**Subject – Macroeconomics**

**Notes Unit 1 Part B**

**By -**

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## Income Method -

In this method, we add net income payments received by all citizens of a country in a particular year. Net incomes that result in all the factors of production like net rents, wages, interest, and profits are all added together, but income received in the form of transfer payments are omitted.

**Income Method Formula**

National Income (NNPFC) = Net Domestic Product at Factor Cost (NDPFC) + Net Factor

**Income from Abroad**

Here NDPFC = Compensation of Employees + Operating Surplus + Mixed-Income
Here Operating Surplus = Rent + Interest + Profit

## Steps of Income Method Formula -

1. **Identification and Classification of Production Units**

   The first step in calculating national income by income method is to identify and segregate the units of production. They are classified into three categories, primary, secondary, and tertiary.

2. **Classify and Estimate the Factor Income**

The next step of the income method of national income is to classify factor payments in different categories like wages, rent, interest, profit, and mixed income. Otherwise, they can be classified into compensation to employees, operating surplus, and mixed income.

After classifying, estimate the number of such payments made by enterprises.

**3. Calculating Domestic Income**

Summing up all factor incomes of every sector will present the domestic income figure (NDPFC).

NDPFC = Compensation of Employees + Operating Surplus + Mixed-Income

**4. Estimate NFIA to arrive at National Income**

The last step to reach the final National Income figure is to estimate Net Factor Income from Abroad (NFIA) with NDPFC.
National Income (NNPFC) = Net Domestic Product at Factor Cost (NDPFC) + Net Factor Income from Abroad (NFIA)

## Product Method -

According to this method, the aggregate value of final goods and services produced in a country during a financial year is computed at market prices. To find out GNP, the data of all the productive activities-agricultural products, Minerals, Industrial products, the contributions to production made by transport, insurance, communication, lawyers, doctors, teachers. Etc are accumulated and assessed.

## Expenditure Method -

The total expenditure by the society in a financial year is summed up together and includes personal consumption expenditure, net domestic investment, government expenditure on goods and services, and net foreign investment. This concept is backed by the assumption that national income is equal to national expenditure.

## Value Added Method -

**Value-added** refers to the addition in the value of a raw material or intermediate good by an organization during the production process. To calculate the national income through the value-added method, the difference between the value of output and the value of intermediate goods is taken. The value-added method is the most commonly used method to estimate national income as it avoids double counting, which is a major error while calculating national income.

**Value Added = Value of Output – Intermediate Consumption**

**For example,** A baker needs only flour to produce the goods. He purchases the flour from a miller as an intermediate good worth ₹30 and converts the flour into bread with the help of production activities, and sells the bread for ₹50.

Here, flour is an **Intermediate Good** whose value is ₹30 and is termed the value of **Intermediate Consumption**.

Bread sold to the baker is the final good whose value is ₹50 and is termed **Value of Output**. It shows that the baker has added a value of ₹20 to the flow of final goods & services in the economy.

As discussed above, the difference between the value of output and the value of intermediate goods is known as value added.

Value Added = Value of Output – Intermediate Consumption

= 50 – 30

= ₹ 20

## Meaning of Capital Formation -

People will argue about what it takes to make an economy great, but when it comes to the basics, there's really not all that much to argue about. Whether an economy is based on higher taxation and more government services or on less taxation and more privatization, a truly good economy is in balance and is functioning well when it has a strong middle class (with many opportunities for upward mobility) and a low rate of unemployment. When the citizens of a country are

educated and are motivated to make needed innovations that bring in capital, its economy is bound to grow. Ignorance and poverty always drag an economy down.

Put simply, **capital formation** is the creation of capital. But what is **capital**? The word can have several different meanings but here, it refers to the tools that are used to generate wealth. For example, a computer system that's installed in an office to increase productivity and efficiency would be considered capital. The concept of capital formation was introduced by Simon Smith Kuznets, an economist who later won a Nobel Prize in Economic Science. The idea of capital formation is now considered to be one of the most important ways to assess the state of a country's economy.

### Gross Domestic Product -

The **gross domestic product** (or GDP for short) is the value of all the goods and services that are produced within a country during a specified period of time, which is usually a year. Capital formation is directly related to the GDP. In other words, if the rate of capital formation increases, so does the GDP. The concept of GDP was also introduced by Kuznet and has been used since 1991 to measure the economic health of the U.S. While it doesn't reflect the quality of life or the overall state of public welfare, the GDP does provide a sort of model of a country's economic status.

## Capital Formation Stages -

It's also worth noting that capital formation doesn't simply occur on its own. It requires that people of the country in question save money for the purpose of investing in that country's economy. The better the average income of a given country, the greater the chances that its people will be able to save and to invest in capital formation.

Capital formation occurs in three stages, which are the creation of savings, the mobilization of savings, and the investment of savings. All three of these stages are necessary in order to produce the capital needed to empower an economy to grow.

**1. Creation of Savings**

The **creation of savings** refers to the ability of everyday people to save money rather than spend it. When people save money, they aren't spending it on the consumer goods that would need to be produced if they purchased them. This releases the need for producing those goods, and it also means that the saved money can instead be used for capital investments, like buying stocks, opening a store to sell crafts, getting a computer to use for remote employment, or similar. Governments also save money by collecting taxes.

### 2. Mobilization of Savings

**Mobilization of savings** is the process by which saved money is transferred to those who will ultimately invest it. These people are generally entrepreneurs and businessmen, leaders of various companies, or innovators. Banks who give loans and governments who award grants may also mobilize savings.

### 3. Investment of Savings

**Investment of savings** involves putting money into a project, account, or other kind of ongoing process that conceivably will offer a profit in the future. Those who invest savings must be willing to take a certain amount of risk. People usually invest in business ventures when there is a good potential for profit, and they invest in stocks and mutual funds when there is a good record of financial growth for the company selling the stocks or funds. Investors need to understand the markets in which they operate in order to assess the likelihood that an investment will succeed. However, investment is a crucial element of growth in an economy.

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