SRI LANKA

Association of Accounting Technicians of Sri Lanka

AA1 Examination - January 2018

Questions and Suggested Answers
Subject No : AA13

ECONOMICS FOR BUSINESS & ACCOUNTING (EBA)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

EDUCATION AND TRAINING DIVISION

AA1 Examination - January 2018
(AA13) Economics for Business & Accounting

SUGGESTED ANSWERS

SECTION – A

Objective Test Questions (OTQs)

Twenty (20) compulsory questions.

(Total 40 marks)

Suggested Answers to Question One:

Question No	Answer
1.1	1
1.2	4
1.3	4
1.4	1
1.5	4
1.6	4
1.7	2
1.8	3
1.9	2
1.10	4
1.11	False
1.12	False
1.13	True
1.14	True
1.15	True
1.16	Market
1.17	Marginal Production
1.18	Producer’s Surplus
1.19	4%
1.20	Economic growth

End of Section A

SECTION –B

Four (04) compulsory questions
(Total 40 marks)

Suggested Answers to Question Two:

(a) Explain the four(04) factors of production (economic resources).

Land

The term 'land' refers to all-natural resources. This includes rivers, streams, wild animals, minerals etc. Therefore, land is a factor which has an inelastic supply. Continuous use leads to the depletion of certain types of natural resources. The productivity of land could be enhanced through human effort. Land is an essential element in the production process. The payment for the use of land is known as rent.

Labour

Human effort which is mental or physical, used for the purpose of production is known as labour. The reward for labour is the wage. Labour is diverse in nature. The quantity of human resources depends on the following factors.

(i) Size of the population
(ii) Their health and physical strength
(iii) Education and skills

Capital

All man-made resources used in production are known as capital. It is a factor of production which could be developed. The reward for capital is known as interest. Buildings, machinery and equipment, irrigation, etc are capital resources. They are productive but they may depreciate due to usage.

Entrepreneurship

The term 'entrepreneurship' refers to the party which is involved in organizing the factors of production and putting them together in order to produce goods and services. The reward paid for entrepreneurship is known as the profit. The entrepreneur organizes business activity by taking risks.

(06 marks)

(b) i. Equilibrium Price

At Equilibrium Price Qd = Qs

$100-2p = -50+3p$

$150 = 5p$

$30 = P$

(02 marks)

2. Equilibrium Quantity

Substitution to Qd equation

Qd = 100 – 2p

Qd = 100 – (2*30)

Qd = 40

(02 marks)

(Total 10 marks)

Suggested Answers to Question Three:

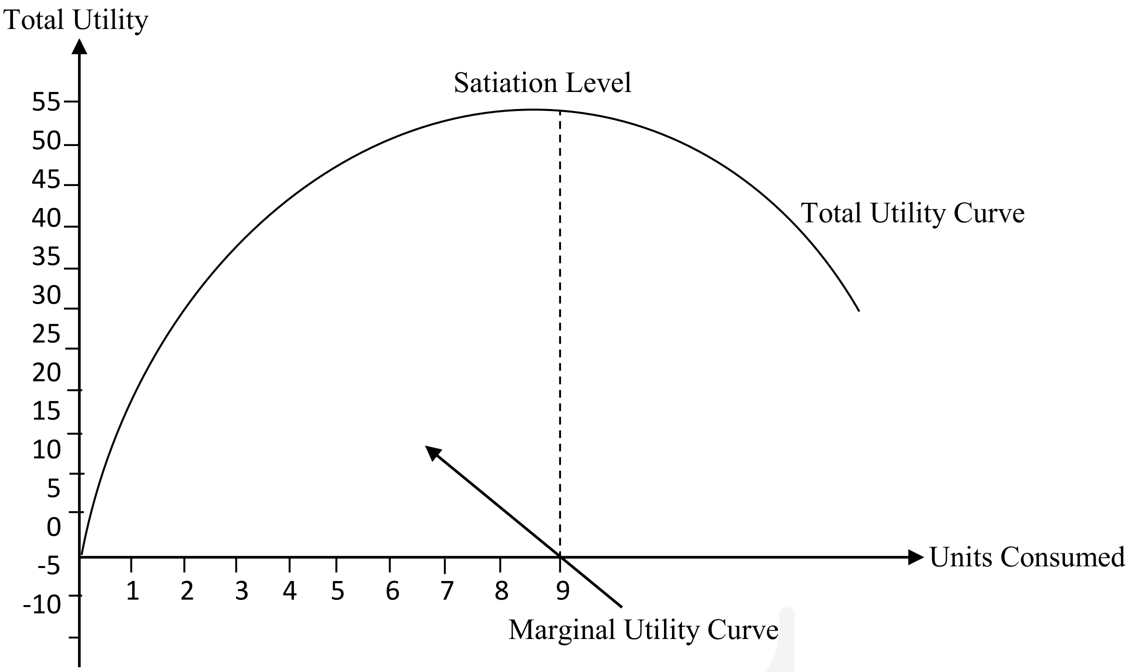
(a)

Diminishing Marginal Utility

When the total utility is increasing at a diminishing rate, the marginal utility will diminish even though it is positive. The marginal utility of the last unit consumed is less than the marginal utility of the previous unit. This is known as diminishing marginal utility. When the total utility is maximized, marginal utility will be zero. Furthermore, when the total utility is decreasing marginal utility will be negative.

Eg :- Utility of consumption of ice cream is as follows;

Units of Ice Cream Consumed	Total Utility	Marginal Utility
1	10	10
2	19	9
3	27	8
4	34	7
5	40	6
6	45	5
7	49	4
8	51	2
9	51	0
10	50	-1
11	48	-2



It was stated that the aim of the consumer is to maximize satisfaction or utility. But he has to act within two limitations. In the first place his income is limited. This is known as the budget constraint. Secondly the market prices of goods are beyond his control.

(06 marks)

(b) State four (04) determinants of demand.

- Own Price of the Commodity
- Prices of Other Related Goods (Substitutes and Complements)
- Consumer Income
- Consumer Taste & Preference / Consumer Expectation
- Other Factors
  - i. The behaviour of future market prices
  - ii. The number of consumers in the market
  - iii. Weather and climatic factors
  - iv. Social and cultural factors
  - v. Advertising
  - vi. Imitation
  - vii. Population
  - viii. Income distribution

(04 marks)

(Total 10 marks)

Suggested Answers to Question Four:

(a) **State four (04) characteristics of the Government Budget.**

(i) A budget is prepared for the coming financial year.

(ii) It contains the expected income and expenditure for the coming financial year.

(iii) It includes the revenue proposals to finance the expenditure.

(iv) If there is a deficit, the budget includes the methods of financing it.

(v) It contains the political and economic polices of the government.

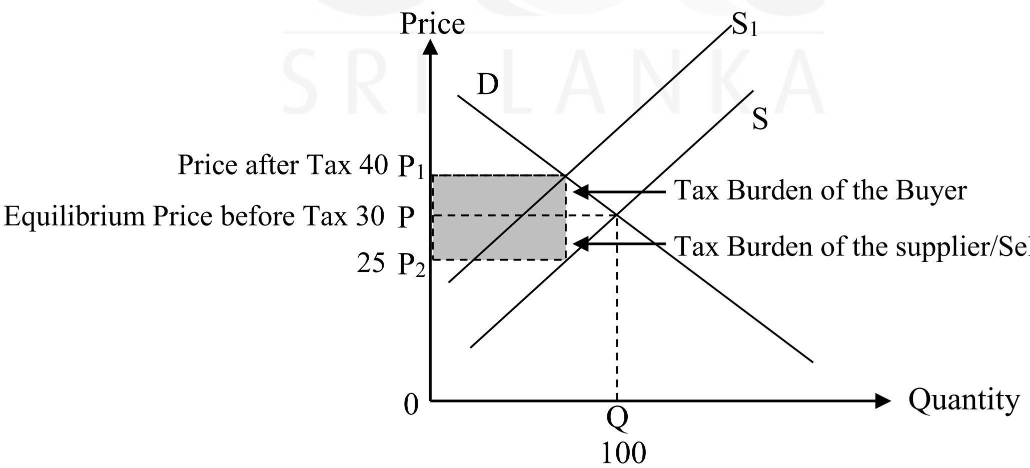
(04 marks)

(b) Explain the consequences of imposing a unit tax for a commodity by the government as an indirect tax.

A specific tax per unit

When the government imposes a unit tax on the quantity of a commodity sold in the market, the market supply curve of the commodity shifts inwards or to the left by the value of the tax. It is assumed that the tax affects the supply curve only. The diagram below shows how the tax is distributed between the consumer and the supplier.

- However, the proportion of the tax borne by the consumer and the seller depends on the elasticities of demand and supply.
- A tax of Rs 15 imposed by the government.



The diagram above shows that the equilibrium price prior to tax was Rs 30/-. The government has imposed a tax of Rs 15/- per unit. As a result the supply curve has shifted to the left as S1.

The price has increased to Rs40/-. It means that the consumer has borne a tax burden of Rs 10/-. The remaining Rs 5/- was borne by the supplier or the seller.

(06 marks)

(Total 10 marks)

Suggested Answers to Question Five:

(a) Explain the difference between comparative advantage and absolute advantage.

When a nation can make a product at a higher quality and faster rate than another, it has an absolute advantage. Comparative advantage is based on opportunity cost, which is the benefit one forfeits by choosing an alternative option. If one nation has a lower opportunity cost than another to produce a good, it has a comparative advantage.

Let's say that France and Italy have enough resources to make wine or cheese, but not both. France can make 20 units of wine or 10 units of cheese. Its opportunity cost of each unit of wine is half a unit of cheese, or 10 units of cheese divided by 20 units of wine. Its opportunity cost of cheese is 2 units of wine, or 20 divided by 10.

Italy can make 30 units of wine and 22 units of cheese, giving it an absolute advantage for both. Its opportunity cost for cheese is 1.36 units of wine, and its opportunity cost of wine is 0.73 units of cheese.

France has a comparative advantage for producing wine. Italy has the comparative advantage with cheese.

(04 marks)

(b) Explain three (03) disadvantages of international trade.

i) Import of harmful goods. Foreign trade may lead to import of harmful goods like cigarettes, drugs etc. which may affect the health of the residents of the country.

ii) It may exhaust resources. International trade leads to intensive cultivation of land. Thus it has the operations of law of diminishing returns in agricultural countries.

iii) Over Specialization. Over Specialization may be very risky for a country.

iv) A country might depend for its food mainly on foreign countries. In times of war there is a serious danger of not having essential food items for such countries.

v) One country may gain at the expensive of another.

vi) Foreign trade may lead to many problems among countries which compete with each other in finding out new markets and sources of raw material for their industries.

(06 marks)

(Total 10 marks)

End of Section B

SECTION –C

A compulsory question.
(Total 20 marks)

Suggested Answers to Question Six:

(A)

(a) Gross Domestic Expenditure.

Gross domestic Expenditure	=	Private Consumption Expenditure	+	Government Consumption Expenditure	+	Gross Domestic Capital Formation
Gross domestic (GDE) Expenditure	=	1,000	+	1,500	+	2,500

Gross Domestic Expenditure (GDE) = 5,000 Mn.

(04 marks)

(b) Gross Domestic Product (GDP) at market prices.

Gross Domestic Product (GDP) = GDE + Net Exports
Gross Domestic Product (GDP) = 5,000 + 1,300
Gross Domestic Product (GDP) = 6,300 Mn.

(02 marks)

(c) Gross National Product (GNP) at market prices.

Gross National Product (GNP) = GDP +/- Net Factor Income from Abroad
Gross National Product (GNP) = 6,300 + 650
Gross National Product (GNP) = 6,950 Mn.

(02 marks)

(d) Net National Product (NNP) at market prices.

Net National Product (NNP) = GNP – Depreciation
Net National Product (NNP) = 6,950 – 500
Net National Product (NNP) = 6,450 Mn.

(02 marks)

(B) In a country there are two main macro-economic policies as Monetary Policy and Fiscal Policy. You are required to,
Explain what is meant by the Fiscal Policy with an example for the fiscal policy instruments.

Fiscal Policy

Fiscal Policy can be defined as the government spending and revenue policies that influence macro economic conditions

The main instruments of fiscal policy are

- Taxation
- Government expenditure
- Public debt
- Budget
- Public works

(04 marks)

(C)

A persistent rise in the general price level of a country is known as inflation. Demand pull inflation and cost push inflation are main causes of inflation.

You are required to:

(a) Demand-Pull Inflation

Inflation occurs when the aggregate demand rises and exceeds the aggregate supply at the current price level. When an economy is operating at full employment, an increase in aggregate demand will inevitably lead to inflation. Even though there is unemployment in the economy, if the aggregate demand increases faster than the output inflation might occur. Too much money may chasing too few goods.

Let us now examine how the demand increases.

(a) The percentage increase in the money supply is higher than the percentage increase in output.

(b) Government borrowing from the banking system to finance budget deficits.

(c) Credit expansion by the banks.

(d) A sudden rise in export earnings or foreign exchange earnings.

(e) Inflation expectations. - Expectation of a further rise in the price level will increase the present demand.

(03 marks)

(b) State three (03) steps to be taken by a country for reducing the inflation.

Summary of policies to reduce inflation

01. Monetary policy – Higher interest rates. This increases the cost of borrowing and discourages spending. This leads to lower economic growth and lower inflation.

02. Tight fiscal policy – Higher income tax and/or lower government spending, will reduce aggregate demand, leading to lower growth and less demand pull inflation

03. Supply side policies – These aim to increase long-term competitiveness, e.g. privatization and deregulation may help reduce costs of business, leading to lower inflation.

(03 marks)

(Total 20 marks)

End of Section C

Notice :

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