Q.11 What do you mean by value added method of estimating national income of a country? Explain the steps for calculating national income by value added method. What are the significance (importance) of this method. Explain with the limitations of value added method of national income accounting.

Answer :

Thus Value added method is the modified form of product method of estimating national income of a country. In this method, the increased value of goods and services at different stages of production is counted for estimating national income.

Value added method is defined as the sum total of value added by different producing units of a country in their production process. It is the difference between the value of output and cost of intermediate goods. Therefore,

Value Added = Value of output - Cost of intermediate goods.

Steps :

For measuring national income by value added method, the contribution of each producing units in the domestic territory should be included. For calculating national income through this method three important steps should be followed. These steps are -

(i) First step of value added method for calculating national income is the identification and classification of producing units. All producing units are classified into three catagories, which are the primary sector, secondary sector and tertiary sector. Generally, the items which are contributing to national income should identify in which sector it includes.

(ii) Second important step is considered as estimation of net value added. In this step, it becomes necessary to calculate the net value added by each sector of the economy. But the net indirect taxes should not be included in this method.

(iii) Finally, national income through value added method requires to estimate net factor income from abroad. In this step, national income is the addition of net factor income from abroad with net domestic product at factor cost.

Significance or importance :

The value added method have certain important significance because of which it considers as the important method of national income accounting. The major significance of this method are

(a) Value added method is highly significant because of the fact that it always avoids the problem of double counting.

(b) Another important implication of this method is that it always helps for finding out the increased value of output at different stages of production.

(c) Value added method does not include the sale and purchase of second-hand goods in national income accounting.

(d) Value added method is highly significant because it includes the net value added at factor cost.

Limitations of Value Added Method :

Value addd method has subjected to a number of practical difficulties. The major limitations of this method are -

(i) When the sale and purchase of second hand goods are included, then this method fails to provide an appropriate result.

(ii) Another important difficulty is that when services for self-consumption are included, then this method willnot provide an appropriate result.

(iii) Another difficulty is that in a country where literacy rate is poor, then this method can not be applied.

Q. 12 Explain the reconciliation between different methods of estimating national income of a country.

Answer :

While for calculating national income of the country, there are four important methods which are product method, income method, expenditure method and value added method. Apart from value added method, all the three methods will provide the same result. Generally, in product and income method, national income at factor cost can be measured. Again in the expenditure method, national income at market prices can be measured. When the result of net indirect taxes are included in product and income methods then the result which is obtained is equivalent to the result of expenditure method.

While for calculating national income of a country, all the methods of estimating national income always includes the value of net exports. The net export is mainly the difference of total value of exports and the total value of imports.

Again, product method, expenditure method and income method invites the problem of double counting. It should be important to note that the value added method minimises the problem of double counting.

In this way, it can be stated that though the method of estimating national income of a country are different, they will provide the same national income figures.

Q.13 What are the practical difficulties of estimating national income of a country?

Answer :

The calculation of national income of a country is faced with a number of conceptual and statistical difficulties. As a result, the estimation of national income of the country cannot be considered as perfect. The major drawbacks of national income estimation in a country like India can be stated as follows

(i) **Definition of Nation :** In national income studies, the definition of nation goes beyond the political boundaries. National income fails to include income produced outside the definite boundaries of the country properly.

(ii) **Choice of method :** Another important practical difficulties of estimating national income is considered as selecting a suitable method. In other words, it is practically difficult to decide which method is to be used in estimating national income.

(iii) **Double counting :** When a single commodity is included more than once in national income estimates then the problem which has arised, is called the problem of double counting. With the presence of this problem, actual value of income of the country cannot be determined.

(iv) **Illegal income :** Income earned through illegal activities like gambling, illicit production of wine etc. are not included in national income. By excluding such activities, the national income is under estimated.

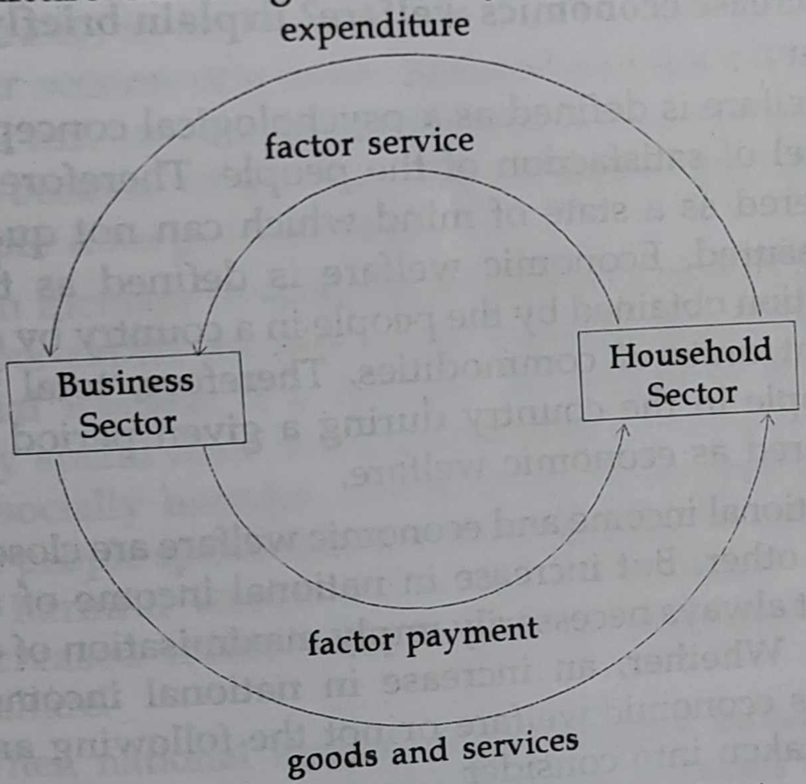
(v) **Transfer payments :** Another difficulty in national income is of including transfer payment. It is not easy to decide whether to include the payment received of an amount of pension, unemployment benefits etc. in national income.

Q. 14 Explain briefly the concept of circular flow of income in a two-sector economy.

Answer :

The circular flow of income is defined as the process whereby the national income and expenditure of an economy flow in a circular manner continuously. In other words, the movement of income and expenditure of a country during a given period of time is considered as circular flow of income. The various components of national income and expenditure like saving, investment, taxation, government expenditure etc. can be shown in a circular diagram. The complete movement of all the components in a country between sectors are called circular flow.

In circular flow of income, it is assumed that there are two sectors which are the house-hold sector and business sector. That sector which owns all the factors of production, is called house-hold sector. This sector receives income by selling the services to business sector. On the other hand, the business sector is defined as the sector who produces products and sell them to the house-hold sector. Thus, the house-hold sector buys the output of the business sector and try to increase their satisfaction. On the other hand, the business sector earns income from the house-hold sector by selling their products. The complete movement of all such income and expenditure can diagramatically by shown as follows



In the diagram it is observed that the business sector buys factor services from household sector and the household sector obtains income by selling their services. The household sector purchases all goods and services provided by the business sector and makes payment. Thus, payments go around in a circular manner from the business sector to the household sector and vice-versa. The complete movement can be observed through the arrows in the outer portion and inner portion. It is important to note that circular flow of income emphasises that gross national product becomes equal to gross national income.