

KASNEB NOTES: NEW SYLLABUS

PRINCIPLES OF  
ECONOMICS 2021  
NOTES

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2021

REVISED SYLLABUS NOTES

# **ECONOMICS NOTES**

## **ATD LEVEL III**

### **REVISED SYLLABUS**

**2021**

## UNIT DESCRIPTION

This paper is intended to equip the candidate with knowledge, skills and attitude to identify the impact and interaction of economic principles in various situations and apply the principles in decision making.

## LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Apply basic mathematical and graphical techniques to analyse economic relationships
- Apply the knowledge of economics in decision making
- Analyse economic problems and suggest possible policy related recommendations
- Apply knowledge of economics in international trade and finance
- Relate economics to income levels and development in a country

## CONTENT

### MICROECONOMICS

#### 1. Introduction to economics

- Definition of economics
- Basic economic concepts: economic resources, human wants, scarcity and choice, opportunity cost, production possibility curves/frontiers
- Scope of economics: Micro and macro economics
- Methodology of economics: positive and normative economics, scientific methods, economics as a social science.
- Economic systems: planned economy, free market economy, mixed economy
- Consumers' sovereignty and its limitations

#### 2. Demand, supply and determination of equilibrium

- Demand analysis
- Definition
- Law of demand
- Exceptional demand curves
- Individual demand versus market demand
- Factors influencing demand
- Types of demand
- Movement along and shifts of demand curves
- Elasticity of demand
- Types of elasticity: price, income and cross elasticity
- Measurement of elasticity; point and arc elasticity
- Factors influencing elasticity of demand
- Application of elasticity of demand

## **3. Supply analysis**

- Definition
- Individual versus market supply
- Factors influencing supply
- Movements along and shifts of supply curves
- Definition of elasticity of supply
- Price elasticity of supply
- Factors influencing elasticity of supply
- Application of elasticity of supply

## **4. Determination of equilibrium**

- Interaction of supply and demand, equilibrium price and quantity
- Mathematical approach to equilibrium analysis
- Stable versus unstable equilibrium
- Effects of shifts in demand and supply on market equilibrium
- Effect of taxes and subsidies on market equilibrium
- Price controls: Maximum and Minimum price control
- Price decontrol: Effect of Minimum and Maximum price decontrol
- Reasons for price fluctuations in agriculture

## **5. The theory of consumer behaviour**

- Approaches to the theory of the consumer - cardinal versus ordinal approach
- Utility analysis, marginal utility (MU), law of diminishing marginal utility (DMU)
- Limitations of cardinal approach
- Indifference curve analysis; Indifference curve and budget line
- Consumer equilibrium; effects of changes in prices and incomes on consumer equilibrium
- Derivation of a demand curve
- Applications of indifference curve analysis: substitution effect and income effect for a normal good, inferior good and a giffen good; derivation of the Engels curve
- Consumer surplus/Marshallian surplus

## **6. The theory of a firm: The theory of production**

- Factors of production
- Mobility of factors of production
- Short run analysis
- Total product, average and marginal products
- Stages in production and the law of variable proportions/the law of diminishing returns
- Long run analysis
- Isoquant and isocost lines

- The concept of producer equilibrium and firm's expansion curve
- Law of diminishing returns to scale
- Demand and supply of factors of production
- Wage determination: demand and supply for labour
- Wage differential
- Trade unions: functions, effectiveness and challenges
- Transfer earnings and economic rent

## **7. The theory of costs**

- Short run costs analysis and size of the firm's total cost, fixed cost, average cost, variable costs and marginal cost
- Long run costs analysis
- Optimal size of a firm
- Economies and diseconomies of scale

## **8. Market structures**

- Definition of a market
- Necessary and sufficient conditions for profit maximisation
- Mathematical approach to profit maximisation
- Output, prices and efficiency of: Perfect competition, monopoly, monopolistic competition, oligopolistic competition

## **2. MACROECONOMICS**

### **9. National income**

- Definition of national income
- Circular flow of income
- Methods/approaches to measuring national income
- Concepts of national income: gross domestic product (GDP), gross national product (GNP) and net national product (NNP), net national income (NNI) at market price and factor cost, disposable income
- Difficulties in measuring national income
- Uses of income statistics
- Analysis of consumption, saving and investment and their interaction in a simple economic model
- Mathematical approach to the determination of equilibrium national income
- Inflationary and deflationary gaps
- The multiplier and accelerator concepts
- Business cycles/cyclical fluctuations

### **10. Economic growth, economic development and economic planning**

- The differences between economic growth and economic development
- Actual and potential growth
- The benefits and costs of economic growth
- Determinants of economic development
- Common characteristics of developing countries
- Obstacles to economic development
- The need for development planning
- Short term, medium term and long term planning tools
- Challenges to economic planning in developing countries

## 11. Money and banking

### Money

- The nature and functions of money
- Demand and supply of money
- Theories of demand for money: The quantity theory, the Keynesian liquidity preference theory

### The banking system

- Definition of commercial banks
- The role of commercial banks and non-banking financial institutions in the economy
- Credit creation
- Definition of central bank
- The role of the central bank; traditional and changing role in a liberalised economy, such as financial sector reform, exchange rate reform
- Monetary policy, definition, objectives, instruments and limitations
- Classical theory of interest rate determination
- Interest rates and their effects on the level of investment, output, inflation and employment
- Harmonisation of fiscal and monetary policies
- Simple IS - LM Model
- Partial equilibrium and general equilibrium

## 12. Inflation and unemployment

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- Definition and types of inflation
- Causes of inflation: cost push and demand pull
- Effects of inflation
- Measures to control inflation

## 13. Unemployment

- Definition of unemployment
- Types and causes of unemployment
- Control measures of unemployment
- Relationship between unemployment and inflation: The Phillips curve

### **14. Agriculture and Industry**

- Role of agriculture in economic development
- Challenges facing agricultural sector in developing countries
- Policies to improve the agricultural sector
- Role of industry in economic development
- Benefits of small scale industries in developing countries
- Obstacles to industrial development in developing countries
- Policies to enhance industrial development in developing countries

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## TOPIC 1

### INTRODUCTION TO ECONOMICS

#### Definition of Economics

**Economics** is a social science which studies the allocation of scarce resources which have alternative uses among competing and usually limitless wants of the consumers in the society. It is thus concerned with the way people apply their knowledge, skills and effort to the gift of nature in order to satisfy human their material wants

It is also defined as the study of how human beings strive to satisfy their unlimited wants using limited resources.

#### BASIC ECONOMIC CONCEPTS

##### ECONOMIC RESOURCES

These are ingredients that are available for providing goods and services in order to certify the human wants. A resource must be scarce and have money value.

##### Characteristics of economic resources

1. They are scarce in relation to their uses
2. They have a monetary value.
3. They have alternative uses.
4. They are unevenly distributed
5. They have utility
6. Can be combined to produce goods and services. They are transferrable from one place to another.

##### Types of economic resources

There are three main ways of classifying economic resources namely;

1. **Natural resources** -They are also called the gifts of nature and are fixed in such by they are held in trust by the government for the citizens. They include; forest, river, mountain, minerals and lakes.
2. **Artificial resources** -They are created by people through various production activities e.g. machinery, tools, roads, railway, airport, dams, bridges, h.e.p, harbours, soaps, books.

3. **Human resources**-They are mental/physical efforts offered by people to the production society. These efforts cannot be separated from their providers e.g. teaching, health services, mechanics, carpentry, engineers etc.

**Natural Resources** refer to anything given by God or nature such as fertile soil, rivers, lakes, mountains etc.

**Man Made Resources** refers to anything created by man to assist in further production such as tools, equipment's, roads and buildings etc.

## HUMAN WANTS

This are basic needs that human beings need to function normally this include; food, shelter, clothing and air. Things like radio, education, watches, and vehicles are not very basic. They are meant to have an individual have a happy and comfortable and luxurious life.

- **Form utility** - This is created through changing the form of a raw material to a finished product. It is usually done during various manufacturing processes. The finished goods are in a better form for use than the raw materials.
- **Time utility** - this is created through warehousing or storage
- **Possession utility** - This is created through trade or exchange.
- **Place utility** - this is created through distribution. After goods have been produced, they must be moved to the places where they are required for use.

## Characteristics of human wants

1. They are many, numerous and unlimited.
2. They continually change with time and other factors.
3. Some are repetitive e.g. supper, lunch etc.
4. Wants are competitive
5. Wants are complementary-Used together e.g. shoe polish and a shoe.
6. Wants are habitual that they always occur e.g. toothpaste, perfume etc.
7. Wants are universal-Everybody wants them.

## Characteristics of basic wants

1. One can't do without them.
2. They are felt needs
3. Can't be postponed
4. They are satisfied before secondary wants.

## **Difficulties in satisfying human wants**

Although human wants are there to satisfy man with lives requirements, it is not always possible to have them this is because;

- They are too many and new ones keep cropping up.
- Resources to satisfy them are never enough (limited).
- They are repetitive hence people will always strive for more resources.
- They continually change with time and other factors like age and gender.
- Some are habitual making life unbearable without them.
- Due to scarcity of resources, a problem of deciding which want to satisfy first with scarce resources arise.

## **Types of human wants**

They are classified into two groups.

1. **Basic human needs**-This are things one cannot do without e.g. food. They always come at the top for the scale of preference and failure to satisfy them one can lead a miserable life or even die.
2. **Secondary human wants**-they are things one cannot do without. They help one lead a happy meaningful and comfortable life e.g. TV set, radio, cars, education, sodas etc.

**NB:** One must satisfy basic needs before attaining secondary wants.

Since the resources to satisfy human wants are scarce, one has to select on what wants are to be satisfied first and which can wait.

## **SCARCITY AND CHOICE**

**Scarcity and Choice** if the resources available are not enough to produce goods and services to satisfy all the wants then they are said to be scarce. As a result, individuals and society cannot have all the things that they want. Since resources are limited, choices have to be made. The choice to satisfy one want implies others are forgone. Individuals have to make choices e.g. consumers with their limited income and unlimited wants have to choose how they spent their income.

## **Importance of scarcity**

- i. Makes people to work hard
- ii. Stimulates usage of available resources

## **OPPORTUNITY COST**

**Opportunity Cost** refers to the value of benefit expected from the best second alternative forgone. It is based on the fact that resources being scarce have competing alternative

uses. The choice to satisfy one alternative means that another is forgone. The value of the second best forgone alternative is the opportunity cost.

**Utility**-this is the quality of that commodity that satisfies human want.

**Economics**-subject/discipline

**Economy**-this is the country's financial position.

**Economies**-this are the benefits of large scale.

**Ceteris paribus** - this is a major concept meaning, other factors held constant

**Pareto efficiency** - this is a situation in which it is not possible to make someone better off without making someone worse off.

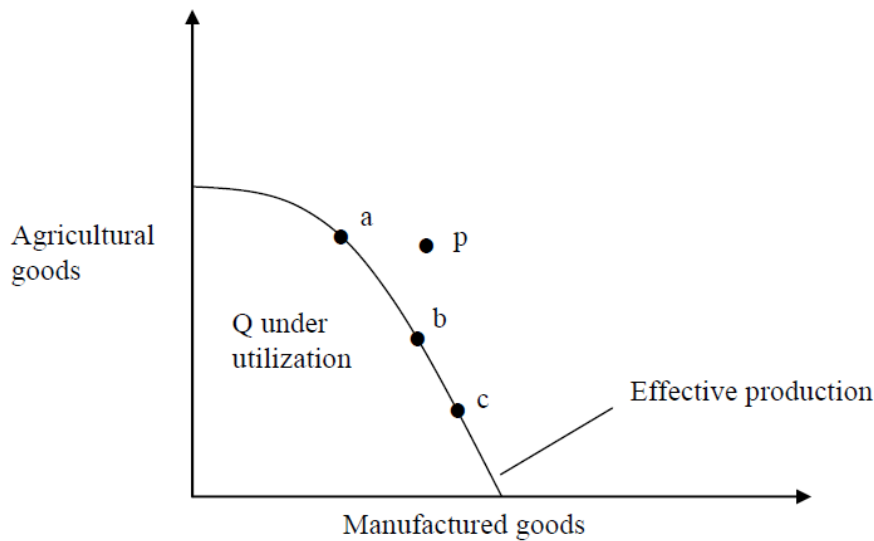
**Consumer sovereignty** - this refers to the freedom of individuals and households to decide for themselves what they want to buy in a given market.

### **PRODUCTION POSSIBILITY FRONTIER/CAPACITY (PPF/PPC)**

It provides a graphical illustration of the problem of scarcity and choice which is the basic economic problem. The curve shows what a country produces with existing supply of land, capital and entrepreneurship ability. With limited supply of economics resources a country has a wide variety of options and variety of goods and services it can produce. Assume a simple hypothetical economy where a country produces two types of goods i.e. agriculture and manufactured goods. The two extreme possibilities are:

- a) The country commits all its resources to the production of agriculture and non to manufacturing.
- b) All the resources are put to manufacture and none to agriculture.

These two extreme cases are unlikely and the country will most likely choose to produce goods of both commodities. The opportunity cost of producing either of them is increasing which the law of diminishing return.



## SCOPE OF ECONOMICS

The main branches of economics are:

### 1. Microeconomics

This is the study of the smallest economic decisions making units of the society.

Microeconomics theory is a branch of economics that studies the behavior of individual decision making units such as consumers, resource owners and business firm as well as individual markets in a free market economy. The aim of microeconomics is to explain the determination of prices and quantities of individual goods and services.

Microeconomics also considers the impact of government regulation and taxation of individual markets. For example, microeconomics analyses the forces that determine the prices and quantities of television sets sold. Microeconomics can be considered as the ultimate cellular structure of economics. It is the study of individuals, households and firms. The major areas are *demand and supply analysis*, *market equilibrium*, *consumer theory*, *theory of the firm*, *market structure and distribution theory*

### 2. Macroeconomics

This is the study of bigger and complex systems. Macroeconomic theory is the study of the behavior of the economy as a whole whereby the relationship is considered between broad economic aggregates such as national income, employment and prices. The economy is disaggregated into broadly homogenous categories and determinants of the behavior of these aggregates are integrated to provide a model to the entire economy. Macroeconomics focuses on the economic stabilization whereby government policy is used to moderate business cycles and encourages real economic growth.

Macroeconomics became a separate topic of discussion in the aftermath of John Maynard Keynes and the great depression. The line between microeconomics and macroeconomics is, however, blurred and there are many areas of overlap between the two. Key areas of macroeconomics are: *national income , economic growth and development , money and banking , public finance unemployment ,inflation and international trade*

## Why Study Economics?

It is useful to study economics for the following reasons

- i. Economics provides the underlying principles of optimal resource allocation and thus enables individuals and firms to make economically rational decisions. Thus for example the preparation of budgets involves knowledge of demand and elasticity analysis. The making of price policy decisions draws heavily on the concept of elasticity in economics. Additionally, the theory of production in economics is concerned with the principles that facilitate the optimal combination factors of production.
- ii. A study of economics enables individuals and organizations to appreciate the constraints imposed by the economic environment within which any entity operates. Thus an individual or firm is more fully enabled to appreciate the implications of the annual budget considering how for example the increased liberation of the economy will affect a particular business entity and the economy in general. Additionally, the student of economics is able to appreciate the effects of such economic variables as inflation, exchange rates, interest rates money supply and so on.
- iii. The area of development economics is fundamentally concerned with the reasons why societies develop and means of accelerating development. It is vital for individuals as citizens to appreciate the parameters that determine the development process so that they contribute more fully to facilitate and contribute to solving the economic problems that characterize their society.
- iv. Economics is an analytical subject and its study can help develop logical reasoning which is never superfluous.
- v. It is an examinable and mandatory for students perusing business courses
- vi. Students appreciate the effect of economic variables e.g. inflation, exchange rate, interest rate, money and supply etc.

## THE METHODOLOGY OF ECONOMICS

The methodology used in studying and applying economics can be divided into three. These are basically the methods of solving economic problems.

1. **Positive economics** is concerned with what is, or how the economic problem facing societies are actually solved. It deals with facts using positive statements. For example; “Kenya is a member of the East African community” and “Uganda is currently Kenya’s major trading partner” are positive statements. For example a dispute over whether Uganda is currently Kenya’s major trading partner can be settled by looking at the statistics of Kenya’s trade with its partners.
2. **Normative economics** refers to the part of economics that deals with the value of judgments. This implies that normative deals with what ought to be, or how the economic problems facing the society should be solved. Normative statements usually reflect people’s moral attitudes and are expressions of what particular individuals or groups think ought to be done. A statement such as “Uganda should join the Southern Africa Development Community” or “upper income classes ought to be taxed heavily”, are normative statements.
3. **Scientific method:** Economics make use of scientific method to develop theories. Inquiry is generally confined to positive questions. One of the major objectives of sciences is to develop theories. A theory is a general or unifying principle that describes and explains the relationship between things observed in the world around us. The purpose of a theory is to predict and explain. The search for a theory begins whenever a regular pattern is observed in the relationship between two or more variables and one asks why this should be so. A theory refers to a hypothesis that has been successfully tested. It is important to note that economic hypothesis is not tested by realism of its assumptions but its ability to predict accurately and explain. The following procedures are adopted in the scientific method:
  - a) The concepts are defined in such a way that they can be measured in order to be able to test the theory against the facts.
  - b) A hypothesis formulated.
  - c) The hypothesis is then used to make predictions.
  - d) The hypothesis is tested by considering whether its predictions are supported by facts.

## METHODOLOGY OF ECONOMICS

### POSITIVE AND NORMATIVE ECONOMICS

Economics is a science as well as art. But which type of science is a big question here, i.e. positive or normative? **Positive economics** is related to the analysis which is limited to cause and effect relationship. On the other hand, **normative economics** aims at examining real economic events from the moral and ethical point of view. It is used to judge whether the economic events are desirable or not.

While positive economics is based on facts about the economy. Normative economics is value judgment based. Most of the people think that the statements which are commonly