- **CONCEPT AND COMPONENTS OF CONSUMPTION EXPENDITURE**:- We can state that (I) households, (ii) government, and (iii) non-profit private institution are the final users of consumer goods produced in the economy.

  Households buy consumer goods for the satisfaction of their wants. The government buys consumer goods for distribution among defence forces, for mid-day meals in the government schools, and such other purposes. Non-profit private institutions buy consumer goods for charity. If we add up expenditure on the purchase of consumer goods by the households, government and non-profit private institutions, we get an estimate of total consumption expenditure in the economy.

  Any expenditure incurred by these users on the purchase of final (consumer) goods is treated as a part of aggregate consumption expenditure.

> Aggregate Consumption Expenditure = Consumption expenditure by the households + consumption expenditure by the government + Consumption expenditure by the non-profit private institutions (NGO, temples, mosques, gurudwaras, and others)

- **WHAT IS INVESTMENT**?

  Capital stock implies production capacity of the producers. Larger the capital stock with the producers, greater is their capacity to produce goods and services. Producers always try to increases their capital stock, so that their capacity to produce increases over time. Increases in the stock of capital during the year is called investment during the year.

  $I = \Delta K$

  Here, I = Investment; K = Capital Stock; ΔK = Change in capital stock during the year

  Change in the stock of capital is also called capital formation.

> Investment is a process of capital formation, or a process that increases the stock of capital.

- **FIXED INVESTMENT AND INVENTORY INVESTMENT**:- Investment has two components:

1. **FIXED INVESTMENT**:- Fixed investment refers to increase in the stock of fixed assets of the producers during an accounting year. Expenditure of the producers on the purchase of fixed assets or capital goods (like plant and machinery) causes fixed investment.

   EXAMPLE: - If at the beginning of the year 2017, a producer has stock of 8 machines and at the end of 2017, he has a stock of 10 machines, then the stock of his fixed assets increases by 2 machines during the year 2017. Fixed investment of the producer during the year 2017 = 2 machines.

> **Fixed investment**
> = Stock of fixed assets with the producers at the end of the accounting year -- stock of fixed assets with the producers at the beginning of the accounting year = Increases in the stock of fixed assets with the producers during an accounting year

Fixed investment is also called fixed capital formation.

- **SIGNIFICANCE OF FIXED INVESTMENT**:-

a. It raises production capacity of the producers.
b. By raising production capacity of the producers, fixed investment leads to higher level of output in the economy.
c. Higher level of output leads to higher rate of economic growth, popularly known as GDP growth.

2. **INVENTORY INVESTMENT**:- At a point of time, producers hold the stock of (i) finished goods (unsold goods), (ii) semi-finished goods (goods which are in the process of production), and (iii) raw

material. This is called inventory stock. This stock keeps varying over time. Change in inventory stock during the year is called inventory investment of the producers.

Inventory Investment
= Inventory stock at the end of the accounting year - Inventory stock at the beginning of the accounting year = change in inventory stock during an accounting year

❖ **<u>SIGNIFICANCE OF FIXED INVESTMENT</u>**:-

a. It ensures uninterrupted supply of inputs in the process of production.
b. With enough stock of raw material the producers can avoid the day-to-day purchases from the market.

The stock of finished goods is significant because it enables the producers to meet the potential (future) demand for their product. In the absence of abundant stocks, domestic producers may lose potential demand for the product to the rival producers in the international market.

Desired inventory stock refers to planned inventory stock. This is maintained by the producers to meet the future demand.

Undesired inventory stock, on the other hand, refers to unplanned inventory stock. It arises because demand for the product turns out to be lower than expected. Unplanned inventory stock leads to losses.

❖ **<u>DIFFERENCE BETWEEN STOCK AND FLOW</u>**:-

Basic	**Stock**	**Flow**
Meaning	Stock variable refers to that variable, which is measured at a particular point of time.	Flow variable refers to that variable, which is measured over a period of time.
Time dimension	It does not have a time dimension.	It has a time dimension as its magnitude can be measured over a period of time.
Nature of concept	It is a static concept.	It is a dynamic concept.
Examples	1. wealth 2. labour force 3. Capital 4. Quantity / Supply of money in a country 5. Bank Deposits 6. water in the overhead tank 7. Distance between Delhi and Mumbai 8. Rice stored in a godown 9. Population of a country	1. Income 2. Expenditure of money 3. Capital formation 4. Change in the supply of money in a country 5. Interest on capital 6. Leakage of water from the overhead tank 7. Speed of a car going from Delhi to Mumbai 8. Sales to rice. 9. Number of births.
Impact	Stock impacts the flow. Greater the stock of capital, greater is the flow of goods and services.	Flow impacts the stock. Greater the flow of income, greater is the stock of wealth with the people.

❖ **<u>TYPES OF CIRCULAR FLOW</u>**:-

A. **REAL FLOW**;- Real flow refers to the flow of factor services from households to firms and the corresponding flow of goods and services from firms to households. Households provide factor services to the firms, in turn, provide goods and services to them as a reward for their productive services.

- It is also known as physical flow,
- There is only exchange of goods and services between the two sectors Without involvement of any money.
- Real flow determines the offered to firms, then volume of production will be more and it speeds up the process of economic growth.

B. **MONEY FLOW**:- Money flow refers to flow of factor payments from fir l household for their factor services and corresponding flow of consumption expenditure' from households to firms for purchase of goods and services produced by the firms.

- It is also known as nominal flow.
- It involves exchange of money between the two sectors.

Basis	**Real flow**	**Money flow**
Meaning	It is the flow of goods and services between firms and households.	It is the flow of money between firms and households.
Kind of exchange	It involves exchange of goods and services	It involves exchange of money.
Difficulty in exchange	There may be difficulties of barter system in exchange of goods and factor services	There is no such difficulty in case of money flow.
Alternative name	It is also known as physical flow.	It is also known as nominal flow.

❖ **DIFFERENCE BETWEEN EXPECTED OBSOLENCE AND UNEXPECTED OBSOLESCENCE**:-

Expected obsolescence	**Unexpected obsolescence**
1. It refers to a fall in the value of fixed assets due to change in technology or change in demand 2. It is a part depreciation 3. Expected obsolescence is managed through depreciation reserve fund.	1. It refers to a fall in the value of fixed assets due to natural calamities or economic recession. 2. It is not a part of depreciation 3. Unexpected obsolescence of the fixed assets.

❖ **TWO SECTORS OF THE ECONOMY**:-

a. **HOUSEHOLD SECTOR**;- It include consumers of goods and. services. Households are also the owners of the factors of production.

b. **PRODUCER SECTOR**:- It includes all providing units in the economy. For the production of goods and services, the firms hire/purchase factors of production from the households.

Q1. Which is better: Nominal GDP or Real GDP?

Ans. Real GDP is better as compared to Nominal GDP because of following reasons:

1. Real GDP helps in determining the effect of increased production of goods and services as it is affected by change in physical output only. On the other hand, Nominal GDP can increase even without any increase in physical output as it is affected by change in prices also.

2. Real GDP is a better measure to make periodic comparison in the physical output of goods and services over different years.
3. Real GDP facilities international comparison of economic performance across the countries. Therefore, Real GDP is better than Nominal GDP as it truly reflects the growth of an economy.

Q2. Current Transfers Vs Capital Transfers.

Ans. Transfers receipts are of two types:

a. Current Transfer; (b) Capital Transfer.

1. Current transfers are made out of income, whereas, capital transfers are made out of the wealth of the payer.
2. Current transfers are generally regular in nature, whereas, capital transfers are irregular.
3. Current transfers are meant for consumption purposes, whereas, capital transfers are meant for capital formation.
4. **Examples of current transfers:** Old age pension, gifts, unemployment allowance, etc. **Examples of capital transfers**: Investment grant, capital gains tax, war damages, etc.

❖ **In a closed economy**,

1. There are only 2 sectors in the economy: Households and Firms. It means, there is no government and foreign sector.
2. Household sector supplies factor services only to firms and the firms hire factor services only from households.
3. Firms produce goods and services and sell their entire output to the households.
4. Households receive factor income for their services and spend the entire amount on consumption of goods and services.
5. There are no savings in the economy, i.e. neither the households save firm their incomes, nor the firms save from their profits.

The circular flow of two sector economy can be better understood with the help of diagram.

- The outer loop of diagram shows the real flow, i.e. flow of factor services from households to firms and corresponding flow of goods and services from firm to households.
- The inner loop shows the money flow, i.e. flow of factor payments from firms to households and the corresponding flow of consumption expenditure from households to firms.
  Diagram:

Q3. Explain the problem of double counting in the estimation of national income with the help of an example. State two methods of avoiding it.

Ans. Problems of double counting refers to the counting of the value of output of a good more than once. It leads to overestimation of NI, which will then not be a true indicator of economic growth.

Explaining the above problem with the help of an example. Suppose a farmer produce wheat .1.0 ',worth Rs. 2,000. He sells this wheat to the baker who converts it into bread and sells it to the grocer for Rs. 4,0..00. The grocer sells the bread to the consumer for Rs. 4,400. The total output of the 3 producers is Rs. 10,400 but this is not the value of bread two times. This definitely will lead to overestimation of NI. There are two ways to avoid it.

a. Take value added instead of value of total output. Let us explain this with the help of schedule based on the above example.

1	**2**	**3**	**4**
Producer	**Value of output**	**Intermediate consumption**	**Value added (2-3) value of final output**
Farmer Baker Grocer	2000 4000 4400	- 2000 4000	2000 2000 400
Total	10,400	6,000	NI= 4400

On the basis of this above table, we find the sum total value added by the three producers — Farmer, baker and grocer is Rs.4,400 (2000 + 2000 + 400) and this is the value which is to be counted while estimating NI (as it does not include double counting).

b. Take the value of final products only. We already know these products are purchased for consumption I investment or both. The total value added is nothing else but the value of the final products only.
Value of final product =Value of output — Intermediate consumption