

Chapter 2: National Income Accounting

2.1. The concept of national income accounting: National income accounting is an accounting record of the level of economic activities of an economy. It is a method of preparing and presenting national income account based on the principle of double (debit and credit side) entry system of business accounting. **It is a measure of aggregate output, income and expenditure.** National income is the aggregate monetary of all final goods and services produced in a country during a year. The significance of national income is that it is the value of the goods and services, which can be used up in consumption by the residents of the country. It represents that part of the flow of goods and services generated by the production process, which is produced in order to satisfy the wants of the people. In simple words, national income is the aggregate factor income (i.e., earning of labour and capital, etc), which arises from the current production of goods and services by the nation's economy. The nation's economy refers to the factor of production (labour and capital) supplied by the normal residents of the national territory. From the above definitions it is clear that the concept of national income has three types of interpretations:

- National income represents a receipt total,
- National income represents an expenditure total, and
- National income represents a total value of production.

This three-fold interpretation takes place because of the fact that every expenditure is at the same time a receipt, and if goods or services bought are valued at their sales prices, we have a three-fold identity that the value received equals the value paid, equal the value of goods and services given in exchange.

Features of national income account

A description of the above definition brings the following features of national income

- ✓ National income is the income of a country,
- ✓ It is counted for a period of one accounting year,
- ✓ National income includes all final types of goods and services in calculation,
- ✓ It measures the flow of goods and services only i.e. national income is a flow concept
- ✓ It can be expressed in terms of monetary value of goods and services,

Determinants of national income/Factors determining national income /

There are a number of influences that determine the size of the national income in a country. It is on account of these influences that one country may have a larger national income than another. Following are the three main influences:

- 1. Quantity and Quality of Factors of production.** The quantity and quality of a country's stocks of the factors of production is one of the most important influences on its national income. The quantity and

quality of land, the climate, the rainfall etc., determine the quantity and quality of agricultural production, and hence, the size of national income. The quantity of a labour has doubled influences since labour is at the same time both a factor of production as well as the consumer of what is produced. The quality of labour, depending upon inborn intelligence, education and training, also influences the volume of industrial production. Capital may comprise simple, primitive tools or the most modern type of industrial equipment. The quantity and quality of capital is one of the greatest influences on total output. Likewise, the quantity and quality of entrepreneurial ability is also an important element to consider within the determination of the size of national income of a country.

2. **The state of technology and technical know-how:** if advanced technology and latest equipment is used the process of production then the more good can produce which increases size of national income. Another influence on national income is the state of technical know-how in the country. A country with a poor technical knowledge cannot have a large-sized national income, because it will not be in a position to make the best possible use of its resources.
3. **Political stability:** Political stability is an essential prerequisite for maintaining production at the highest level. Republic.
4. **Means of transportation and communication:** the well-developed means of transportation and communication facilitate the exchange of goods and services and so increase the mobility of factors of production. It also strength the trade activity in the economy in the country while rising national income.
5. **Availability of natural resources:** availability of natural resource and its maximum exploitation increases the size of national income.

2.2 The concepts of GDP and GNP

1. **Gross Domestic Product (GDP):** is the market value of all the final goods and services produced within the **domestic territory of a country during a year**. It is an attempt to summarize all economic activity over a period of time in terms of a single number; it is a measure of the economy's total output, expenditure and of total income. Frome the above definition we should have to take in to account the following important concepts;
 - ✓ The value of all final goods and services produced in the economy
 - ✓ The goods and services are currently produced or new product not existing or old goods and services and hence, GDP is a flow measure of output per time period.
 - ✓ Evaluated at market prices: Net prices for firms is market price minus indirect taxes which gives factor cost. But GDP is measured at market prices than at factor costs. Market value (price) is used to aggregate the quantities of different goods and services into one measurement.

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- ✓ It can be calculated in a given time period (not that GDP is a flow not a stock).

There are two ways to view GDP. These are GDP as the total income of everyone in the economy and GDP as the total expenditure on the economy's output of goods and services. GDP measures something people care about their incomes. Similarly, an economy with a large output of goods and services can better satisfy the demands of households, firms, and the government. How can GDP measure both the economy's income and the expenditure on its output? The reason is that these two quantities are really the same for a nation.

GDP is the most comprehensive measure of a nation's economic activity. Policymakers use GDP figures to monitor short-run fluctuations in economic activity as well as long-run growth trends. It is worthwhile, **however, to recognize important limitations of the GDP concept.**

- **Nonmarket Productive activities are left out:** Because goods and services are evaluated at market prices in GDP, nonmarket production is left out. E.g. Homemaker service
- **The underground economy is left out:** GDP also excludes illegal forms of economic activity and legal activities that are not reported to avoid paying taxes, the underground economy.
- **GDP is not a welfare measure:** GDP measures production of goods and services; it is not a measure of welfare or even of material well-being.
- **Transfer payments** e.g. the state pension paid to retired people; income support paid to families on low incomes; the Jobseekers' Allowance given to the unemployed and others.

Gross national product GNP is the market value of all final goods and services produced by domestically **owned factors** of production within a given period.

The difference between GDP and GNP corresponds to the net income earned by foreigners.

- ✓ When GDP exceeds GNP residents of a given country are earning less abroad than foreigners are earning i.e. $NFI < 0$
- ✓ When GDP less than GNP residents of a given country are earning more from abroad than foreigners are earning from our country. i.e. $NFI > 0$
- ✓ When GDP equal to GNP $NFI = 0$

2.3 Approaches of measuring national income (GDP/GNP)

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GDP/GNP can be measured using different ways. In measuring GDP, there are some basic rules that we have to follow.

Rules for computing GDP:

1. GDP measures the value (not the quantity) of goods and services. It is adding different goods and services into a single monetary value.
2. Sales of used goods is not included as part of GDP. GDP measures only the value of currently produced goods and services.
3. Inventory: when a firm increases its inventory goods, this investment in inventory is counted as expenditure by firm owners. Thus production for inventory increases GDP just as much as production for final sale. A sale out of inventory, however, is a combination of positive spending (the purchase) and negative spending (inventory disinvestment), so it does not influence GDP.
4. Intermediate goods and value added: GDP includes only final goods not intermediate goods. Adding intermediate goods is a double counting. Or the other way is to compute the value of all final goods and services being the sum of the value added at each stage of production.
5. Housing services and other imputations: via an estimate called imputed value (rental estimation of housing service enjoyed by house owners).

There are three ways to measure GDP:

- A. **Income approach:** Computing the GDP by adding up all earnings from resources used to produce output (e.g. labour, payment, and wage) in one country in one year. The assumption here is whatever is produced in a given economy will be distributed to the factors of production employed for the production process. We can group these factor-incomes in the following categories:
 - Wages and salaries of the employees (or compensation to employees). It includes the wages and salaries received by the employees during the year plus certain supplements like contributions by the employers

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to social security and other provident funds or pension funds of the workers.

- Incomes of non-company business. Includes the incomes earned by individual proprietors, parents and self-employed persons.
- Rental incomes of persons: rental income earned by individuals on agricultural and non-agricultural property.
- Corporate profits: - corporate profits earned by business corporations before the payment of corporate profit taxes or the payment of dividends to the shareholders. Thus, the corporate profits, used in calculating the GNP, are equal to the sum of corporate profit taxes plus dividends paid to the shareholders plus undistributed corporate profits.
- Incomes from Interest: - net interest earned by individuals from sources other than the organs of the government.

Altogether, $GNP = \text{Wages and salaries of employees (W/S)} + \text{Income of non-company business (I)} + \text{Rental incomes of persons (R)} + \text{Corporate profits (II)} + \text{Income from net interest (r)} + \text{Indirect taxes (IT)} + \text{Depreciation of capital goods (D)}$.

Symbolically: $GNP = W/S + I + R + II + r + IT + D$

Therefore, $GDP = W/S + I + R + II + r + IT + D - NFIF$

Example: - let the following hypothetical data is given for a certain country. Compute GDP and GNP using income approach. Ans. $GDP = 17770$ billion dollars and $GNP = 18070$ billion dollars.

Types of income	Amount (in billion birr)
Compensation of employees	10,8000
Proprietor's income	400
Rental income	600

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Corporate profit	4000
Net interest	170
Deprecation	1600
Indirect business taxes	200
Income earned by foreigners in the country	500
Income earned by citizens abroad	800

B. Expenditure approach: Computing the GDP by adding up all spending on all final goods and services produced in one country in one year. This approach is based on the assumption that whatever is produced in a given economy will be purchased by households for consumption (C), or purchased by business firms for investment (I), or purchased by government (G), or exported to the rest of the world (i.e. consumed by foreigners). Since we are interested in the market value of domestically produced final goods and services, we deduct whatever is imported from abroad for consumption, or investment.

Consumption consists of the goods and services bought by households. It includes nondurable goods, durable goods and services.

Nondurable goods are used for short period of time, like food and clothing while durable goods are goods that last for a long time, as cars and TVs. Services include the work done for consumers by individuals and firms, such as haircuts and doctor visits.

Investment is also divided into three subcategories: business fixed investment, residential fixed investment, and inventory investment.

Government purchases are the goods and services bought by federal, state and local governments. This category includes such items as military equipment, highways, and the services that government workers provide.

$$\text{GNP} = C + I + G + FI$$

Example: - Assume that the following data is given on Ethiopian economy for 2008. Consumption of non-durable goods, durable goods and services

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accounts for 390, 450 and 560 respectively. The non-residential fixed investment is about 680 and the residential fixed investment is 280. Inventory investment accounts for 190. The government spends 490 at federal level, 370 for defense, 395 for non-defense activities and 780 is spent by local and regional governments. The amount of Ethiopian export is 870 while its import is 980. All the numbers are in millions of dollars. What was the amount of gross domestic product for Ethiopia in 2008?

C. Output (Value Added) approach: measures GDP by summing the value of output in each sector of the economy. GDP is broken down into broad product categories e.g. construction, agriculture, etc. GDP then equals the value added in each sector. Value added is the value of a firm's output minus the value of intermediate goods bought from other firms.

Example: - A farmer produces oil seeds and sells it to edible oil factory for birr 10,000. The oil factory uses the oil seeds to produce edible oil, which it sells to retailers for birr 15,000. Retailers buy the oil and sell it for birr 24,000. Compute the value of the final product. 24000.

✓ All approach provides the same estimates.

2.4 Other Social Accounts

Gross National Income (GNP): is the value of final goods and services produced by domestically owned factors of production within a given period. GDP measures the total income produce domestically while GNP measures the total income earned by nationals.

$$\text{GNP} = \text{GDP} + \text{factor payments from abroad} - \text{factor payments to abroad}$$

That is, we add receipts of factor income (wages, profits and rent) from the rest of the world and subtract payments of factor income to the rest of the world.

Net national product (NNP): $\text{NNP} = \text{GNP} - \text{depreciation}$. Depreciation is the consumption of fixed capital. Because depreciation of capital is the cost

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of producing the output of an economy, subtracting depreciation shows the net result of economic activity.

National income: is the sum of all factor earnings from current production of goods and services. Factor earnings are incomes of factors of production: land, labor, and capital. Each dollar of GNP is one dollar of final sales, and if there were no charges against GNP other than factor incomes, GNP and national income would be equal. Depreciation and indirect business taxes are not part of earnings of factors of production. Thus GNP and national income diverges by these factors.

National income = NNP - Indirect business taxes (e.g. sales tax and excise tax)

Personal income: is the total income of households. It is the income received by households after paying social insurance taxes but before paying personal income taxes.

Personal income = national income - (corporate profits tax payments and undistributed profits) - social security payments + transfer payments to persons + personal interest income.

Personal Disposable Income (PDI): is the amount households and non-corporate business having available to spend after satisfying their tax obligations to the government.

PDI = Personal Income - Personal taxes

Nominal versus Real GDP

Nominal GDP: -measures the value of the economy's total output at the prices prevailing during which the output is produced.

Real GDP: measures the total output produced in anyone period at the prices of some base year i.e. it measures output valued at constant price. Real GDP, which values output produced in different years at the same prices, implies an estimate of the real or physical change in production of output between any specific years.

Real GDP changes because the available amount of resources in the economy changes.

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Nominal GDP is the value of final goods and services at current prices, i.e. it measures the current dollar value of the economy output.

A rise in the prices of goods and services will increase the (nominal) GDP even if there is no increase in the production. But Real GDP is a measure of production that corrects for the inflation. It uses prices of a certain year (base year) to compute the value of goods and services produced in each year. Because of inflation the nominal GDP grows faster than real GDP.

Measuring the cost of living

A. The Consumer Price Index

The consumer price index (CPI):-is a measure of the overall cost of the goods and services bought by a typical consumer. It puts the price of many goods and services into a single index measuring the overall level of prices. The CPI measures the retail prices of a fixed “market basket” of several thousand goods and services purchased by households. It is an explicit price index in the sense that it directly measures movements in the weighted average of the prices of the goods and services in the market basket. Thus CPI is the price of the “market basket” of goods and services to price of the same basket in some base year.

Five steps in calculating CPI:

1. **Fix the Basket:** The first step in computing the consumer price index is to determine which prices are most important to the typical consumer. If the typical consumer buys more Injera than bread, then the price of Injera is more important than the price of bread and, therefore, should be given greater weight in measuring the cost of living.
2. **Find the Prices:** The second step in computing the consumer price index is to find the prices of each of the goods and services in the basket for each point in time.
3. **Compute the Basket’s Cost:** The third step is to use the data on prices to calculate the cost of the basket of goods and services at different times.
4. **Choose a Base Year and Compute the Index:** The fourth step is to designate one year as the base year, which is the benchmark against

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which other years are compared. To calculate the index, the price of the basket of goods and services in each year is divided by the price of the basket in the base year, and this ratio is then multiplied by 100. The resulting number is the consumer price index.

5. Compute the Inflation Rate: The fifth and final step is to use the consumer price index to calculate the inflation rate, which is the percentage change in the price index from the preceding period. That is, the inflation rate between two consecutive years is computed as follows:

$$\text{Inflation rate in year 2} = \frac{\text{CPI in year 2} - \text{CPI in year 1}}{\text{CPI in year 1}} \times 100$$

For example, suppose that the typical consumer buys 5 apples and 2 oranges every month. Then the basket of goods consists of 5 apples and 2 oranges, and the CPI is:

$$\text{CPI} = \frac{(5 \times \text{Current Price of Apples}) + (2 \times \text{Current Price of Oranges})}{(5 \times \text{2001 Price of Apples}) + (2 \times \text{2001 Price of Oranges})}$$

In this CPI calculation, 2001 is the base year. The index tells how much it costs to buy 5 apples and 2 oranges in the current year relative to how much it cost to buy the same basket of fruit in 2001.

Weaknesses of the CPI as a Measure of the Average Level of Prices

- Substitution bias
 - o When the price of one good change, consumers often respond by substituting another good in its place.
 - o The CPI does not allow for this substitution; it is calculated using a fixed basket of goods and services.
 - o This implies that the CPI overstates the increase in the cost of living over time.
- Introduction of new goods
 - o When a new good is introduced, consumers have a wider variety of goods and services to choose from.

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- o This makes every dollar more valuable, which means that there is an increase in the purchasing power of the dollar.
- o Because the market basket is not revised often enough, these new goods are left out of the bundle of goods and services included in the basket.
- Unmeasured quality change:
 - o If the quality of a good falls from one year to the next, the value of a dollar falls; if quality rises, the value of the dollar rises.
 - o Attempts are made to correct prices for changes in quality, but it is often difficult to do so because quality is hard to measure.
- B. **GDP Deflator:** -Another measure of the average price level is the GDP deflator. This index measures the average level of prices of all goods and services that make up GDP (including investment and consumption goods not in the CPI). The GDP deflator is the ratio of nominal GDP to real GDP. Because nominal GDP is current output valued at current prices and real GDP is current output valued at base-year prices, the GDP deflator reflects the current level of prices relative to the level of prices in the base year.

$$\text{GDP deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

There are three key differences between CPI and GDP Deflator:

- a. GDP deflator measures the price of all goods and services produced, whereas the CPI measures the prices of only goods and services bought by consumers. Thus an increase in the price of goods and services bought by firms and/or government will show up in the GDP deflator but not in the CPI.
- b. GDP deflator includes only those goods produced domestically
- c. CPI assigns fixed weights to the price of different goods and services whereas the GDP deflator assigns changing weights. In other words, the CPI is computed using a fixed basket of goods while the GDP

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deflator allows the basket of goods to change overtime as the composition of GDP changes.

It is difficult to take GDP deflator or CPI as a superior measure of cost of living. Both have their own advantages and disadvantages. For instance, assume the prices of different products are changing by different amount. The fixed basket index - CPI - tends to overstate the cost of living because it does not account that consumers have the opportunity to substitute less expensive goods for more expensive ones. The changing basket index - GDP deflator - understates the increase in cost of living. While it accounts for substitution of alternative goods, it does not reflect the reduction in consumer's welfare that may result from such substitutions.

GDP and Welfare

GDP is a measure of the economic prosperity of a country compiled as output or income. There is a strong correlation between the development in GDP and changes in several important social factors, including tax payments and unemployment and, to a lesser extent, health and education. However, GDP is regularly criticized for not presenting a fair view of welfare. If GDP is a poor measure of welfare, focusing one-sidedly on increasing GDP may lead to misguided political decisions. For example, Nobel laureate Joseph Stiglitz has argued that the objective of the highest possible GDP growth will result in reduced welfare. The criticism of GDP as a measure of welfare is two-fold.

Firstly, there are a number of compilation problems, including the breakdown by price and quantity changes and the calculation of public output. These problems can cause both the level of GDP and GDP growth to deviate from actual output. Furthermore, changes in the terms of trade may cause income to develop differently from output. As a result, applying the level of GDP and GDP growth as measures of economic prosperity is not fully possible.

Secondly, a number of factors of major significance to welfare are not included in GDP. A number of factors may affect welfare, e.g. leisure time,

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health condition and level of education. These welfare indicators do not seem to provide a significantly better picture of welfare due to the strong correlation between e.g. health and education and GDP.

Instead, other welfare indicators attempt to measure welfare directly, including by means of questionnaires on the subjective feeling of happiness. The patterns of these indicators are different from that of GDP.

There is a strong cross-country correlation between GDP and happiness, but measured over time, happiness seems to be independent of the development in GDP. One explanation of this apparent paradox is that happiness is related to the relative position in the income hierarchy rather than to the absolute level of income. Consequently, the feeling of happiness is not increased by higher income if everyone else has also become more affluent. In addition to being a poor measure of welfare, GDP is also criticized of not including sustainability. Sustainability can be viewed as ongoing maintenance of necessary resources, e.g. the capital stock, the "natural capital" measured by the quantity of natural resources and environmental quality as well as the amount of human capital. Indicators illustrating sustainability should be analyzed in parallel with welfare indicators. Despite a number of reservations, GDP as an indicator of prosperity should play a key role in the welfare debate. Increased prosperity can be used to improve areas that are deemed to be central to welfare. Furthermore, GDP is strongly correlated with a number of factors of importance to welfare, including unemployment, health and education. Aspects affecting welfare but not included in GDP should be part of the political debate, but they should not necessarily be comprised by a single welfare indicator.

The Business Cycle

Inflation, growth and unemployment are related through the business cycle. The business cycle is the more or less regular pattern of expansion (recovery) and contraction (recession) in economic activity around the path of trend growth. Inflation, growth and unemployment all have clear cyclical patterns.

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- At a cyclical peak – economic activity is high relative to trend
- At a cyclical trough – the low point in economic activity is reached

Trend path of GDP is the path GDP would take if factors of production were fully employed.



Output is not always at its trend level, that is, the level corresponding to full employment of factors of production. Rather output fluctuates around the trend level.

During an expansion (recovery) the employment of factors of production increases. Output rises above the trend because people work overtime and machinery is used for several shifts. During a recession unemployment increases and less output is produced than can be produced with existing resources and technology. The wavy line shows these cyclical departures of output from trend. Deviations of output from trend are referred to as the output gap. The output gap measures the gap between actual output and the output the economy could produce at full employment given the existing resources.

$$\text{Output Gap} = \text{Potential output} - \text{Actual output}$$

The output gap allows us to measure the size of the cyclical deviations of output from its potential output level or trend output. Positive gap, when potential output is greater than actual output, more resources become unemployed and actual output falls below potential output, that is, the economy is in a recession. Negative gap, when actual output is greater than potential output, resources are overemployed, like workers are working

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overtime and machineries are more utilized by shift, that is, the economy is expanding and accessibility of job are widespread.

From the business cycle it is assumed that often a long expansion reduces unemployment too much, causes inflationary pressure, and therefore triggers policies to fight inflation, and such policies usually create recessions.

Unemployment and Inflation

The Phillips curve describes an empirical relationship between inflation and unemployment; the higher the rate of unemployment, the lower the rate of inflation.

When policymakers move the economy up along the short-run aggregate supply curve, they reduce the unemployment rate and raise the inflation rate. Conversely, when they contract aggregate demand and move the economy down the short-run aggregate supply curve, unemployment rises and inflation falls. This tradeoff between inflation and unemployment, called

Phillips curve.

It was made in the 1950's in Great Britain and has since become a cornerstone of macroeconomics. It shows that high rate of unemployment are accompanied by low rates of inflation and vice versa. The curve suggests that less unemployment can always be attained by incurring more inflation and that the inflation rate can always be reduced by incurring the costs of more unemployment. In other words, the curve suggests that there is tradeoff between inflation and unemployment.

Economic events since 1970, particularly 1974 and 1981 were accompanied by both high unemployment and high inflation, led to skeptical consideration of the Philips curve. **The modern view on the tradeoff between inflation and unemployment, is, there is a relationship between inflation and unemployment of the Phillips curve type in short run.** But the short run Phillips curve does not remain stable; it shifts as expectations of inflation changes. In the long run there is no trade off worth speaking between

Inflation rate

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inflation and unemployment, i.e. the unemployment rate is basically independent of the long run inflation rate.

Growth and unemployment: high GDP growth is accompanied by declining unemployment. Economic expansion is associated with falling unemployment rate. Periods of recession are associated with low growth and rising unemployment.

Okun's law: a relationship between real growth and changes in the unemployment rate is known as Okun's law. Since employed workers contribute to the production of goods while unemployed workers do not, increases in the unemployment rate should be associated with decreases in the growth rate of GDP.

Okun's law states that unemployment rate declines when growth is above the trend rate of 2.25 percent. Specifically, for each percentage point of growth in real GDP above the trend rate that is sustained for a year, the unemployment rate declines by half (0.5%) percentage point.

$\Delta u = -0.5(y - 2.25)$, where Δu is change in unemployment,
 y is growth rate of output and 2.25 is the trend growth of output.

Inflation is always and everywhere a monetary phenomenon. Inflation implies the rise in the general price level. As we have discussed above inflation is a cost to the society.

Two causes of rising and falling inflation

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- **Demand -pull inflation:** we know that the relationship between inflation and unemployment is negative. Low unemployment pulls inflation rate up. Inflation caused because of high aggregate demand is responsible for such type of inflation. For example, an increase in demand for the products makes supplier to raise the price of the product in order to **control the supply limitation**, which will come later.
- **Cost-push inflation:** Inflation also rises and falls because of supply shocks. An adverse supply shock, such as the rise in world oil prices in the 1970s, implies a rise in inflation. The supply shocks are typically events that push up the costs of production.

Costs of inflation

- One cost is the distortion of the inflation tax on the amount of money people hold. A higher inflation rate leads to a higher nominal interest rate, which in turn leads to lower real money balances.
- A second cost of inflation arises because high inflation induces firms to change their posted prices more often. Changing prices is sometimes costly: for example, it may require printing and distributing a new catalog. These costs are called **menu costs**, because the higher the rate of inflation, the more often restaurants have to print new menus.
- A third cost of inflation arises because firms facing menu costs change prices infrequently; therefore, the higher the rate of inflation, the greater the variability in relative prices. For example, suppose a firm issues a new catalog every January. If there is no inflation, then the firm's prices relative to the overall price level are constant over the year. Yet inflation is 1 percent per month, then from the beginning to the end of the year the firm's relative price falls by 12 percent. Sales from this catalog will tend to be low early in the year (when its prices are relatively high) and high later in the year (when its prices are relatively low).
- A fourth cost of inflation results from the tax laws. Many provisions in the tax code do not take into account the effect of inflation. Inflation can alter individual tax liability, often in ways that lawmakers did not intend.
- A fifth cost of inflation is the inconvenience of living in a world with a changing price level. Money is the yardstick with which we measure economic transactions. When there is inflation, that yardstick is changing in length.