

ECONOMICS

PART 1

CPA SECTION 2

CCP SECTION 2

CIFA SECTION 2

CS SECTION 2

STUDY NOTES

GENERAL OBJECTIVES

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

4.0 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
- Demonstrate an understanding of emerging economic issues.

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MICROECONOMICS

CHAPTER 1

INTRODUCTION TO ECONOMICS

DEFINITION OF ECONOMICS

(i) What is Economics?

The modern word "Economics" has its origin in the Greek word "Oikonomos" meaning a steward. The two parts of this word "Oikos", a house and "nomos", a manager sum up what economics is all about. How do we manage our house, what account of stewardship can we render to our families, to the nation, to all our descendants?

There is an economic aspect to almost any topic we care to mention – education, employment, housing, transport, defence etc. Economics is a comprehensive theory of how the society works. But as such, it is difficult to define. The great classical economist Alfred Marshal defined economics as the "*Study of man in the ordinary business of life*".

This, however, is rather too vague a definition. This is because any definition should take account of the guiding idea in economics which is *scarcity*. The great American economist Paul Samuelson thus defined it as: "*The study of how people and society choose to employ scarce resources that could have alternative uses in order to produce various commodities and to distribute them for consumption, now or in future amongst various persons and groups in society*". Virtually everything is scarce; not just diamonds and oil but also bread and water. The word scarcity as used in economics means that; *All resources are scarce in the sense that there are not enough to fill everyone's wants to the point of satiety*.

We therefore have limited resources, both in rich countries and in poor countries. The economist's job is to evaluate the choices that exist for the use of these resources. Thus we have another characteristic of economics; it is concerned with *choice*.

Another aspect of the problem is people themselves; they do not just want more food or more clothing they want particular types of food, specific items of clothing and so on. By want we mean; "*A materialistic desire for an activity or an item. Human wants are infinite*".

We have now assembled the three vital ingredients in our definition, People (human wants), Scarcity and choice. Thus for our purpose we could define economics as:

"The social science which is concerned with the allocation of scarce resources to provide goods and services which meet the needs and wants of the consumers"

(ii) The Scope of Economics?

The study of economics begins with understanding of human "wants". Scarcity forces us to economise. We weigh up the various alternatives and select that particular assortment of goods which yields the highest return from our limited resources. Modern economists use this idea to define the scope of their studies.

Although economics is closely connected with such social sciences as ethics, politics, sociology, psychology and anthropology, it is distinguished from them by its concentration on one particular aspect of human behaviour – choosing between alternatives in order to obtain the maximum satisfaction from limited resources.

In effect, the economist limits the study by selecting four fundamental characteristics of human existence and investigating what happens when they are all found together, as they usually are.

First, the ends of human beings are without limit. Second, those ends are of varying importance.

Third, the means available for achieving those ends – human time and energy and material resources – are limited. Fourth, the means can be used in many different ways: that is, they can produce many different goods.

But no single characteristic by itself is necessarily of interest to the economist. Only when all four characteristics are found together does an economic problem arise.

Resources: The ingredients that are combined together by economists and termed economic goods i.e. goods that are scarce in relation to the demand for them.

- i. Economic Goods: All things which people want are lumped together by economists and termed economic goods i.e. goods that are scarce in relation to the demand for them.
- ii. Free Goods: These are goods which people can have as much as they want, e.g. air.

MICROECONOMICS AND MACROECONOMICS

Overall the study of economics is divided into two halves, microeconomics and macroeconomics.

(a) "**Micro**" comes from the Greek word meaning small, and microeconomics is the study of individual economic units or particular parts of the economy e.g. how does an individual household decide to spend its income? How does an individual firm decide what volume of output to produce or what products to make? How is price of an individual product determined? How are wage levels determined in a particular industry? It thus gives a worm's eye view of the economy.

(b) "**Macro**" comes from the Greek word meaning large, and macroeconomics is the study of "global" or collective decisions by individual households or producers. It looks at a national or international economy as a whole, e.g. Total Output, Income and Expenditure,

Unemployment, Inflation Interest Rates and Balance of International Trade, etc and what economic policies a government can pursue to influence the conditions of the national economy. It thus gives a bird's eye-view of the economy.

Economic theory

A body of economic principles built up as a result of logical reasoning, it provides the tools of economic analysis. It is pursued irrespective of whether it appears to be of any practical advantage or not.

THE METHODOLOGY OF ECONOMICS AND ITS BASIC CONCEPTS

Economics proceeds as an evolutionary discipline, looking at data, developing hypotheses, testing them and reaching sometimes uneasy consensus on how the economy works. This is called the scientific method which begins with the formulation of a theory about behaviour. For example, we may put forward the idea that the demand for a good is determined by its price. On the basis of this we may reason that as the price is increased, demand goes down, while if the prices are decreased the demand will go up. This then gives us a hypothesis which can be tested on observed behaviour. This testing of ideas on the evidence is known as *empiricism*.

Ceteris paribus

The economic world is extremely complicated. There are millions of people and firms; thousands of prices and industries. One possible way of figuring out economic laws in such a setting is by **controlled experiments**. A controlled experiment takes place when everything else but the item under investigation is held constant. This is an essential component of scientific method.

However economists have no such luxury when testing economic laws. Therefore, when formulating economic principles economists are usually careful to state that such and such will happen, **ceteris paribus** which is the Latin expression meaning **all other things remaining constant**.

ECONOMIC DESCRIPTION AND ANALYSIS

Economics is used in two important ways today. The first is to describe, explain and predict the behaviour of production, inflation, incomes etc. But for many, the fruit of such labours is found in a second task – to improve economic performance.

Thus, we first attempt to describe the hardships of poverty. We then might present programs that could reduce the extent of poverty. Or we might start with an analysis of how higher energy taxes would lead to lower energy consumption. We might then conclude that the country should raise its gasoline taxes.

In each case, we first engage in positive economics, and then in normative economics.

Positive and Normative Economics You may already have strong personal views about what sort of economic society we should have e.g. whether a free market “capitalist” economy is desirable, or whether a “communist” command economy is preferable. In our study of economics, one of

the central distinction is between a value judgement and a factual statement. Positive Economics is concerned with the objective statements about what does happen or what will happen. It limits itself to statements that can be verified by reference to facts e.g. How does a higher level of unemployment affect inflation or how will a gasoline tax affect gasoline usage? A positive approach is more objective, and more scientific and it is the approach we shall try to take in our study of economics here.

Normative Economics, on the other hand, appreciates that in practice many economic decisions involve subjective judgements; that is, they cannot be made solely by an objective appraisal of the facts but depend to some extent on personal views in interpreting facts – ethics and value judgements. They can be argued about but they can never be settled by science or by appeal to facts, e.g. should taxation soak the rich to help the poor? Or should the defence spending grow at 3 or 5 or 10 per cent per year? They involve what ought to be and are settled by political choice.

Economic goals and problems

Whatever political party is in power, four main economic goals are:

- control of inflation
- reduction of unemployment
- promotion of economic growth
- attainment of a favourable balance of payments.

In addition to these generally agreed objectives, more “political” economic policies might be pursued, such as the redistribution of income.

SCARCITY, CHOICE, OPPORTUNITY COST AND PRODUCTION POSSIBILITY FRONTIERS AND CURVES

(i) 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”.

(ii) 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.

(iii) PRODUCTION POSSIBILITIES AND OPPORTUNITY COSTS

Limitations of the total resources capable of producing different commodities forces society to choose between relatively scarce commodities. This can be illustrated quantitatively by simple arithmetic examples and geometrical diagrams.

Suppose, to take an example, that a society can spend money on two products, guns and butter. The society's resources are limited; therefore there are restrictions on the amount of guns and butter that can be made, which can be shown by a "production possibility" or "transformation curve".

ALTERNATIVE PRODUCTION POSSIBILITIES

Possibilities	Butter (million pounds)	Guns(thousands)
A	0	15
B	1	14
C	2	12
D	3	9
E	4	5
F	5	0

Table 1.1: Full employment of scarce resources implies guns- butter trade off

The above possibilities can be illustrated graphically using a production possibility frontier. By production possibility frontier we mean; "A geometric representation of production possibilities of two commodities feasible within an economy, given a fixed quantity of available resources and constant technological conditions.

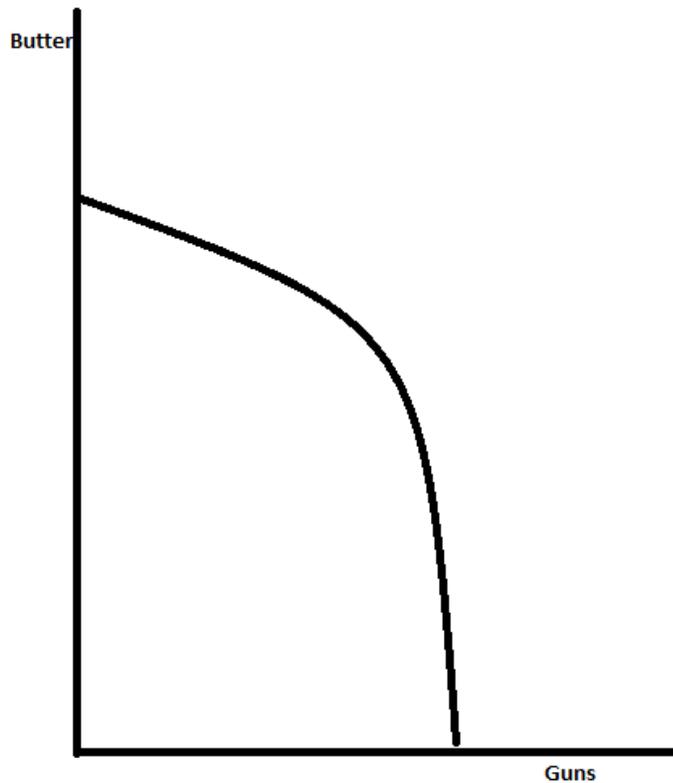


Figure Possibilities of transforming butter into guns.

The concave (to the origin) shape of the curve stems from an assumption that resources are not perfectly occupationally mobile. Points outside the P.P frontier (to the North East) are unattainable under the present technical know-how. Points inside it say, H, would be inefficient since resources are not being fully employed, resources are not being properly used, or outdated production techniques are utilized.

If production is on the frontier the resources are being fully utilized. Points on the production possibility curve such as B,C and E show the maximum possible output of the two commodities.

Output G will only become a production possibility if the country's ability to produce increases and the production possibility curve moves outwards. This can happen when there are changes such as increase in the labour force, increase in the stock of capital goods (factories power stations, transport networks, machinery) and/or an increase in technical knowledge.

(iv) Some of the uses of the possibility frontier

The production-possibility Frontier represented as a single curve can help introduce many of the most basic concepts of Economics.

The central economic problem

There are many economic problems which we encounter everyday – poverty, inflation, unemployment etc. However if we use the term *The Economic Problem* we are referring to the overall problem of the scarcity of resources. Each society has to make the best use of scarce resources. The great American economist Paul A. Samuelson said that every economic society has to answer three fundamental questions;

What commodities shall be produced, clothes, food, cars, submarines etc. and in what quantities?
How shall goods be produced? That is given that we have scarcity of resources of land, labour etc, how should we combine them to produce goods and services which we want?

For whom shall goods be produced? Who is to enjoy and get the benefit of the nation's goods and services? Or to put it in another way, how is national product to be divided among different individuals and families?

ECONOMIC SYSTEMS, FREE ECONOMY, PLANNED ECONOMY AND MIXED ECONOMY

While there are a million variations on answers to these questions; when we look around the world we find that there are only a limited number of ways in which societies have set about answering them. These ways or methods are called Economic systems. They are free enterprise, centrally planned and mixed economies. We will now examine these briefly.

a) THE FREE ECONOMY /ENTERPRISE: THE PRICE SYSTEM

The free market system is where the decision about what is produced is the outcome of millions of separate individual decisions made by consumers, producers and owners of productive services. The decisions reflect private preferences and interests.

For the free enterprise to operate there must be a *price system/mechanism*.

The price system is the situation where the vital economic decisions in the economy are reached through the workings of the market price.

Thus, everything – houses, labour, food, land etc come to have its market price, and it is through the workings of the market prices that the "What?", "How?", and "For whom?" decisions are taken. The free market thus gives rise to what is called **Consumer Sovereignty** – a situation in which consumers are **the ultimate dictators**, subject to the level of technology, of the kind and quantity of commodities to be produced. Consumers are said to exercise this power by bidding up the prices of the goods they want most; and suppliers, following the lure of higher prices and profits, produce more of the goods.

The features of a free market system are:

(i) Ownership of Means of Production

Individuals are free to own the means of production i.e. land, capital and *enjoy incomes from* them in the form of rent, interest and profits.

(ii) Freedom of Choice and Enterprise

Entrepreneurs are free to *invest in businesses of their choice, produce any product of their choice, workers are free to sell their labour in occupations and industries of their choice; Consumers are free to consume products of their choice.*

(iii) Self Interest as the Dominating Motive

Firms aim at maximising their profits, workers aim at maximising their wages, landowners aim at maximising their return from their land, and consumers at maximising their satisfaction

(iv) Competition

Economic rivalry or competition envisages a situation where, in the market for each commodity, there are a large number of buyers and sellers. It is the forces of total demand and total supply which determine the market price, and each participant, whether buyer or seller, must take this price as given since it's beyond his or her influence or control.

(v) Reliance on the Price Mechanism

Price mechanism is where the prices are determined on the market by supply and demand, and consumers base their expenditure plans and producers their production plans on market prices.

Price mechanism rations the scarce goods and services in that, those who can afford the price will buy and those who cannot afford the price will not pay.

(vi) Limited Role of Government

In these systems, apart from playing its traditional role of providing defence, police service and such infrastructural facilities as roads for public transport, the Government plays a very limited role in directly economic profit making activities.

Resource allocation in a free enterprise

Although there are no central committees organising the allocation of resources, there is supposed to be no chaos but order. The major price and allocation decisions are made in the markets. The market being *the process by which the buyers and sellers of a good interact to determine its price and quantity.*

If more is wanted of any commodity say wheat – a flood of new orders will be placed for it. As the buyers scramble around to buy more wheat, the sellers will raise the price of wheat to ration out a limited supply. And the higher price will cause more wheat to be produced. The reverse will also be true.

What is true of the market for commodities is also true for the markets for factors of production such as labour, land and capital inputs.

People, by being willing to spend money, signal to producers what it is they wish to be produced. **Thus what** things will be produced will is determined by the shilling votes of consumers, not every five years at the polls, but every day in their decisions to purchase this item and not that. The “How?” question is answered because one producer has to compete with others in the market; if that producer cannot produce as cheaply as possible then customers will be lost to competitors. Prices are the signals for the appropriate technology.

The “for whom?” question is answered by the fact that anyone who has the money and is willing to spend it can receive the goods produced. Who has the money is determined by supply and demand in the markets for factors of production (i.e. land, labour, and capital). These markets determine the wage rates, land rents, interests rates and profits that go to make up people’s incomes. The distribution of income among the population is thus determined by **amounts** of factors (person-hours, Acres etc) owned and the prices of the factors (wages-rates, land-rents etc).

Advantages of a Free Market System

Incentive: People are encouraged to work hard because opportunities exist for individuals to accumulate high levels of wealth.

Choice: People can spend their money how they want; they can choose to set up their own firm or they can choose for whom they want to work.

Competition: Through competition, less efficient producers are priced out of the market; more efficient producers supply their own products at lower prices for the consumers and use factors of production more efficiently. The factors of production which are no longer needed can be used in production elsewhere. Competition also stimulates new ideas and processes, which again leads to efficient use of resources.

A free market also responds well to changes in consumer wishes, that is, it is flexible.

Because the decision happen in response to change in the market there is no need to use additional resources to make decisions, record them and check on whether or not they are being carried out. The size of the civil service is reduced.

Disadvantages of a Free Economy

The free market gives rise to certain inefficiencies called market failures i.e. where the market system fails to provide an optimal allocation of resources. These include:

Unequal distribution of wealth: The wealthier members of the society tend to hold most of the economic and political power, while the poorer members have much less influence. There is an unequal distribution of resources and sometimes production concentrates on luxuries i.e. the wants of the rich. This can lead to excessive numbers of luxury goods being produced in the economy.

It may also result to social problems like crimes, corruption, etc.

Public goods: These are goods which provide benefits which are not confined to one individual household i.e. possess the characteristic of non-rival consumption and non-exclusion. The price mechanism may therefore not work efficiently to provide these services e.g. defence, education and health services.

Externalities: Since the profit motive is all important to producers, they may ignore social costs production, such as pollution. Alternatively, the market system may not reward producers whose activities have positive or beneficial effects on society.

Hardship: Although in theory factors of production such as labour are “mobile” and can be switched from one market to another, in practice this is a major problem and can lead to hardship through unemployment. It also leads to these scarce factors of production being wasted by not using them to fullest advantage.

Wasted or reduced competition: some firms may use expensive advertising campaigns to sell “new” products which are basically the same as many other products currently on sale. Other firms, who control most of the supply of some goods may choose to restrict supply and therefore keep prices artificially high; or, with other suppliers, they may agree on the prices to charge and so price will not be determined by the interaction of supply and demand.

The operation of a free market depends upon producers having the confidence that they will be able to sell what they produce. If they see the risk as being unacceptable, they will not employ resources, including labour and the general standard of living of the country will fall..

b) PLANNED ECONOMIES

Is a system where all major economic decisions are made by a government ministry or planning organisation. Here all questions about the allocation of resources are determined by the government.

Features of this system

The command economies relies exclusively on the state. The government will decide what is made, how it is made, how much is made and how distribution takes place. The resources – factors of production – on behalf of the producers and consumers. Price levels are not determined by the forces of supply and demand but are fixed by the government.

Although division of labour and specialisation are found, the planned economies tend to be more self-sufficient and tend to take part in less international trade than market economies.

Advantages of Planned System

- i. **Uses of resources:** Central planning can lead to the full use of all the factors of production, so reducing or ending unemployment.
- ii. **Large scale production:** Economies of scale become possible due to mass production taking place.
- iii. **Public services:** “Natural monopolies” such as the supply of domestic power or defence can be provided efficiently through central planning.
- iv. **Basic services:** There is less concentration on making luxuries for those who can afford them and greater emphasis on providing a range of goods and services for all the population.
- v. There are less dramatic differences in wealth and income distribution than in market economy

Disadvantages of the Planned System

The centrally planned economies suffer from the following limitations:

Lack of choice: Consumers have little influence over what is produced and people may have little to say in what they do as a career.

Little incentive: Since competition between different producers is not as important as in the market economy, there is no great incentive to improve existing systems of production or work.

Workers are given no real incentives to work harder and so production levels are not as high as they could be.

Centralised control: Because the state makes all the decisions, there must be large influential government departments. The existence of such a powerful and large bureaucracy can lead to inefficient planning and to problems of communication. Furthermore, government officials can become over privileged and use their position for personal gain, rather than for the good of the rest of the society.

The task of assessing the available resources and deciding on what to produce, how much to produce and how to produce and distribute can be too much for the central planning committee.

Also the maintenance of such a committee can be quite costly.

C) THE MIXED ECONOMY

There are no economies in the world which are entirely ‘market’ or planned, all will contain elements of both systems.

The degree of mix in any one economy is the result of a complex interaction of cultural, historic and political factors. For example the USA which is a typical example of a largely work-based

society, but the government still plans certain areas of the economy such as defence and provides very basic care for those who cannot afford medical insurance.

FEATURES

The mixed economy includes elements of both market and planned economies. The government operates and controls the public sector, which typically consists of a range of public services such as health and education, as well as some local government services. The private sector is largely governed by the force of mechanism and “market forces”, although in practice it is also controlled by various regulations and laws.

Some services may be subsidised, provided at a loss but kept for the benefit of society in general (many national railways, for example, are loss making), other services such as education or the police may be provided free of charge (though they are paid for through the taxation system). The private sector is regulated, i.e. influenced by the price mechanism but also subject to some further government control, such as through pollution, safety and employment regulation.

Advantages of the Mixed Economy

Necessary services are provided in a true market economy, services which were not able to make profit would not be provided.

Incentive: Since there is a private sector where individuals can make a lot of money, incentives still exist in the mixed economy.

Competition: Prices of goods and services in the private sector are kept down through competition taking place.

Disadvantages of Mixed Economy

Large monopolies can still exist in the private sector, and so competition does not really take place. There is likely to be a lot of bureaucracy and “red tape” due to existence of a public sector.

SPECIALIZATION AND EXCHANGE

a) Specialization

The economies of mass production upon which modern standards of living are based would not be possible if production took place in self-sufficient farm households or regions.

As such, many societies and individuals specialize or concentrate on only one activity or type of production.

Division of labour and specialisation

Division of labour refers to the situation in which the production process is split into very large number of individual operations and each operation is the special task of one worker. The

workers then specialise on one activity. Four distinct stages can be distinguished in the development of division of labour and specialization.

Specialisation by craft

Specialisation by process

Regional specialisation

International division of labour

Advantages of Division of Labour

(i) Greater skill of worker

The constant repetition of a task makes its performance almost automatic. The workers thus acquire greater skills at their job.

(ii) A saving of time

By keeping to a single operation, a worker can accomplish a great deal more, since he wastes less time between operations. Less time, too, is required learning how to perform a single operation than to learn a complete trade.

(iii) Employment of specialists

Specialisation makes it possible for each workman to specialise in the work for which he has the greatest aptitude

(iv) Use of machinery

Specialisation permits the use of some tools specific to a particular task, which can make the life of a worker that much easier.

(v) Less fatigue

It is sometimes claimed that the worker, habituated to the repetition of simple tasks, becomes less fatigued by his work.

Disadvantages of Division of Labour and Specialisation

(i) Monotony

Doing the same work repeatedly can result in boredom, and this can offset the efficiency that would otherwise result from experience.

(ii) Decline of craftsmanship

If a person does the same kind of work repeatedly according to laid down routine, he loses initiative for innovation and this can lead to loss of job satisfaction.

(iii) Greater risk of unemployment

If a worker is highly specialised, he can be easily unemployed if something goes wrong with the product of his industry (e.g. if the product is found to have negative effects to health, and demands for it falls) or if a machine is introduced to perform his work.

(iv) Increased interdependency

Since each worker contributes only a small part towards the completion of the final product, the efficiency and success of the whole process will depend on the efficiency and co-operation of all the workers. If some of the workers are inefficient, they can frustrate the whole system even if the rest of the workers are doing their work properly.

b) Exchange

When societies or individuals specialize, they are likely to produce a flood of “surplus” goods.

They are thus bound to exchange this surplus for what they don't produce. In primitive cutlers, this exchange will take place in the form of barter. For example, it is not uncommon for food to be exchanged for weapons; or for aid in the building of a house to be exchanged for aid in cleaning a field. But exchange today in all economies – capitalist or communist takes place through the medium of money.

Rationality

One of the most important assumptions in economics and on which much **economic theory** is based, is the rationality of human behaviour. In order to make predictions about human behaviour, economists assume that human behaviour is "**rational**" and that consumers and producers act rationally e.g. in what they will decide to buy or produce at any given price.

ECONOMICS FOR ACCOUNTANTS

A few teachers and some students have questioned the rationale for including economics in a course of study for professional accountants. In order to appreciate the need for the knowledge of economics by accountants it is necessary to know something of the accountant's role. It might be necessary to provide a brief survey of accountancy before going to the value of economics to the accountant.

(i) Accountancy

In general terms accounting consists of procedures for recording, classifying and interpreting selected experiences of an enterprise to promote effective administration. More specially, the accounting function can and often is broken down into specializations, a common distinction being made between **management accounting** and **financial accounting**. Briefly put, the role of the management accountant is to provide management with the best possible information upon which decisions can be based and enable both effective use of an organisation's resources. The older specialization of cost accounting is perhaps best considered as part of management accounting which establishes budgets, standard costs and actual costs of operation and processes. Financial accounting by contrast is concerned with the analysis, classification and recording of

financial transactions in order to illustrate the effects on the performance and financial position of an undertaking. Both aspects of the accounting function must be executed if the organization is to have adequate information for its management to formulate policy and to plan and control operations.

(ii) The role of economic knowledge

In no type of organisation can the accountant operate in isolation, however. He/she must have a working knowledge of many other areas, which impinge on the business or undertaking. The most relevant fields of knowledge are considered to be law, management, statistics, behavioural studies, information technology and economics.

The accountant is not expected to be an expert in these subject areas but to have sufficient knowledge to relate intelligently with specialists in such areas and to know enough to appreciate when and where to go for this specialist knowledge.

As part of the management team or advisor to that team, the accountant needs to appreciate the opportunities and constraints which the economic environment offers or impose on the organisation. This is true whether the organisation is in the private or public sector. All organisations must use the **scarce resources** available to them in an effective and efficient manner if the members of the organisations and the society generally are to gain maximum benefit. Given that allocation of resources is a central concern of economics, the relevance of economics for the accountant follows.

The accountant as a key provider of financial information for planning, control and decision making purposes will be better equipped to provide relevant information if he/she is aware of the organisational objectives, and the environmental constraints within which those objectives are pursued.

As a final word one can also say that accountants need economics to understand analyse and solve economic problems of the organisation and society in general.

QUESTIONS:

1. Write short notes on the following:

- a) Scarcity and choice
- b) Opportunity cost
- c) Production possibility frontier
- d) Positive and normative economics

2. Specialisation brings its benefits but it also has limitations. Discuss the statement.

CHAPTER TWO

DEMAND, SUPPLY AND DETERMINATION OF EQUILIBRIUM

DEMAND ANALYSIS

OBJECTIVES

At the end of the lesson the student should be able to describe the following:

- Demand
- Individual demand versus market demand
- Factors influencing demand
- Exceptional demand curves
- Types of demand
- Elasticity of demand
- Types of elasticity, price, income and price elasticity
- Measurement of elasticity ; point and arc
- Factors influencing elasticity of demand
- Application of elasticity of demand in management and economic policy decision making

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

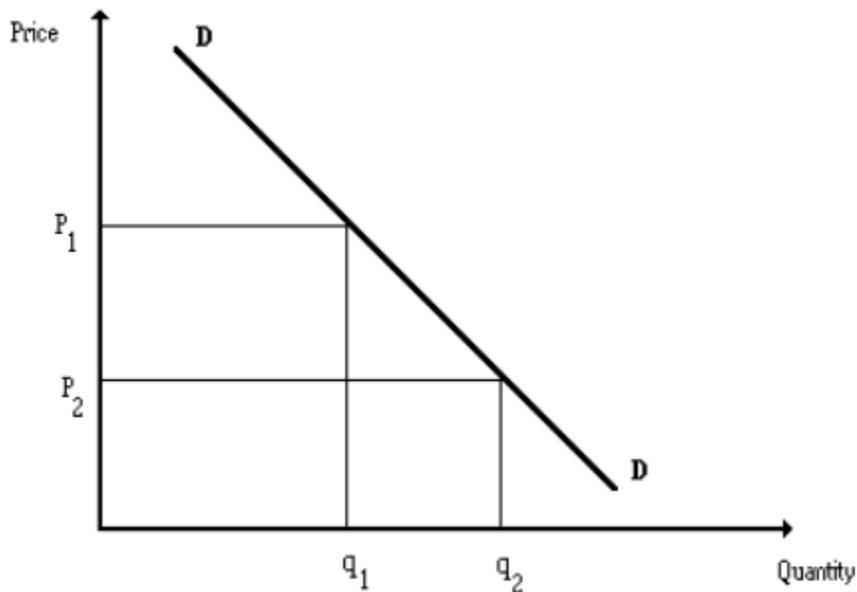
Table: The market demand schedule.

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

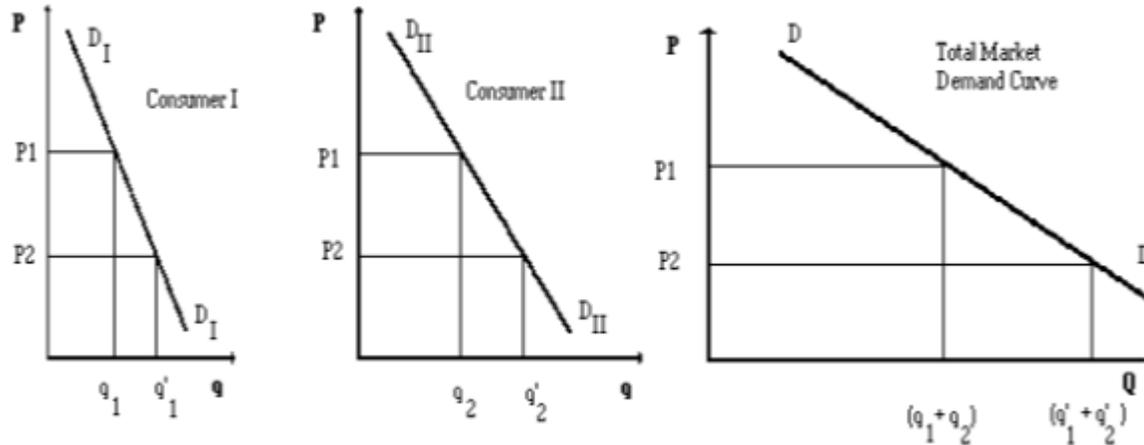


The curve can also be drawn for the entire market demand and is called a **Market Demand**

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 P_1 in the figure above, consumer 1 demands q_1 , consumer II demands quantity q_2 , and total market demand at that price is $(q_1 + q_2)$. At price p_2 , 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.

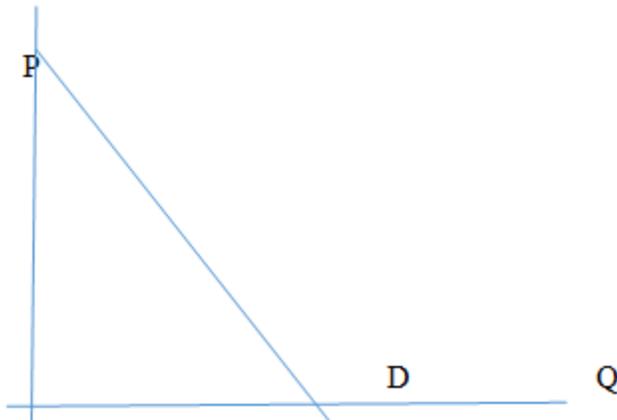
Changes in the price of a product bring about changes in quantity demanded, such that when the price falls more is demanded. This can be illustrated mathematically as follows:

$$Q_d = a - bp$$

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:



(Prices of other related commodities.

Related commodities can be compliments or substitutes.

(i) Compliments: The compliments of a commodity are those used or consumed with it. Suppose commodities A and B are compliments, and the price of A increased.

This will lead to a fall in the quantity demanded of A, and will in turn lead to a fall in the demand for B. Example are bread and butter or cars and petrol.

(ii) Substitutes: The substitutes of a commodity are those that can be used or consumed in the place of the commodity. Suppose commodities X and Y are substitutes. If the price of X increases, the quantity *demanded* of X falls, and the demand for Y increases.

(c) The Aggregate National Income and its distribution among the population. In normal circumstances as income goes up the quantity demanded goes up. In such a case the good is called a **normal good**. However, there are certain goods whose demand shall increase with income up to a certain point, then remain constant. In such a case the good is called a **necessity** e.g. salt. Also there are some goods whose demand shall increase with income up to a certain point then fall as the income continues to increase. In such a case the good is called **an inferior good**.

(d) Taste and preference

There is a direct relationship between quantity demanded and taste. For instance, if consumers' taste and preferences change in favour of a commodity, demand will increase.

On the other hand, if taste and preferences change against the commodity e.g. due to changes in fashion, demand will fall. Taste and preferences are influenced by religion, community background, academic background, environment, etc.

Theories of Demand and Supply and Consumer Behaviour

(e) Expectation of future price changes

If it is believed that the price of a commodity is likely to be higher in the future than at *present*, then even though the price has already risen, more of the commodity may be bought at the higher price.

(g) Climatic/seasonal factors

Seasonal variations affect the demand of certain *commodities* such as cold drinks like sodas and heavy clothing.

(h) The size and structure of population

Changes in population overtime affect the demand for a commodity. Also as population increases, the population structure changes in such away that an increasing proportion of the population consists of young age group. This will lead to a relatively higher demand for those goods and services consumed mostly by young age group e.g. fashions, films, nightclubs, schools, toys, etc.

(i) Government influences e.g. a legislation requiring the wearing of seatbelts.

(j) Advertising especially the persuasive ones

EXCEPTIONAL DEMAND CURVES

There are exceptions when more is demanded when the price increases. These happens in the case of:

(i) Inferior goods: Cheap necessary foodstuffs provide one of the best examples of exceptional demand. When the price of such a commodity increases, the consumers may give up the less essential compliments in an effort to continue consuming the same amount of the foodstuff, which will mean that he will spend more on it. He may find that there is some money left, and this he spends on more of the foodstuff and thus ends up consuming more of it than before the price rise. A highly inferior good is called

Giffen good after Sir Robert Giffen.

(ii) Articles of ostentation (snob appeal or conspicuous consumption): There are some commodities that appear desirable only if they are expensive. In such cases the consumer buys the good or service to show off or impress others. When the price rises, it becomes more impressive to consume the product and he may increase his consumption. Some articles of jewellery, perfumes- and fashion goods fall in this category.

(iii) Speculative demand: If prices are rising rapidly, a rise in price may cause more of a commodity to be demanded for fear that prices may rise further. Alternatively, people may buy hoping to resell it at higher prices. In all these three cases, the demand curve will be positively sloped i.e. the **higher** the price, the greater the quantity bought. These demand curves are called **reverse demand curves** (also called perverse or abnormal demand curve).

TYPES OF DEMAND

There are four types of demand namely Competitive Demand, Joint or Complementary Demand, Composite Demand and Derived Demand. Demand is the amount of a product buyers are willing and able to purchase at a given price over a particular period of time.

a. Competitive Demand

Commodities are substitutes if one can be used in place of the other. Substitute goods serve the same purpose and therefore compete for the consumers' income. They are said to have competitive demand because of the fact that they compete for the consumers' income. Examples of substitute goods are Milo and bournvita, butter and margarine and others. A change in the price of one affects the demand for the other. If for instance there is an increase in the price of butter, demand for margarine will increase which will ultimately increase the price of margarine, provided the supply of margarine does not change. On the other hand a decrease in the price of butter will lead to a decrease in the demand for margarine, and hence a fall in its price, given the supply.

b. Joint or Complementary Demand

Two or more goods are said to be jointly demanded when they must be consumed together to provided a given level of satisfaction. Some examples are cars and fuel, compact disc players and CD. There are perfect complementary goods and imperfect or poor complementary goods. For perfect complementary goods, the consumer practically cannot do without the other. An example is cars and fuel. On the other hand, for imperfect complementary goods, a consumer can do without the other, so long as a substitute is obtained. For complementary demand, a change in the price of one good affects the demand for the other. If there should be an increase in the price of compact disc players, there will be a decrease in the demand for discs, other things being equal.

c. Derived Demand

When the demand for a commodity is derived from the demand for the final commodity, that commodity is said to have derived demand. Wood may be demanded for the purpose of manufacturing furniture and not for its own sake. Here, the demand for wood is derived from the demand for furniture. Demand for wood is therefore a derived demand.

Factors of production such as land, labor, and capital have derived demand. This is because an increase in the demand for a commodity will result in an increase in the factors of production used in producing the goods. The price of the factors of production will increase, other things being equal.

d. Composite Demand

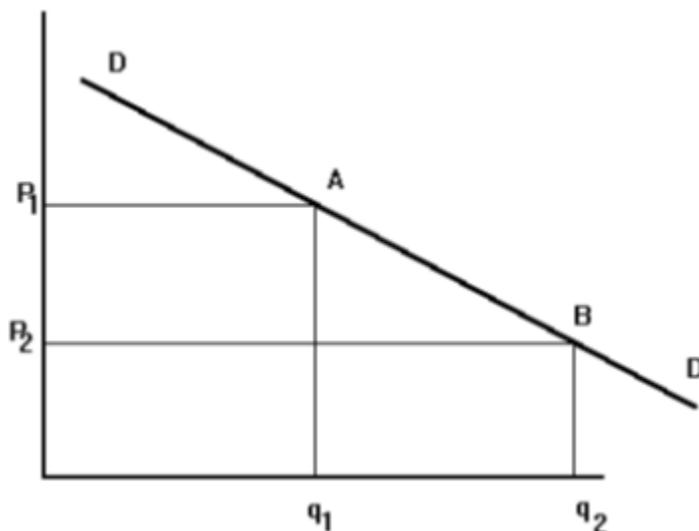
Composite demand applies to commodities which have several uses or are demanded for several and different purposes. Wood as mentioned in the example above is used for furniture – tables, chairs, beds, windows, doors and others. A change in demand for one of them will affect all others. If there is an increase in demand for table this will result in higher prices being paid for wood. The high price for wood will increase the cost of production of chairs, bed, windows and doors and any other thing for which wood is used in manufacturing

MOVEMENT ALONG AND SHIFTS OF DEMAND CURVES

There are basically two; movements in demand curves, namely:

1. Movement along the demand curve.

Movement along the demand curve are brought by changes in own price of the commodity.



When price falls from p_1 to p_2 , quantity demanded increases from q_1 to q_2 and movement along the demand curve is from A to B. Conversely when price rises from p_2 to p_1 quantity demanded falls from q_2 to q_1 and movement along the demand curve is from B to A.

2. Shifts in demand curve

Shifts in the demand curve are brought about by the changes in factors like taste, prices of other related commodities, income etc other than the price of the commodity. The change in the demand for the commodity is indicated by a shift to the right or left of the original demand curve.

In the figure below, DD represents the initial demand before the changes. When the demand increases, the demand curve shifts to the right from position DD to positions D2D2. The quantity

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