SRI LANKA

Association of Accounting Technicians of Sri Lanka

Level I Examination – July 2021

Suggested Answers

(103) ECONOMICS (ECN)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

Level I Examination - January 2021

(103) ECONOMICS

SUGGESTED ANSWERS

(Total 40 Marks) **SECTION - A**

Suggested Answers to Question One:

Question No	Answer
1.1	(2)
1.2	(3)
1.3	(1)
1.4	(4)
1.5	(4)
1.6	(1)
1.7	(4)
1.8	(1)
1.9	(3)
1.10	(2)

1.11 Constant

1.12 Economic

1.13 False

1.14 True

1.15 Factors that determine the Demand

1. Price of the own good.
2. Price of the related goods.
3. Consumer income.
4. Taste and preference of consumers.
5. Future expectations.
6. Number of buyers and its composition.

1.16 Reasons for inverse (negative) relationship between Price and Quantity Demanded

1. Substitution Effect
2. Income Effect

1.17 Determinants of Price Elasticity of Supply

1. The level of mobility of factors of production.
2. Nature of the good.
3. Ability to maintain stocks and shares.
4. The time required to change supply in process in price of the given good.
5. Cost of production.
6. Availability of storage facilities.

1.18 Stages of Returns to Scale

1. Increasing Returns to Scale
2. Decreasing Returns to Scale
3. Constant Returns to Scale

1.19 Difference between Accounting Profit and Economic Profit

The difference between total revenue and accounting cost is known as accounting profit whereas the difference between total revenue and economic cost is known as economic profit. Implicit cost of the production is not deducted in accounting profit whereas it has been deducted in calculating Economic profit. Only direct cost is considered for accounting profit but both direct and indirect costs are considered for economic profit.

Accounting Profit = Total Revenue - Explicit cost

Economic Profit = Total Revenue - (Explicit Cost + Implicit Cost)

1.20 Short-run Production Process

The production process in which goods and services are produced with fixed and variable factors of production. The short run in a process is the time period within which amounts of certain factor inputs used in the production cannot be changed. The cost and the production behaviour in the short run are determined by the Law of diminishing return. Therefore, in the short run both fixed and variable inputs are used in the production.

(02 marks each, Total 40 marks)

End of Section A

Suggested Answers to Question Two:

Chapter 1 - Economic Concepts and Systems related to Business Environment

(a) Following characteristics can be recognized in a mixed economy.

1. **Property ownership**: A mixed economy has public and private property ownership. Some resources are owned by the government and others are controlled by the private property owners.
2. **Problem solving mechanism:** Both Price Mechanism and Planning Mechanism are used to allocate resources and distribute goods and services in the society to solve fundamental economic problems.
3. **Incentive system:** Private sector decides production and other economic activities based on profit motive where as government sector carries out economic activities so as to maximize social welfare to the public.
4. **Creating employment opportunities:** Both private as well as state sectors contribute in creating employment opportunities.

(03 marks)

(b)

The basic economic problem of a market economy is solved by the private property owners by using price mechanism so as to maximize personal benefits.

1 **What to produce and in what quantities? (Allocation problem)**

What to produce refers to those goods and services and the quantity of each that the economy should produce. It is a problem of allocation of scare resources which have alternative uses of resources among the various economic activities. This problem is common to all societies.

This problem is solved based on the commodity price by the price mechanism which is guided by demand for goods and services. Private produces choose high price product and produce more quantities from high product and less quantities from low price product. Accordingly, in market economic system, enterprises use more resources in producing goods and services on which the profitability is higher.

2 **How to produce?**

How to produce refers to the choice of the combinations of factors and the particular technique to use in producing a good and service. Since a good or service can normally be produced with different factor combinations and different techniques, a problem arises as to which of these to use. This problem is common to all societies.

This problem is solved based on the factor price by the price mechanism. The technique with the least cost that ensures the maximum profitability is chosen in solving this question. Private produces choose low price technology to maximized profit and minimized cost of the production.

3 To whom to produce?

For whom to produce refers to the determination in the distribution of national income among the factor owners of the economy. As resources are not enough to produce for every one of the societies, this problem is common to all societies.

This problem is solved based on the demand for goods and services by the price mechanism. The consumers' demand for goods and services produced in the economy is determined by the disposable income of the house hold. Private produces produce goods and services for high income people to maximize their profits.

(04 marks)

(c) Human Needs and wants

Human needs are essential physical and mental conditions or requirements that must be satisfied by a person for the survival of life. Whereas human wants are the different means or methods that can be used to satisfy human needs.

Examples:

Need	***Wants***
Food	Bread, Rice, curries, String hoppers etc.
Cloths	Shirts, T-shirt, Trousers and others

In addition to the above difference, following differences can also be recognized.

- Human needs are common to all. Needs do not differ from person to person but wants differ from person to person.
- Human needs are limited in numbers (human needs are limited) whereas wants are unlimited.
- Human needs cannot be changed however wants are affected by the external factors.

(03 marks)

(Total 10 marks)

Suggested Answers to Question Three:

Chapter 2- Demand, Supply, Equilibrium and Ways of Government Intervention

(a)

i.

Qd = 16,600 - 3p

Qs = -6,000 + 2p

Qd = Qs at the equilibrium

16,600 - 3p = -6,000 + 2p

22,600 = 5p

22,600/5 = p

4520 = P

Equilibrium Price = Rs 4,520/

ii.

P=4520 is substituted to the Qd equation,

Qd = 16,600 - 3p

Qd = 16,600 - (3 x 4,520)

Qd = 16,600 - 13,560

Qd = 3,040

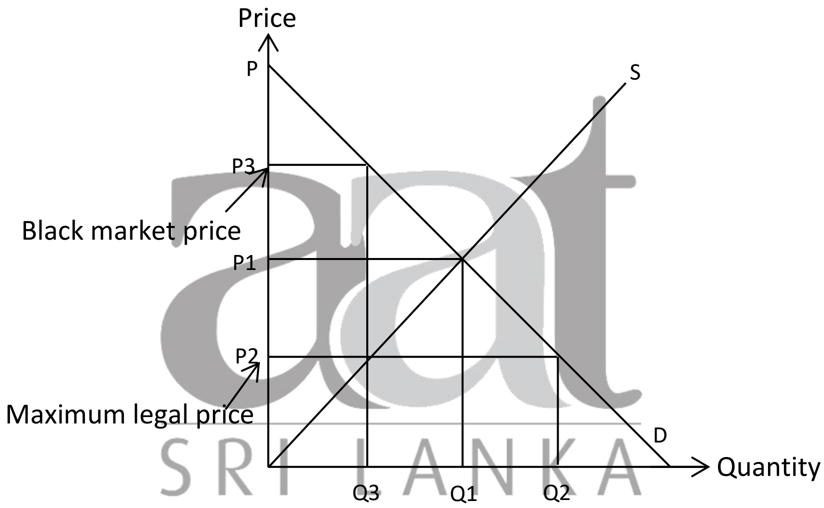
Equilibrium Quantity = 3,040 Units

(04 marks)

(b)

Maximum price (price ceiling)

This is a legal price imposed by the government below the equilibrium price of a product or service so as to provide benefits to the consumers. Any price above the maximum price is illegal and known as black-market price.



The maximum legal price is imposed by the government to protect the consumers. If maximum price is P2, the quantity that consumers are willing to process is Q2 and suppliers are willing to produce Q3. It creates and excess demand and there is a shortage of supply in the market.

Economic consequences of a maximum price policy

1 Quantity of demand increases and quantity of supply decreases and excess demand is emerged in the market.
2 If the necessary measures are not taken to eliminate excess demand there is a possibility to increase the market price to a very high level causing more difficulties for consumers.
3 Black markets and black-market prices will emerge due to shortage of commodity in the market.
4 Consumer surplus and consumer welfare come down.

5 Government can implement following policies to eliminate the excess demand,
   - Implements quota systems
   - Subsidization scheme
   - Import the excess demand
   - Encourage firms to increase their supply
6 Government expenditure increases due to implementation of price policy.
7 Producers can sell goods at higher price under the excess demand situation.

(06 marks)
(Total 10 marks)

Suggested Answers to Question Four:

Chapter 3- Behavior of Production Process and Different Market Structures

(a) Characteristics of Perfect Competition

1 Large number of buyers and sellers in the market
2 Firms supply and produce homogeneous goods and services
3 Free entry and free.
4 Firms make only normal profit in the long-run due to free entry and exit. (Zero economic profit on the long-run)
5 Marginal Revenue of a competitive firm is equal to the Average Revenue (MR=AR)
6 Perfectly competitive firms are price takers
7 Perfect information
8 Perfect mobility of factors of production

(04 marks)

Chapter 5- Financial System, Money and General Price Level

(b) Economic consequences of an increase in inflation in a country like Sri Lanka

1 Increase in prices of Goods and Services

Main course of inflation is increase in goods and services in the country. It highly affects to lower income families and it leads to a fall in real income. Real income and purchasing power of people (fixed income earners and low income earners) decrease and standard of living declines.

2 Decrease in Economic Growth

Economic growth is continuous increase on real gross domestic production. Due to inflation gross domestic production may decrease and production within the country will be discouraged and the economy will not be able to achieve an economic growth. This will affect to decrease the economic growth.

3 Adverse effect to Balance of Payment

If the price of goods and services within the country increase too much then people and business may start to import more goods from abroad because they are cheaper as a result Balance of Payment will adversely be affected (emerging BOP problems).

4 Increase in Borrowing

High inflation can lead to higher borrowing costs for businesses and people it will lead to increase in borrowing.

5 Increase in Salaries and Wages

High inflation can lead to an increase in salaries of employees and they demand to decrease real incomes. This can lead to a rise in unit labour costs and lower profit or businesses. Workers and trade unions will demand for increasing their salaries. This will cause problems at work.

6 Decrease in Business Competitiveness

If the country has a much higher rate of inflation than other countries this will make it exports less price competitive in the world market. Prices of goods and services are cheaper than Sri Lankans goods and services.

7 Decrease in living standards of people in Sri Lanka

Due to inflation, prices of goods and services increase and decrease real income of the people. Ultimately it affects to reduce living standards of people.

8 Increase in unemployment rate

When the production decreased in the country, there will be a reduction in employment and as a result unemployment rate will increase in the economy.

9 Increase in cost of production of the organization.

When prices of raw material and other cost increase the cost of the production increases and as a result profitability will decrease.

10 Decrease in Investments/ Savings

People have to spend more in goods and services. Therefore, they reduce their savings and investment. Investment is a main factor for the development of a country.

(06 marks)
(Total 10 marks)

Suggested Answers to Question Five:

Chapter 6- International Trade and Foreign Exchange Market

(a)

1 Quotas: it places a physical limitation on the quantity of imports allowed into a country.
2 Foreign Exchange Control.
3 Subsidies given to the local producers who produce the same product.
4 Setting limits for standards in administration and technology.
5 Introduction of economic embargos.
6 Voluntary limits on exports.

(02 marks)

(b)
(i)

- *Country X* has the absolute advantage in the production of *Rice*
- *Country Y* has the absolute advantage in the production of *Wheat*

(02 marks)

(ii)

	Opportunity Cost, Rice	**Opportunity Cost, Wheat**
X	$\frac{2}{8}$ = 0.25 (1R=0.25W)	$\frac{8}{2}$ = 4 (1W=4R)
Y	$\frac{4}{4}$ = 1 (1R=1W)	$\frac{4}{4}$ = 1 (1W=1R)

Country -X has the Comparative advantages in the production of Rice whereas County -Y has the comparative advantage as both countries produce each product at the lowest opportunity cost compared to the other.

(04 marks)

(c)

Sub-accounts of Current are,

1. Trade account (Exports of goods, Import of goods)
2. Service account (Export of services , Import of services)
3. Primary Income Account
4. Secondary Income Account

(02 marks)

(Total 10 marks)

End of Section B

Total 40 Marks

SECTION - C

Suggested Answers to Question Six:

Chapter 4 – National Accounting and Role of the Government

(A)

(a)

The expenditure incurred by the government to process current economic activities such as government services are known as recurrent expenditure. The current expenditure includes following components,

- Recurrent expenditure on Goods and services
- Interest payments
- Recurrent transfers and subsidies

Capital expenditure is the cost incurred to support the acquisition of fixed assets, benefits of which go beyond the period during which the given cost has to be borne. There are two types of capital expenditure,

- Expenditure on acquisition of real assets.
- Capital transfers.

(03 marks)

(b)

Indirect taxes are the tax of which the tax burden can be transferred to another party. These taxes are usually imposed on expenditure and paid by the consumers.

Example: Value Added tax, Import duty

(02 marks)

(B)

(a)

		(Rs. million)
(i)	**Gross Value Added (GVA) at basic price**	
	Compensation of employees	7,500
	Gross operating surplus	13,600
	Mixed income	1,200
	Other Taxes less Subsidies on Production	150
	Gross Value Added (GVA) at basic price	**22,450**

(05 marks)

(ii)	**Gross Domestic Product (GDP) at market price.**	
	Gross Value Added (GVA) at basic price	22,450
	Net taxes on production and imports	2,000
	Gross Domestic Product (GDP) at market price	**24,450**

(02 marks)

(iii) Gross National Income (GNI)

Gross Domestic Product (GDP) at market price	24,450
Net Foreign Primary Income	(1,400)
Gross National Income (GNI)	**23,050**

(02 marks)

(b) Importance of preparing National Accounts

1. To assess economic performance.
2. To make comparisons with others countries in the world.
3. To measure economic growth.
4. To understand the economic structure of the country.
5. To estimate per-capita national income.
6. To forecast behavour of national macroeconomic variables.
7. To have an understanding about exposure to resource composition and utilization.
8. To identify functional relationships between economic factors.

(04 marks)

(C)

The Policy measures taken by the government in relation to the government expenditure, taxation and borrowing to achieve macroeconomic goals are referred to as Fiscal Policy. The fiscal policy can be formulated in different forms such as contractionary fiscal policy, expansionary policy, or neutral fiscal policy. The main variables of the policy are government expenditure and government revenue.

(02 marks)

(Total 20 Marks)

End of Section C

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