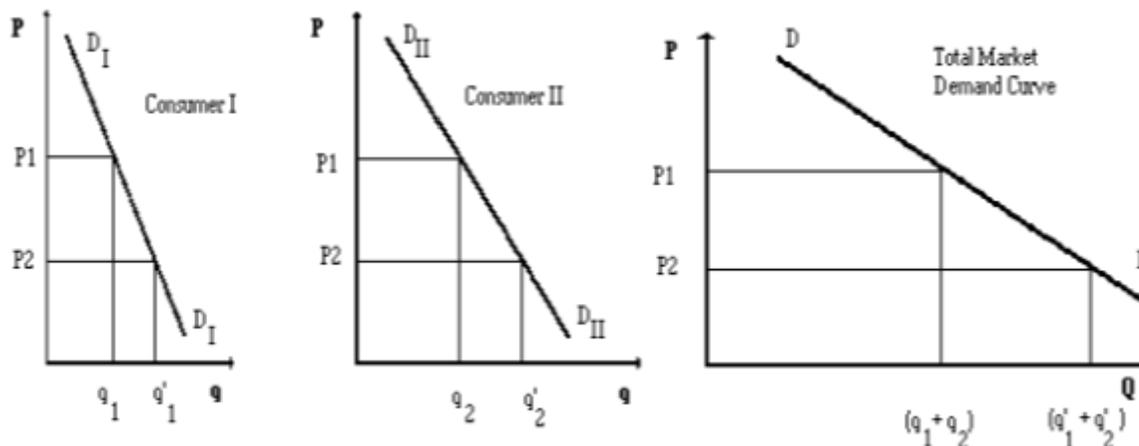
An individual demand curve is the graph relating prices to quantities demanded at those prices by an individual consumer of a given commodity



The curve can also be drawn for the entire market demand and is called a **Market Demand Curve**:

A market demand curve is the horizontal summation of the individual demand curves i.e. by taking the sum of the quantities consumed by individual consumers at each price.

Consider a market consisting of two consumers:



.At price P1 in the figure above, consumer 1 demands q1, consumer II demands quantity q2, and total market demand at that price is (q1+q2). At price p2, consumer 1 demands q'1, and consumer II demands quantity q'2 and total market demand at that price is (q'1+q'2). DD is the total market demand curve.

FACTORS INFLUENCING DEMAND

These are broadly divided into factors **determining household** demand and factors affecting **market demand**.

Factors affecting household demand

- The taste of the household
- The income of the household
- The necessity of the commodity, and its alternatives if any
- The price of other goods

Factors affecting the total market demand

These are broadly divided into the determinants of demand and conditions of demand.

(a) Own price of the product

This is the most important determinant of demand. The determinants of demand other than price are referred to as the conditions of demand.

Changes in the price of a product bring about changes in quantity demanded, such that when the price falls more is demanded. This can be illustrated mathematically as follows:

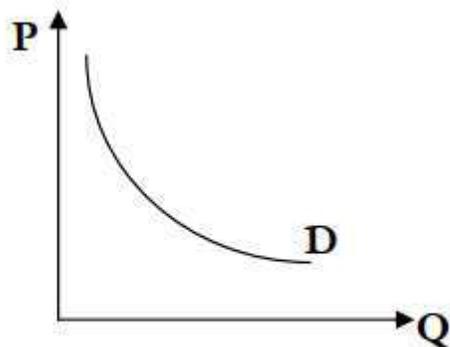
$$Q_d = a - bp$$

Where Q_d is quantity demanded

a is the factor by which price changes

p is the price

Thus, ceteris paribus, there is an inverse relationship between price and quantity demanded. Thus the normal demand curve slopes downwards from left to right as follows:



Exceptional demand curves

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TOPIC 3

THEORY OF THE CONSUMER BEHAVIOUR

APPROACHES TO THE THEORY OF THE CONSUMER

CARDINAL VERSUS ORDINAL APPROACH

Through the study of theory of consumer behaviour we can be able to explain why consumers buy more at a lower price than at a higher price or put differently why individuals or households spend their money as they do. We shall assume that the consumer is rational and aims at maximising his satisfaction, so given his income he consumes that basket of goods and services which produces maximum satisfaction. Two major theories explain the behaviour of the consumer, neither presents a totally complete picture. The first approach is the marginal utility, or cardinalist approach. The second approach centres on the indifference curve analysis or the ordinalist approach.

CARDINAL UTILITY APPROACH

The downward sloping nature of the demand curve can be explained by using the **law of diminishing marginal utility**. For instance, consider a consumer who has to choose between two goods, X and Y, which have prices P_x and P_y respectively. Assume that the individual is rational and so wishes to maximise total utility subject to the size of the income.

The consumer will be maximising total utility when his or her income has been allocated in such way that utility to be derived from the consumption of one extra shillings worth of X is equal to the utility to be derived from the consumption of one extra shillings worth of Y. In other words, when the marginal utility per shilling of X is equal to the marginal utility per shilling of Y. Only when this is true will it not be possible to increase total utility by switching expenditure from one good to another. This condition for **consumer equilibrium** can be written as follows:

$$M_{ux}/P_x = M_{uy}/P_y$$

Where MU_x and MU_y are the marginal utilities of X and Y respectively and P_x and P_y are the prices (in shillings) of X and Y respectively.

Any number of commodities may then be added to the equation. The table below gives

hypothetical marginal utility figures for a consumer who wishes to distribute expenditure of K£44 between three commodities X, Y and Z.

Marginal utilities derived from each Kg of:

Kg consumed	x (£8/kg)	Y (£4/kg)	Z (£2/kg)
1	72	60	64
2	48	44	56
3	40	32	40
4	36	24	28
5	32	20	16
6	20	8	12
7	12	4	8

In order to maximize utility, the consumer must distribute available income so that:

$$Mux/PX = MuY/Py = Muz/Pz$$

From the table you can see that this yields, a selection where the consumer buys 2 kg of X, 4 kg of Y and 6 kg of Z. Hence:

$$48/8 = 24/4 = 12/2$$

If the consumer wishes to spend all the K£44, it is impossible to distribute it any other way which would yield greater total quality. This theorem is called the concept of **equi-marginal utilities**.

The demand curve

Suppose that starting from a condition of equilibrium, the price of X falls relative to Y. We now have a condition where the utility from the last shilling spent on X will be greater than the utility from the last shillings spent on Y. Mathematically this can be written as:

$$Mux/Px > MuY/Py$$

In order to restore the equilibrium the consumer will buy more of X (and less of Y), thus reducing the marginal utility of X. The consumer will continue substituting X for Y until equilibrium is achieved. Thus we have attained the normal demand relationship that, ceteris paribus, as the price of X falls, more of it is bought. We have therefore a normal downward sloping demand curve. The demand curve we have derived is the individuals' demand curve for a product. The market demand curve can be then obtained by aggregating all the individual demand curves.

The explanation we have obtained here is of the price (or substitution) effect.

Market demand and consumers surplus.

Suppose that the market price of a cup of coffee is K£4 but the consumer was willing to pay £9 for the first unit, £8 for the second, £7 for the third, £6 for the fourth, £5 for the fifth and £4 for the sixth.

However, he pays the market price for all the six cups. The consumer thus earns a surplus on the first five units consumed i.e.

A measure of the difference between the value that consumers place on their total consumption of some commodity and the amount they actually pay for it.

For continuous demand curves, consumer's surplus can be measured by the area under the demand curve and above the price.

NB: The shaded area represents utility which the consumers received but did not pay for i.e. consumer surplus.

Mathematically it can be calculated as follows:

$$£5 + £4 + £3 + £2 + £1 = £15$$

ORDINAL APPROACH

In the 1930s a group of economists, including Sir John Hicks and Sir Roy Allen, came to believe that cardinal measurement of utility was not necessary. They argued that demand behavior could be explained with ordinal numbers (that is, first, second, third, and so on). This is because, it is argued, individuals are able to rank their preferences, saying that they would prefer this bundle of goods to that bundle of goods and so on. Finite measurement of utility therefore becomes unnecessary and it's sufficient simply to place in order consumers preference to investigate this we must investigate indifference curves.

UTILITY ANALYSIS, MARGINAL UTILITY(MU), LAW OF DIMINISHING MARGINAL UTILITY**Utility**

Utility is the amount of satisfaction derived from the consumption of a commodity or service at a particular time. Utility is not inherent but a psychological satisfaction, i.e. depends on the individual's own subjective estimate of the amount of satisfaction to be obtained from the consumption of the commodity.

Marginal Utility

The extra utility derived from the consumption of one more unit of a good, the consumption of all other goods remaining unchanged.

THE LAW OF DIMINISHING MARGINAL UTILITY

This states that as the quantity of a good consumed by an individual increases, the marginal utility of the good will eventually decrease.

Units of X consumed	Total Utility/ TU (utils)	Marginal Utility/ MU (utils)
0	0	0
1	15	15
2	25	10
3	33	8
4	38	5
5	40	2
6	40	0
7	39	-1

Consuming 1 unit of X gives 15 utils of satisfaction, consuming 2 units gives 25 utils, and so on.

The figure of marginal utility decline as each successive unit is consumed. If the consumer goes on consuming more and more units, eventually he reaches a point (the sixth unit) where additional units yields no extra satisfaction at all.

LIMITATIONS OF CARDINAL APPROACH

- Utility cannot be measured objectively and the attempt to measure it by an economist Walras using utils doesn't give a satisfactory solution
- The assumption of constant marginal utility of money is unrealistic because as income increase, the marginal utility of money also increases
- The assumption of diminishing marginal utility is a psychological law that is a feeling that cannot be quantified

INDIFFERENCE CURVE ANALYSIS

In order to explain indifference curves, we will again make the simplifying assumption that the consumer buys two goods, x and y.

The table below gives a number of combinations of x and y which the consumer considers to give the same satisfaction as for example, combination c of bx and 4y is thought to give the same satisfaction as D where 7x and 2y are consumed. The consumer is thus said to be indifferent as to which combination they have hence the name given to this type of analysis.

An indifference schedule

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TOPIC 4

THE THEORY OF PRODUCTION

FACTORS OF PRODUCTION

The sum total of the economic resources which we have in order to provide for our economic wants are termed as *factors of production*. Traditionally economists have classified these under four headings. They are:

- i. Labour
- ii. Land
- iii. Capital
- iv. Enterprise

The first two are termed primary factors since they are not the result of the economic process; they are, so to speak, what we have to start with. The secondary factors, however are a consequences of an economic system.

i) Land

The term land is used in the widest sense to include all the free gifts of nature; farmlands, minerals wealth such as coal mines, fishing grounds, forests, rivers and lakes.

In practise it may be very difficult to separate land from other factors of production such as capital but, theoretically, it has two unique features which distinguish it.

Firstly, it is **fixed in supply**. As land includes the sea in definition, then we are thus talking about the whole planet, and it is obvious that we cannot acquire more land in this sense.

Secondly, land has no cost of production. The **individual** who is trying to **rent** a piece of land may have to pay a great deal of money but it never cost **society** as a whole anything to produce land.

ii) Capital

Capital as a factor of production can be defined either as the stock of wealth existing at any one time and as such, capital consists of all the real **physical** assets of society. An alternative formulation of capital is that it refers to all those goods, which are used in the production of further wealth.

Capital can be divided into **fixed capital**, which is such things as building, roads, machinery etc and **working capital** or **circulating capital** which consists of stocks of raw materials and semi-manufactured goods. The distinction is that fixed capital continues through many rounds of production while working capital is used up in one round; For example, a classroom would be fixed capital, while stocks of chalk to be used for writing would be circulating/working capital.

As stated previously, capital is a secondary factor of production, which means that results from the economics system. Capital has been created by individuals **forgoing current consumption**, i.e. people have refrained from consuming all their wealth immediately and have saved resources which can then be used in the production of further wealth.

iii) Labour

Labour is the exercise of human, physical and mental effort directed to the production of goods and services. Included in this definition is all the labour which people undertake for reward, either in form of wages and salaries or incomes from self employment. We would not, therefore include housework or the efforts of do-it-yourself enthusiasts, even though these may be hard work.

Some aspects of labour

Labour is no doubt the most important of all factor or production, for the efficiency of any production will to a large extent depend on the **efficiency** and **supply** of the labour working in the process. Besides labour is also the end for which all production is undertaken.

Supply of labour

Supply of labour refers to the number of workers (or, more generally, the number of labour hours) available to an economy. The supply of labour will be determined by:

I. Population Size

In any given economy, the population size determines the upper limit of labour supply.

Clearly there cannot be more labour than there is population.

II. Age Structure

- The population is divided into three age groups. These are:
- The young age group usually below the age of 18, which is considered to be the minimum age of adulthood. People below this age are not in the labour supply, i.e. they are not supposed to be working or looking for work.
- The working age group, usually between 18 and 60, although the upper age limit for this group varies from country to country. In Kenya for example, for public servants, it is 55 years. It is the size of this group which determines the labour supply.
- The old age group, i.e. above 60 years are not in the labour force.

III. The Working Population

Not everybody in the working age group will be in the labour force. What is called the working population refers to the people who are in the working group, and are either working or are actively looking for work, I.e. would take up work if work was offered to them. These are sometimes called the actively active people. Hence this group excludes the sick, the aged, the disabled and (full time) housewives, as well as students. These are people who are working and are not willing or are not in a position to take up work was given to them.

IV. Education System

If the children are kept in school longer, then this will affect the size of the labour force of the country.

V. Length of the Working Week

This determines labour supply in terms of Man-hours. Hence the fewer the holidays there are, the higher will be the labour supply. This does not, however mean that if the number of working hours in the week are reduced, productivity if there is a high degree of automation.

VI Remuneration

The preceding five factors affect the supply of labour in totality. Remuneration affects the supply of labour to a particular industry. Thus, an industry which offers higher wages than other industries will attract labour from those other industries.

VII The Extent to Barriers to Entry into a Particular Occupation

If there are strong barriers to the occupation mobility of labour into a particular occupation, e.g. special talents required or long periods of training, the supply of labour to that occupation will be limited.

Efficiency of Labour

Efficiency of labour refers to the ability to achieve a greater output in a shorter time without any falling off in the quality of the work – that is to say, increase productivity per man employed. The efficiency of a country's labour force depends on a number of influences.

i. Climate

This can be an important influence on willingness to work, for extremes of temperatures or high, humidity are not conducive to concentration even on congenial tasks.

ii. Education and training

Education and training produce skills and therefore efficient labour. Education has three aspects: general education, technical education and training within industry. A high standard of general education is essential for developing intelligence and providing a foundation upon which more specialized vocational training can be based. Technical training provided in the universities, colleges and by industry itself. Training within industry is given by each firm to its employees.

iii. Working Conditions

Research has shown that if working conditions are safe and hygienic, the efficiency of labour will be higher than if the conditions were unsafe or unhygienic.

iv. Health of the worker

The efficiency of the worker is closely related to his state of health which depends on his being adequately fed, clothed, and housed.

v. Peace of Mind

Anxiety is detrimental to efficiency. People (workers) may be tempted to overwork themselves to save at the expense of health to provide for contingencies like times of sickness, unemployment and old age. Others may be worried about their work or their private problems.

vi. Efficiency of the Factors

The productivity of labour will be increased if the quality of the factors is high. The more fertile the land, the greater will be the output per mass, other things being equal. Similarly, the greater the amount and the better the quality of the capital employed, the greater will be the productivity of the labour.

Efficiency of the organisation is even more important since this determines whether the best use is being made of factors of production.

vii. Motivating factors

These are factors which boost the morale of the workers and hence increase the efficiency.

They include such things as free or subsidised housing, free medical benefits, paid sick leave, allowing workers to buy shares in the company and incorporating workers' representatives in the decision-making of the firm, In this way the workers feel that they are part and parcel of the organisation and are not being used.

viii. The Extent of Specialisation and Division of Labour

The greater the amount of specialisation, the greater will be the output per man, Division of labour increases the efficiency of labour.

ix The Entrepreneur

Land, capital and labour are of no economic importance unless they are organised for production. The entrepreneur is responsible not only for deciding what method of production shall be adopted but for organising the work of others. He has to make many other important decisions such as what to produce and how much to produce.

Functions of the Entrepreneur

1. Uncertainty Bearing

Most production is undertaken in anticipation of demand. Firms will produce those things which they believe will yield profit. They do not know that they will do so because the future is unknown.

2. Management Control

This involves responsibility for broad decisions of policy and the ability to ensure that these decisions are carried out.

TOPIC 5

MARKET STRUCTURES

DEFINITION OF A MARKET

A Market may be defined as an area over which buyers and sellers meet to negotiate the exchange of a well-defined commodity. Markets may also mean the extent of the sale for a commodity as in the phrase, “there is a wide market for this or that commodity”. In a monetary economy, market means the business of buying and selling of goods and services of some kind.

Concepts to know:

i. **Average Revenue (AR):** This is the revenue per unit of the commodity sold. It is obtained by dividing Total Revenue by total quantity sold. For a firm in a perfectly competitive market, the AR is the same as price. Therefore, if price is denoted by P, then we can say:

$$P = AR$$

Because of this, the demand curve which relates prices to quantities demanded at those prices is also called Average Revenue Curve. In economic theory, the demand curve or price line is often referred to as the revenue curve.

ii. **Marginal Revenue (MR):** This is the increase in Total Revenue resulting from the sale of an extra unit of output. Thus, if TR_{n-1} is Total Revenue from the sale of (n-1) units and

TR_n is total revenue from the sale of n units, then the marginal revenue of the nth unit is given as:

$$\frac{dTR}{dQ} = P(1 - 1/E_d) \text{ or } TR_n - TR_{n-1}$$

iii. **Total Revenue:** The money value of the total amount sold and is obtained by multiplying the price by the total quantity sold.

NECESSARY AND SUFFICIENT CONDITIONS FOR PROFIT MAXIMIZATION

Two conditions that however prevail, namely:

i. The necessary condition is that

$$w/r = MPL/MP_k \text{ or } MPL/PL = MP_k/P_k$$

ii. The sufficient condition is that the Isoquant must be convex to the Isocost point of Tangency.

MATHEMATICAL APPROACH TO PROFIT MAXIMIZATION

An industry which is categorized as perfectly competitive is composed of many sellers (such as farmers) providing a homogeneous (having all terms/products of the same degree/kind) good to numerous buyers who are all informed about the product. Both buyers and sellers are free to enter and exit a competitive market at any time. In such a free market, individual firms have no control over price; instead these firms are forced to sell their goods at a price which is determined by the market as a whole. If they choose to sell goods at a higher price, they will not be able to sell much (if any) because consumers could buy homogeneous products from another firm at a lower price. If they choose to sell the good at a lower price, they would sell an infinite (if possible) number of goods, forcing all other firms to lower their price as well. This concept is what gives rise to competitive firms being referred to as “**price takers**.”

Competitive firms' prices are determined by the market, and all goods are sold to all consumers at that same price. Additional revenue added by each unit sold (marginal revenue) will be equal to the price at which that last unit was sold, and because this price will be the same for that unit as any other unit in a competitive industry, price will always be equal to marginal revenue (**P=MR**).

Since competitive firms have no control over the price at which their goods are sold, their only hope to maximize profits is to choose the optimal quantity of goods to sell (**Q**). There are two methods by which one can solve for the optimal quantity for a perfectly competitive firm to produce and sell:

1. Total Revenue (**TR**) and Total Cost (**TC**)
2. Marginal Revenue (**MR**) and Marginal Cost (**MC**)

Each of these methods will be demonstrated with an example

*NOTE: To maximize any equation we must find where the slope of the equation's graph is equal to zero. Because the slope of one equation's line is equal to the derivative of that equation at a given point, we can maximize a given equation by setting the derivative of that equation equal to zero.

1. Total Revenue and Total Cost (everything expressed in dollars)

$$\text{Given: } TC = 100 + 10Q + Q^2$$

$$P = 50$$

We must first figure TR

$$TR = P \times Q \text{ but since we know } P = 50$$

$$TR = 50 \times Q$$

$$\text{Profit (pi) function: } \pi = TR - TC$$

Plug in values for both TR and TC

$$TR = 50 \times Q$$

$$TC = 100 + 10Q + Q^2$$

$$\pi = TR - TC$$

$$\pi = 50Q - (100 + 10Q + Q^2)$$

$$pi = 50Q - 100 - 10Q - Q^2$$

$$pi = 40Q - 100 - Q^2$$

Next, find the derivative of the profit function with respect to Q.

$$\frac{d(pi)}{dQ} \text{ with respect to } Q = 40 - 2Q$$

To maximize profit, set the derivative of the profit function equal to zero and solve for Q

$$40 - 2Q = 0$$

$$40 = 2Q$$

$$20 = Q$$

To maximize profits this competitive producer will produce 20 units to sell them at a price of \$50

2. Marginal Revenue and Marginal Cost (everything expressed in dollars)

We already know:

$$\frac{dTR}{dQ} = MR \quad \text{slope of TR curve}$$

$$\frac{dTC}{dQ} = MC \quad \text{slope of TC curve}$$

$$pi = TR - TC$$

Find the derivative of the profit function with respect to Q

$$dpi = \frac{dTR}{dQ} - \frac{dTC}{dQ}$$

To maximize profit, set the derivative of the profit function equal to zero

$$\frac{dTR}{dQ} - \frac{dTC}{dQ} = 0$$

Since we know that those above fractions are equal to MR and MC respectively we can substitute them into the equation

$$MR - MC = 0$$

$$MR = MC$$

For a competitive firm to maximize profits they must produce at an output where MR is equal to MC

$$\text{Given: } TC = 100 + 10Q + Q^2$$

$$P = 50$$

Find MR

Since this is a competitive firm $MR = P$

$$MR = P, \text{ where}$$

$$P = 50. \text{ So,}$$

$$MR = 50$$

Find MC

$$\frac{dTC}{dQ} = MC$$

$$TC = 100 + 10Q + Q^2$$

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$dTC = 10 + 2Q$. Thus, marginal cost, $MC = 10 + 2Q$.

For a competitive firm to maximize profits MR must be equal to MC

Set MR equal to MC and solve for Q

$$MR = 50$$

$$MC = 10 + 2Q$$

$$MR = MC$$

$$50 = 10 + 2Q$$

$$40 = 2Q$$

$$20 = Q$$

To maximize profits this competitive producer will produce 20 units to sell them at a price of \$50

*As can be seen by the above examples these two methods (Total Revenue and Total Cost Approach and the

Marginal Revenue and Marginal Cost Approach) have each arrived at the same conclusion. Either one can be used on any problem and the answers derived from each method will always be in agreement.

Sample Problems

Now try these on your own! First, solve them using the Total Approach. Then, check your answers by using the Marginal Approach.

1. Given: $TC = 70 + 30Q + 2Q^2$

$P = 40$ find the optimal quantity produced and sold by the firm so that they are maximizing profits.

2. Given: $TC = 400 - 50Q + 5Q^2$

$P = 80$.

Find the optimal quantity produced and sold by the firm so that they are maximizing profits.

ANSWERS: 1. $Q = 2.5$, 2. $Q = 13$

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MACROECONOMICS

TOPIC 6

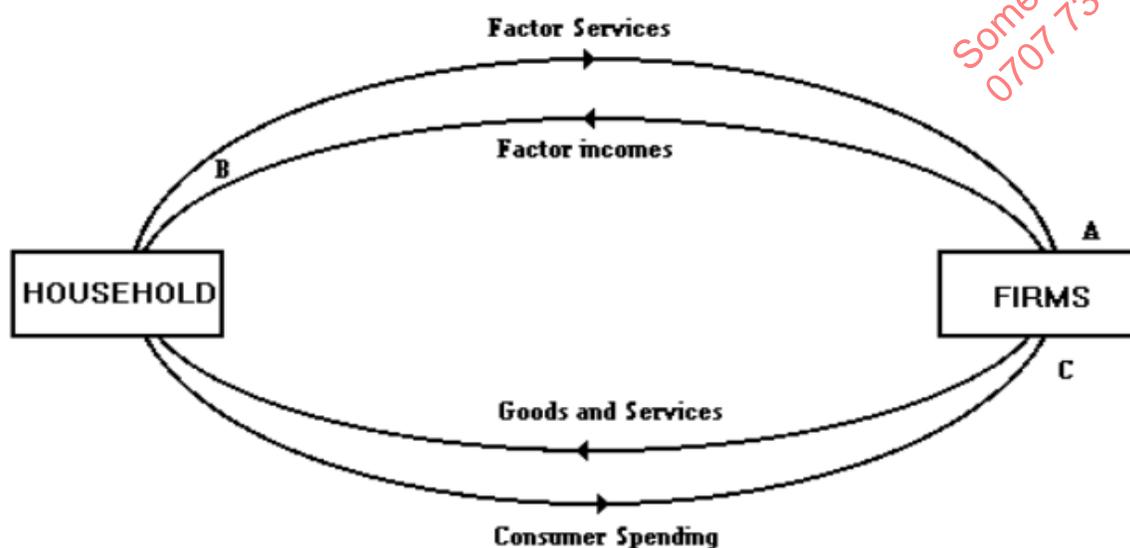
NATIONAL INCOME

DEFINITION OF NATIONAL INCOME

National Income is a measure of the money value of goods and services becoming available to a nation from economic activities. It can also be defined as the total money value of all final goods and services produced by the nationals of a country during some specific period of time – usually a year – and to the total of all incomes earned over the same period of time by the nationals.

THE CIRCULAR FLOW OF INCOME AND EXPENDITURE

This is an economic model illustrating the flow of payments and receipts between domestic firms and domestic households. The households supply **factor services** to the firms. In return, they get **factor incomes**. With factor incomes, they buy **goods and services** from the firms. These flows can be illustrated diagrammatically as follows:



The points at which flows from one sector meet the other sector and generate other flows are called **critical points**. In the above diagram, the critical points are A, B and C. At A, the flow of factor services from the households sector meets the firm sector and generates the **flow of**

factors incomes from the firms to the households. At B, the flow of factor incomes meets the household sector and generates the flow of **consumer spending**. At C, the flow of consumer spending meets the firms sector and generates the flow of **goods and services**.

APPROACHES TO MEASURING NATIONAL INCOME

The compilation of national income statistics is a very laborious task. The total wealth of a nation has to be added up and there are millions of nationals. Moreover, in order to double check and triple check the statistics, the national income statistician has to work out the figures out in three different ways, each way being based on a different aspect. The three aspects are:

a. The national output: - The creation of wealth by the nation's industries. This is valued at factor cost, so it must be the same as b) below.

b. The national income: - The incomes of all the citizens.

c. The national expenditure because whatever we receive we spend, or lend to the banks to invest it, so that the addition of all the expenditure should come to the same as the other two figures.

Put in its simplest form we can express this as an identity:

National output \equiv National Income \equiv National Expenditure.

(i) Using Total Expenditure for Calculating National Income

The expenditure approach centres on the components of **final demand** which generate production. It thus measures GDP as the total sum of expenditure on **final goods and services** produced in an economy. It includes all consumers' expenditure on goods and services, except for the purchase of new houses which is included in gross **fixed capital formation**. Secondly we included all general **government final consumption**. This includes all current expenditure by **central and local** government on goods and services, including wages and salaries of government employees. To these we add **gross fixed capital formation or expenditure on fixed assets** (buildings, machinery, vehicles etc) either for replacing or adding to the stock of existing fixed assets. This is the major part of the investment which takes place in the economy. In addition we add the **value of physical increases in the stocks, or inventories**, during the course of the year. The total of all this gives us **Total domestic expenditure (TDE)**. We then add expenditure on exports to the

TDE and arrive at a measure known as **Total Final Expenditure**. It is so called because it represents the total of all spending on final goods. However, much of the final expenditure is on **imported goods** and we therefore **subtract spending on imports**. Having done this we arrive at a measure known as **gross domestic product at market prices**. To gross domestic product at market price we **subtract the taxes on expenditure** levied by the government and add on the amount of subsidy. When this has been done we arrive at a figure known as **Gross Domestic Product at factor cost**. National Income however is affected by **rent, profit interest** and dividends paid to, or received from, overseas. This is added to GDP as net property income from abroad. This figure may be either **positive or negative**. When this has been taken into account we arrive at the gross national product at factor cost. As production

takes place, the capital stock of a country wears out. Part of the gross fixed capital formation is therefore, to replace worn out capital and is referred to as **Capital Consumption**. When this has been subtracted we arrive at a figure known as the **net national product**. Thus, summarising the above, we can say:

$$Y = C + I + G + (X - M)$$

Calculating National Income from Total Expenditure

Country Y National Expenditure (in £millions)	1999
Expenditure of Consumers	
Food	27,148
Alcoholic drink	13,372
Tobacco	6,208
Housing	27,326
Fuel and light	9,395
Clothing	12,114
Household goods and services	12,274
Transport and communications	31,475
Recreation	16,541
Other goods and services	<u>23,356</u>
Total	179,209
Less: Adjustment of non-profit making bodies	(443)
	178,766
	178,766
Add: Expenditure of non-profit making bodies	<u>3,661</u>
	182,427
Central Government expenditure	40,623
Local Government expenditure	25,236
Capital formation	49,559
Growth in stocks	<u>267</u>
Total Domestic expenditure at market prices	298,112
Deduct: Taxes on expenditure	<u>(49,865)</u>
	248,247
Add: Net result exports-imports	3,186
Subsidies	6,056
Net property income from abroad	<u>1,948</u>
	<u>11,190</u>
	259,437
Less: Estimated depreciation on capital assets	<u>36,490</u>
	<u>222,947m</u>

(ii) Using Factor Incomes for Calculating National Income

A second method is to **sum up all the incomes** to individuals in the form of **wages, rents, interests** and **profits** to get domestic incomes. This is because each time something is produced and sold someone obtains income from producing it. It follows that if we add up all incomes we should get the value of total expenditure, or output. Incomes earned for purposes other than rewards for producing goods and services are ignored. Such incomes are **gifts**,

unemployment or relief benefits, lottery, pensions, grants for students etc. These payments are known as **transfer income (payments)** and including them will lead to **double counting**. The test for inclusion in the national income calculation is therefore that there should be a **“quid pro quo”** that the money should have been paid against the exchange of a good or service. Alternatively, we can say that there should be a **“real”** flow in the opposite direction to the money flow. We must also include income obtained from **subsistence output**. This is the opposite case from transfer payments since there is a flow of real goods and services, but no corresponding money flow. It becomes necessary to “impute” values for the income that would have been received. Similarly workers may, in addition to cash income, receive **income in kind**; if employees are provided with **rent free housing**, the rent which they would have to pay for those houses on the open market should, in principle, be “imputed” as part of their income from employment. The sum of these incomes gives **gross domestic product GDP**.

This includes incomes earned by foreigners at home and excludes incomes earned by nationals abroad. Thus, to **Gross Domestic Income** we add **Net property Income** from abroad. This gives **Gross National Income**. From this we deduct **depreciation** to give **Net National Income**.

Calculating National Income from Factors Incomes

Country Y National Income rewards to factors (in £ millions)

1999

Incomes from employment

Wages and salaries		143,348
Pay in cash and kind of HM Forces		3,121
Employers' contribution to National Health Insurance	10,632	
Employers' contribution to other funds	<u>12,971</u>	
		170,072
Income from self-employment		23,123
Other Incomes		
Profits of companies	41,530	
Surpluses of public corporations	9,661	
Surpluses of other public enterprises (-)	(109)	
Rent		17,424
Imputed charge for consumption of capital	<u>2,456</u>	
		264,157
Less: Stock appreciation		<u>(4,326)</u>
		259,831
Add: net property income from abroad		<u>1,948</u>
		261,779
Less: Residual error	2,342	
Estimated depreciation on capital assets	36,490	<u>(38,832)</u>
		222,947m

Note: The residual error is a small error (about 1%) in the collection of these figures.

(iii) Using the National Output for Calculating National Income

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TOPIC 7

ECONOMIC GROWTH, ECONOMIC DEVELOPMENT AND ECONOMIC PLANNING

THE DIFFERENCE BETWEEN ECONOMIC GROWTH AND ECONOMIC DEVELOPMENT

Economic Growth is a narrower concept than economic development. It is an increase in a country's real level of national output which can be caused by an increase in the quality of resources (by education etc.), increase in the quantity of resources & improvements in technology or in another way an increase in the value of goods and services produced by every sector of the economy. Economic Growth can be measured by an increase in a country's GDP (gross domestic product).

Economic development is a normative concept i.e. it applies in the context of people's sense of morality (right and wrong, good and bad). The definition of economic development given by Michael Todaro is an increase in living standards, improvement in self-esteem needs and freedom from oppression as well as a greater choice. The most accurate method of measuring development is the Human Development Index which takes into account the literacy rates & life expectancy which affects productivity and could lead to Economic Growth. It also leads to the creation of more opportunities in the sectors of education, healthcare, employment and the conservation of the environment. It implies an increase in the per capita income of every citizen.

Economic Growth does not take into account the size of the informal economy. The informal economy is also known as the black economy which is unrecorded economic activity. Development alleviates people from low standards of living into proper employment with suitable shelter. Economic Growth does not take into account the depletion of natural resources which might lead to pollution, congestion & disease. Development however is concerned with sustainability which means meeting the needs of the present without compromising future needs. These environmental effects are becoming more of a problem for Governments now that the pressure has increased on them due to Global warming.

Economic growth is a necessary but not sufficient condition of economic development.

Comparison

	Economic Development	Economic Growth
Implications	Economic development implies an upward movement of the entire social system in terms of income, savings and investment along with progressive changes in socioeconomic structure of country (institutional and technological changes).	Economic growth refers to an increase over time in a country's real output of goods and services (GNP) or real output per capita income.
Factors	Development relates to growth of human capital indexes, a decrease in inequality	Growth relates to a gradual increase in one of the components

	Economic Development	Economic Growth
	figures, and structural changes that improve the general population's quality of life.	of Gross Domestic Product: consumption, government spending, investment, net exports.
Measurement	Qualitative. HDI (Human Development Index), gender-related index (GDI), Human poverty index (HPI), infant mortality, literacy rate etc.	Quantitative. Increases in real GDP.
Effect	Brings qualitative and quantitative changes in the economy	Brings quantitative changes in the economy Economic growth is a more relevant metric for progress in developed countries. But it's widely used in all countries because growth is a necessary condition for development.
Relevance	Economic development is more relevant to measure progress and quality of life in developing nations.	Growth is concerned with increase in the economy's output
Scope	Concerned with structural changes in the economy	

ACTUAL AND POTENTIAL GROWTH

Actual economic growth represents the fact that there is an actual increase in output; whereas potential economic growth represents an increase in the productive capacity of the economy.

Actual growth is defined as an increase in the output that an economy produces over a period of time, the minimum being two consecutive quarters. It economic growth is an increase in what an economy can produce if it is using all its scarce resources. An increase in an economy's productive output can be shown by an outward shift in the economy's production possibility frontier (PPF).

The simplest way to show economic growth is to bundle all goods into two basic categories, *consumer* and *capital* goods. An outward shift of a PPF means that an economy has increased its capacity to produce.

Potential growth is defined in the as the level of output that an economy can produce at a constant inflation rate. Although an economy can temporarily produce more than its potential level of output, that comes at the cost of rising inflation. Potential output depends on the capital stock, the potential labour force (which depends on demographic factors and on participation rates), the non-accelerating inflation rate of unemployment (NAIRU), and the level of labour efficiency.

THE BENEFITS AND COSTS OF GROWTH

Economic growth means an increase in real GDP. This increase in real GDP means there is an increase in the value of national output / national expenditure.

The benefits of economic growth include:

1. **Higher average incomes.** This enables consumers to enjoy more goods and services and enjoy better standards of living.
2. **Lower unemployment** With higher output and positive economic growth firms tend to employ more workers creating more employment.
3. **Lower government borrowing.** Economic growth creates higher tax revenues and there is less need to spend money on benefits such as unemployment benefit. Therefore economic growth helps to reduce government borrowing. Economic growth also plays a role in reducing debt to GDP ratios.
4. **Improved public services.** With increased tax revenues the government can spend more on public services, such as the NHS and education e.t.c.
5. **Money can be spent on protecting the environment.** With higher real GDP a society can devote more resources to promoting recycling and the use of renewable resources
6. **Investment.** Economic growth encourages investment and therefore encourages a virtuous cycle of economic growth.

Despite the benefits of economic growth, there are also potential costs, such as inflation, a current account deficit, environment costs and widening inequality.

However, the costs of economic growth will depend on the type of growth that we see.

Potential costs of economic growth include:

1. Inflation. If AD increases faster than AS then economic growth will be unsustainable. Economic growth tends to cause inflation when the growth rate is above the long run trend rate of growth. It is when demand increases too quickly that we get a positive output gap and firms push up prices.

2. Boom and bust economic cycles. If economic growth is unsustainable then high inflationary growth may be followed by a recession. This occurred in the UK in the late 1980s and early 1990s.

In the 1980s there was an economic boom with growth of over 5% a year. However this caused inflation to rise to over 10%. To reduce inflation the government increased interest rates, this caused the economy to slow down and then enter into a recession.

- However if economic growth is at a sustainable rate this will not occur. For example, between 1993 and 2007, both economic growth and inflation were at a sustainable rate.

3. Current account deficit

Increased economic growth tends to cause an increase in spending on imports therefore causing a deficit on the current account.

4. Environmental costs

Increased economic growth will lead to increased output and therefore increased pollution and congestion. This will cause health problems such as asthma and therefore will reduce the quality of life. Economic growth also means greater use of raw materials and can speed up depletion of non-renewable resources.

5. Inequality

Higher rates of economic growth have often resulted increased inequality because growth can benefit a small section of society more than others. For example, those with assets and wealth will see a proportionally bigger rise in the market value of rents and their wealth. Those unskilled without wealth may benefit much less from growth.

However it depends upon things such as tax rates and the nature of economic growth. Economic growth can also be a force for reducing absolute and relative poverty.

DETERMINANTS OF ECONOMIC DEVELOPMENT

Economic development is a complex process. It is influenced by a number of factors such as natural resources, capital, human resources, technology, social attitude of the people, political condition in the country. All the factors having strong bearing on economic growth are divided into two categories, economic and non-economic. We discuss these determinants or factors of economic development under separate heads now.

(A) Economic Factors.

Economic factors play a very important role in the development of a country. The aggregate output rises or falls mainly due in changes to them. The main economic determinants are (1) Natural Resources (2) Capital (3) Labour (4) Power (5) Transport and Communication (6) Human Capital. These economic factors are discussed in brief.

(1) Natural Resources. The natural resources is the principal factor which affects the development of an economy. If a country is rich in natural resources, it is then able to make rapid progress in growth. In case a country is deficient in forest wealth, mineral resources, water supply, fertility of land etc., it is then normally not in a position to develop rapidly.

The pity with the most of LDC's is that their natural resources are under-utilized, unutilized or misutilized. This is one of the reasons for their backwardness. **It may here be noted that presence of rich resources is not a precondition for economic development.** There are countries in the world which do not have abundant resources, yet they have made rapid progress in growth by superior technology, new researches and higher knowledge. Japan, Switzerland, South Korea are resource poor countries, yet they have made rapid progress in economic growth through advanced technology and new discoveries.

(2) Capital Formation. Capital accumulation or capital formation is an important factor in the economic growth of a country. Capital formation refers to the process of adding to the stock of capital over time. The stock of capital can be built up and increased through three different resources which are as under:-

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TOPIC 8

MONEY AND BANKING

MONEY

THE NATURE AND FUNCTIONS OF MONEY

The development of money was necessitated by specialization and exchange. Money was needed to overcome the shortcomings and frustrations of the barter system which is system where goods and services are exchanged for other goods and services.

Disadvantages of Barter Trade

- It is impossible to barter unless A has what B wants, and A wants what B has. This is called double **coincidence** of wants and is difficult to fulfill in practice.
- Even when each party wants what the other has, it does not follow they can agree on a fair exchange. A good deal of time can be wasted sorting out equations of value.
- The indivisibility of large items is another problem. For instance if a cow is worth two sacks of wheat, what is one sack of wheat worth? Once again we may need to carry over part of the transaction to a later period of time.
- It is possible to confuse the **use value** and **exchange value** of goods and services in a barter economy. Such a confusion precludes a rational allocation of resources and promotion of economic efficiency.
- When exchange takes place over time in an economy, it is necessary to store goods for future exchange. If such goods are perishable by nature, then the system will break down.
- The development of industrial economies usually depends on a division of labour, specialization and allocation of resources on the basis of choices and preferences.

Economic efficiency is achieved by economizing on the use of the most scarce resources. Without a common medium of exchange and a common unit of account which is acceptable to both consumers and producers, it is very difficult to achieve an efficient allocation of resources to satisfy consumer preferences.

For these reasons the barter system is discarded by societies which develop beyond **autarky** to more specialized methods of production. For such peoples a money system is essential.

Money may be defined as anything generally acceptable in the settlement of debts.

The Historical development of money

For the early forms of money, the intrinsic value of the commodities provided the basis for general **acceptability**: For instance, corn, salt, tobacco, or cloth were widely used because they had obvious value themselves. These could be regarded as **commodity money**.

Commodity money had uses other than as a medium of exchange (e.g. salt could be used to preserve meat, as well as in exchange). But money commodities were not particularly convenient to use as money. Some were difficult to **transport**, some **deteriorated overtime**, some **could not be easily divided and some were valued differently by different cultures**.

As the trade developed between different cultures, many chose **precious metal's** mainly gold or silver as their commodity money. These had the advantage of being **easily recognizable, portable, indestructible and scarce** (which meant it preserved its value over time).

The value of the metal was in terms of weight. Thus each time a transaction was made, the metal was weighed and payment made. Due to the inconvenience of weighing each time a transaction was made, this led to the development of coin money. The state took over the **minting** of coins by stamping each as being a particular weight and purity (e.g. one pound of silver). They were later given a rough edge so that people could guard against being cheated by an unscrupulous trade filling the edge down.

It became readily apparent, however, that what was important was public confidence in the “currency” of money, it’s ability to run from hand to hand and circulate freely, rather than its intrinsic value. As a result there was deliberately reduced below the face value of the coinage.

Any person receiving such a coin could afford not to mind, so long as he was confident that anyone to whom he passed on the coin would also “**not mind**”. Debasement represents an early form of fiduciary issue, i.e. issuing of money dependent on the “faith of the public” and was resorted to because it permitted the extension of the supply of money beyond the availability of gold and silver.

Paper Money

Due to the risk of theft, members of the public who owned such metal money would deposit them for safe keeping with **goldsmiths** and other **reliable merchants** who would issue a receipt to the depositor. The metal could not be withdrawn without production of the receipt signed by the depositor. Each time a transaction was made, the required amount of the metal would be withdrawn and payment made.

It was later discovered that as long as the person being paid was convinced the person paying had gold and the reputation of the goldsmith was sufficient to ensure acceptability of his promise to pay, it became convenient for the depositor to pass on the goldsmith’s receipt and the person being paid will withdraw the gold himself. Initially, the gold would be withdrawn immediately after the transaction was made. But eventually it was discovered that so long as each time a transaction was made the person being paid was convinced that there was gold, the signed receipt could change hands more than once. Eventually, the receipts were made payable to the bearer (rather than the depositor) and started to circulate as a means of payment themselves, without the coins having to leave the vaults. This led to the development of **paper money**, which had the added advantage of lightness.

Initially, paper money was backed by precious metal and convertible into precious metal on demand. However, the goldsmiths or early bankers discovered that not all the gold they held was claimed at the same time and that more gold kept on coming in (gold later became the only accepted form of money). Consequently they started to issue more bank notes than they had gold to back them, and the extra money created was lent out as loans on which interest was

charged. This became lucrative business, so much so that in the 18th and 19th centuries there was a bank crisis in England when the banks failed to honour their obligations to their depositors, i.e. there were more demands than there was gold to meet them. This caused the government to intervene into the banking system so as to restore confidence. Initially each bank was allowed to issue its own currency and to issue more currency than it had gold to back it.

This is called **fractional backing**, but the Bank of England put restrictions on how much money could be issued.

Eventually, the role of issuing currency was completely taken over by the Central Bank for effective control. Initially, the money issued by the Central Bank was backed by gold (fractionally), i.e. the holder had the right to claim gold from the Central Bank. However, since money is essentially needed for purchase of goods and services, present day money is not backed by gold, but it is based on the level of production, the higher the output, the higher is the money supply. Thus, present day money is called **TOKEN MONEY** i.e. money backed by the level of output.

Over time, therefore, it became clear that for an item to act as money it must possess the following characteristics.

- **Acceptability**

If money is to be used as medium of exchange for goods and services, then it must be generally accepted as having value in exchange. This was true of metallic money in the past because it was in high and stable demand for its ornamental value. It is true of paper money, due to the good name of the note-issuing authority.

- **Portability**

If an item is to be used as money, it must be easily portable, so that it is a convenient means of exchange.

- **Scarcity**

If money is to be used in exchange for scarce goods and services, then it is important that money is in scarce supply. For an item to be acceptable as money, it must be scarce.

- **Divisibility**

It is essential that any asset which is used as money is divisible into small units, so that it can be used in exchange for items of low value.

- **Durability**

Money has to pass through many different hands during its working life. Precious metals became popular because they do not deteriorate rapidly in use. Any asset which is to be used as money must be durable. It must not depreciate over time so that it can be used as a store of wealth.

- **Homogeneity**

It is desirable that money should be as uniform as possible.

Functions of money

- a. **Medium of exchange:** Money facilitates the exchange of goods and services in the economy. Workers accept money for their wages because they know that money can be exchanged for all the different things they will need. Use of money as an intermediary in transactions therefore, removes the requirement for double coincidence of wants between transactions. Without money, the world's complicated economic systems which are based on specialization and the division of labour, would be impossible. The use of money enables a person who receives payment for services in money to obtain an exchange for it, the assortment of goods and services from the particular amount of expenditure which will give maximum satisfaction.
- b. **Unit of account:** Money is a means by which the prices of goods and services are quoted and accounts kept. The use of money for accounting purposes makes possible the operation of the price system and automatically provides the basis for keeping accounts, calculating profit and loss, costing etc. It facilitates the evaluation of performance and forward planning. It also allows for the comparison of the relative values of goods and services even without an intention of actually spending (money) on them e.g. "window shopping".
- c. **Store of Wealth/value:** The use of money makes it possible to separate the act of sale from the act of purchase. Money is the most convenient way of keeping any form of property which is surplus to immediate use; thus in particular, money is a store of value of which all assets/property can be converted. By refraining from spending a portion of one's current income for some time, it becomes possible to set up a large sum of money to spend later (of course subject to the time value of money). Less durable or otherwise perishable goods tend to depreciate considerably over time, and owners of such goods avoid loss by converting them into money.
- d. **Standard of deferred payment:** Many transactions involve future payment, e.g. hire purchase, mortgages, long term construction works and bank credit facilities. Money thus provides the unit in which, given the stability in its value, loans are advanced/made and future contracts fixed. Borrowers never want money for its own sake, but only for the command it gives over real resources. The use of money again allows a firm to borrow for the payment of wages, purchase of raw materials or generally to offset outstanding debt obligations; with money borrowing and lending become much easier, convenient and satisfying. It's about making commerce and industry more viable.

Only money, of all possible assets, can be converted into other goods immediately and without cost.

The Determination of the Value Money

Since money is primarily a medium of exchange, the value of money means what money will buy. If at one time a certain amount of money buys fewer things than at a previous time, it can be said that the value of money has fallen. Since money itself is used as unit of account and a means of measuring the "value" of other things, its own value can be seen only through the prices of other things. Changes in the value of money, therefore, are shown through changes in prices.

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TOPIC 9

INFLATION AND UNEMPLOYMENT

DEFINITION AND TYPES OF INFLATION

Meaning

The word inflation has at least four meanings.

- A persistent rise in the general level of prices, or alternatively a persistent falls in the value of money.
- Any increase in the quantity of money, however small can be regarded as inflationary.
- Inflation can also be regarded to refer to a situation where the volume of purchasing power is persistently running ahead of the output of goods and services, so that there is a continuous tendency of prices – both of commodities and factors of production – to rise because the supply of goods and services and factors of production fails to keep pace with demand for them. This type of inflation can, therefore, be described as persistent/creeping inflation.
- Finally inflation can also mean runaway inflation or hyper-inflation or galloping inflation where a persistent inflation gets out of control and the value of money declines rapidly to a tiny fraction of its former value and eventually to almost nothing, so that a new currency has to be adopted.

Demand-pull inflation is when aggregate demand exceeds the value of output (measured in constant prices) at full employment. The excess demand of goods and services cannot be met in real terms and therefore is met by rises in the prices of goods. Demand-pull inflation could be caused by:

Causes of Inflation

At present three main explanations are put forward: cost-push, demand-pull, and monetary.

Cost-push inflation occurs when the increasing costs of production push up the general level of prices. It is therefore inflation from the supply side of the economy. It occurs as a result of increase in:

a. Wage costs: Powerful trade unions will demand higher wages without corresponding increases in productivity. Since wages are usually one of the most important costs of production, this has an important effect upon the price. The employers generally accede to these demands and pass the increased wage cost on to the consumer in terms of higher prices.

b. Import prices: A country carrying out foreign trade with another is likely to import the inflation of that country in the form of intermediate goods.

c. Exchange rates: It is estimated that each time a country devalues its currency by 4 per cent, this will lead to a rise of 1 per cent in domestic inflation.

d. Mark-up pricing: Many large firms fix their prices on unit cost plus profit basis. This makes prices more sensitive to supply than to demand influences and can mean that they tend to go up automatically with rising costs, whatever the state of economy.

e. Structural rigidity: The theory assumes that resources do not move quickly from one use to another and that wages and prices can increase but not decrease. Given these conditions, when patterns of demand and cost change, real adjustments occur only very slowly.

Shortages appear in potentially expanding sectors and prices rise because slow movement of resources prevent the sector and prices rise because of slow sectors keep factors of production on part-time employment or even full time employment because mobility is low in the economy. Because their prices are rigid, there is no deflation in these potentially contracting sectors. Thus the process of expanding sectors leads to price rises, and prices in contracting sectors stay the same. On average, therefore, prices rise.

f. Expectational theory: This depends on a general set of expectations of price and wage increases. Such expectations may have been generated by a continuing demand inflation.

Wage contracts may be made on a cost plus basis.

- **Increases in general level of demand of goods and services.** A rise in aggregate demand in a situation of nearly full employment will create excess demand in many individual markets, and prices will be bid upward. The rise in demand for goods and services will cause a rise in demand for factors and their prices will be bid upward as well. Thus, inflation in the prices of both consumer goods and factors of production is caused by a rise in aggregate demand.
- **General shortage of goods and services.** If there is a general shortage of commodities e.g. in times of disasters like earthquakes, floods or wars, the general level of prices will rise because of excess demand over supply.
- **Government spending:** Hyper-inflation certainly rises as a result of government action. Government may finance spending through budget deficits; either resorting to the printing press to print money with which to pay bills or, what amounts to the same thing, borrowing from the central bank for this purpose. Many economists believe that all inflation is caused by increases in money supply.

Monetarist economists believe that “inflation is always and everywhere a monetary phenomenon in the sense that it can only be produced by a more rapid increase in the quantity of money than in output” as Friedman wrote in 1970.

The monetarist’s theory is based upon the identity:

$$M \times V = P \times T$$

And thus this was turned into a theory by assuming that V and T are constant. Thus, we would

THE EFFECTS OF INFLATION AND HOW TO CONTROL INFLATION

Inflation has different effects on different economic activities on both micro and macro levels.

Some of these problems are considered below:

- i. During inflation money loses value. This implies that in the lending-borrowing process, lenders will be losing and borrowers will be gaining, at least to the extent of the time value of money. Cost of capital/credit will increase and the demand for funds is discouraged in the economy, limiting the availability of investable funds. Moreover, the limited funds available will be invested in physical facilities which appreciate in value over time. It's also impossible the diversion of investment portfolio into speculative activities away from directly productive ventures.
- ii. Other things constant, during inflation more disposable incomes will be allocated to consumption since prices will be high and real incomes very low. In this way, marginal propensity to save will decline culminating in inadequate saved funds. This hinders the process of capital formation and thus the economic prosperity to the country.
- iii. The effects of inflation on economic growth have inconclusive evidence. Some scholars and researchers have contended that inflation leads to an expansion in economic growth while others associate inflation to economic stagnation. Such kind of inflation if mild, will act as an incentive to producers to expand output and if the reverse happened, there will be a fall in production resulting into stagflation i.e. a situation where there is inflation and stagnation in production activities.
- iv. When inflation imply that domestic commodity prices are higher than the world market prices, a country's exports fall while the import bill expands. This basically due to the increased domestic demand for imports much more than the foreign demand for domestic produced goods (exports). The effect is a deficit in international trade account causing balance of payment problems for the country that suffers inflation.
- v. During inflation, income distribution in a country worsens. The low income strata get more affected especially where the basic line sustaining commodities' prices rise persistently. In fact such persistence accelerates the loss of purchasing power and the vicious cycle of poverty.
- vi. Increased production-It is argued that if inflation is of the demand-pull type, this can lead to increased production if the high demand stimulates further investment. This is a positive effect of inflation as it will lead to increased employment.
- vii. Political instability-When inflation progresses to hyper-inflation, the unit of currency is destroyed and with it basis of a free contractual society.
- viii. Inflation and Unemployment-For many years, it was believed that there was a trade-off between inflation and unemployment i.e. reducing inflation would cause more unemployment and vice versa.

Measures to control inflation

An inflationary situation can effectively be addressed/tackled if the cause is first and foremost identified. Governments have basically three policy measures to adopt in order to control inflation, namely:

Fiscal Policy: This policy is based on demand management in terms of either raising or lowering the level of aggregate demand. The government could attempt to influence one of the components $C + I + G (X - M)$ of the aggregate demand by reducing government expenditure and raising taxes. This policy is effective only against demand-pull inflation.

Monetary Policy: For many years monetary policy was seen as only supplementary to fiscal policy. Neo-Keynesians contend that monetary policy works through the rate of interest while monetarists' viewpoint is to control money supply through setting targets for monetary growth.

This could be achieved through what is known as medium term financial strategy (MTFs) which aims to gradually reducing the growth of money in line with the growth of real economy – the use of monetary policy instruments such as the bank rate, open market operations (OMO) and variable reserve requirement (cash & liquidity ratios).

Direct Intervention: Prices and incomes policy: Direct intervention involves fixing wages and prices to ensure there is almost equal rise in wages and other incomes alongside the improvements in productivity in the economy. Nevertheless, these policies become successful for a short period as they end up storing trouble further, once relaxed will lead to frequent price rises and wage fluctuations. Like direct intervention, fiscal and monetary policies may fail if they are relied upon as the only method of controlling inflation, and what is needed is a combination of policies.

QUESTIONS:

1. a) Outline the functions of taxation .
b) What are the possible disadvantages of a progressive income tax system?
2. State and explain Adam Smith's canons of taxation. Give local example as appropriate in each.
3. a) What is meant by inflation
b) What are the major causes of inflation?
c) Explain the economic problems that arise from a high rate of inflation.

DEFINITION OF UNEMPLOYMENT

Total number of able men and women of working age seeking paid work. Unemployment statistics vary according to how unemployment is defined and who is deemed to be part of the workforce. Traditional methods for collecting unemployment data are based, typically, on sampling or the number of unemployment benefit requests. International labor organization (ILO) computes unemployment on the basis of number of people who have looked for employment in the last four weeks and are available to start work within two weeks, plus those who are waiting to start working in a job already obtained.

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TOPIC 10

INTERNATIONAL TRADE AND FINANCE

DEFINITION OF INTERNATIONAL TRADE

It is the exchange of goods and services between one country and another.

International Trade can be in goods, termed visibles or in services, termed invisibles e.g. trade in services such as tourism, shipping and insurance.

Reasons for the Development of International Trade

- Some goods **cannot be produced** by the country at all. The country may simply not possess the raw materials that it requires; thus it has to buy them from other countries. The same would apply to many foodstuffs, where a different climate prevents their cultivation.
- Some goods cannot be produced as **efficiently** as elsewhere. In many cases, a country could produce a particular good, but it would be much less efficient at it than another country.
- It may be better for the country to give up the production of a good (and import it instead) in order to specialize in something else. This is in line with the **principle of comparative advantage**.
- In a free market economy, a consumer is free to choose which goods to buy. A foreign good may be more to his or her liking. This is in line with the **principle of competitive forces** and the exercise of **choice**.
- Shortages:** At a time of high domestic demand for a particular good, production may not meet this demand. In such a situation, imports tend to be bought to overcome the shortage.

THEORY OF ABSOLUTE ADVANTAGE AND COMPARATIVE ADVANTAGE

THEORY OF ABSOLUTE ADVANTAGE

International trade allows a country to specialize in the production of commodities where it more efficient than other countries. For instance, if we take a situation in which each country in a simple two country model has an absolute advantage in producing either fruits or beef but is able to produce the other commodity only if required (for simplicity we assume constant returns to scale and full utilization of resources). Suppose that each country has equal resources and devotes half its limited resources to citrus fruit and half to beef and the production totals are:

	Units of Citrus fruits	Units of Beef
Country X	10	5
Country Y	<u>5</u>	<u>10</u>
World total	<u>15</u>	<u>15</u>

The relative or comparative costs of citrus production is lower in country X than in country Y, but the situation is reserved in the case of beef production. Country X has an absolute advantage in citrus fruit production and Y has an absolute advantage in beef production. If each country specializes in the production of the commodity in which it is most efficient and possesses absolute advantage, we get:

	Units of Citrus fruits	Units of Beef
Country X	20	0
Country Y	0	20
World total	20	20

The gains from trade are obvious with five units more of fruit and five more of beef – provided we assume that transport costs are not so enormous as to rule out gains made.

THEORY OF COMPARATIVE ADVANTAGE

In his theory put forward in a book published in 1817, David Ricardo argued that what was needed for two countries to engage in international trade was comparative advantage.

He believed that 2 countries can still gain, even if one country is more productive than the other in all lines of production. Using the Labour Theory Value, Ricardo's contribution was to show that a sufficient basis for trade was a difference, not in absolute costs. He illustrated his theory with 2 countries and two commodities, I and II and A and B respectively.

COUNTRY	COST OF PRODUCING 1 UNIT (In Manhours)	
	A	B
I	8	9
II	12	10

We can observe that country I has complete absolute advantage in the production of both commodities since it can produce them with a lower level of resources. Country I is more efficient than country II.

Ricardo believed that even then there could still be a basis for trade, so long as country II is not equally less productive, in all lines of production. It still pays both countries to trade. What is important is the Comparative Advantage. A country is said to have comparative advantage in the production of a commodity if it can produce at relatively lower opportunity costs than another country. (The Law of **Comparative Advantage** states that a nation should specialize in producing and exporting those commodities which it can produce at **relatively** lower costs, and that it should import those goods in which it is a relatively high cost producer). Ricardo demonstrated this by introducing the concept of **Opportunity Cost**.

The opportunity Cost of good A is the amount of other goods which have to be given up in order to produce one unit of the good. To produce a unit of good A in country I, you need 8 man hours and 9 man hours to produce good B in the same country. It is thus more expensive to produce good B than A. The opportunity costs of producing a unit of A is equivalent to 8/9 units of good B. One unit of B is equal to 9/8 units of A.

In country II, one unit of A is equal to 12/10 of B and one unit of B = 10/12 units of A.

Therefore he felt that: -

Opportunity cost of producing one unit of:

	A	B
COUNTRY		
I	9/8 (1.25) B	8/9 (0.89) A
II	10/12 (0.83) B	12/10 (1.2) A

B is cheaper to produce in country II in terms of resources as opposed to producing it in country I. The opportunity costs are thus lower in country II than in country I. Consider commodity A valued in terms of B. A cheaper in country I than country II.

A country has comparative advantage in producing commodity if the opportunity cost of producing it is lower than in other countries. Country I has a lower opportunity cost in producing A than B and II has a lower opportunity cost in the production of B than A. In country I, they should specialize in the production of A and Import B.

Limitations of Comparative advantage

This doctrine is valid in the case of a classical competitive market characterized by a large number of informed buyers and sellers and homogenous products in each market, with world market places serving as efficiency determinants for global allocation of resources to their most suitable uses. Unfortunately, world markets and their prices are largely inefficient showing influences of trade barriers, discrimination and market distortions. Individual countries systematically aim at maximizing their potential gains from trade rather than with optimizing the allocation of world resources.

By pursuing gains from trade in the short run young nations may jeopardize long term development prospects because:

- i. It is important to protect infant industries to acquire new skills, technology and home markets that are necessary in the early years of industrial development;
- ii. Concentrating on short term comparative advantage may lead to internalizing wrong externalities e.g. promoting use of illiterate peasants and primary sector production;
- iii. Long term movements in commodity terms of trade disfavour primary commodities as their prices rise more slowly than those of industrial manufactures (income elasticity of demand for primary commodities is lower than for manufactures and as world incomes rise demand for the latter rises more rapidly affecting their relative world prices).

WORLD TRADE ORGANISATION (WTO) AND CONCERNS OF DEVELOPING COUNTRIES

There are many opportunities for small businesses in developing countries. Exports to developing countries may be eligible for aid finance and imports may benefit from preferential UK and EU customs duties under the Generalised System of Preferences (GSP). Small businesses can also trade with developing countries as subcontractors to larger businesses.

The World Trade Organization (WTO) sets a global trading framework for its 153 member countries, two-thirds of which are developing countries. The WTO's open market policies have led to changes in the EU's main trade and aid agreement with 79 developing countries - the Cotonou Agreement. The WTO has also recognised the need to make greater provision for developing countries and also for small business.

This guide covers the main WTO agreements and special measures affecting developing countries - the changes to the Cotonou Agreement - to aid finance and developing country debt, and explains how the GSP works.

How developing countries work within the WTO

The WTO has reached several agreements to reduce and eliminate barriers to global trade, including:

- the General Agreement on Tariffs and Trade (GATT - goods)
- the General Agreement on Trade in Services (GATS)
- the Trade-Related Aspects of Intellectual Property Rights (TRIPS)
- dispute resolution between member governments
- specific product/service and exporter/importer agreements

The WTO also allows developing countries and 'least developed countries' (LDCs) to adapt more slowly to free trade.

There are 50 LDCs as defined by the UN - 32 of which are WTO members. These include self-defined developing countries, and two of the world's largest economies - China and India.

These developing countries have successfully agreed certain changes in WTO agreements, including:

- a programme of Technical Assistance and Capacity Building - for which the UK has pledged £45 million
- a change in the TRIPS rules on patented medicines to allow developing countries to use cheaper medicines under certain circumstances

There are also other changes being considered by the WTO that would benefit developing countries, such as:

- special measures for LDCs and small economies
- changes to the relationship between trade, debt and finance
- the possibility of technology transfers
- the relationship between patents and development

There are also some issues which have not been resolved due to disagreements between developed and developing countries. These issues include:

- agricultural commodities and subsistence farming
- trade, debt and finance
- the lack of safeguard mechanisms for developing countries during an economic crisis

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