TOPIC FIVE – NATIONAL INCOME

- This is the total income received by the providers/owners of the factors of production in a given country over a given time period.

Terms used in national income

(i) **Gross Domestic Product (GDP)**. This is the total monetary value of all goods and services produced in a country during a particular year. Such goods and services must have been produced within the country.

(ii) **Net Domestic Product (NDP)**. This is the GDP less depreciation. Depreciation is the loss in value of the assets such as machines used in the production of goods and services.

(iii) **Gross National Product (GNP)**. This measures the total monetary value of all the goods and services produced by the people of a country regardless of whether they in or outside the country. It takes into account exports and imports. The difference between exports and imports is called net Factor Income from abroad. GNP therefore is the sum of GDP and net factor income from abroad.

(iv) **Net National Product (NNP)**. This recognizes the loss in value of the capital used in the production of goods. Capital here refers to capital goods. NNP is the difference between GNP and the depreciation.

(v) **Per capita income.** This is the average income per head per year in a given country. It is also the national income divided by the population of the country.

CIRCULAR FLOW OF INCOME

- This is the continuous movement of income between the households (providers of factors of production) and the firms (producers of goods and services).
- The factors of production are received from households.
- The firms pay the rewards of such factors to the households (expenditure to the firms and income to the households).
- The households in turn use the income to buy the goods and services produced by the firms (expenditure to households and income to firms).

Assumptions/features of circular flow of income

(i) **Existence of two sectors only.** It is assumed that the economy has only two sectors that is households and firms. The households provide the factors of production while firms are involved in the production of goods and services.

(ii) **Total spending by households**. It is assumed that the households spend all their income on the goods and services produced by the firms i.e. no savings.

(iii) **Total spending by the firms**. It is assumed that the firms spend the money received from the sale of goods and services to pay for the rewards of production factors.

(iv) **Lack of government intervention.** The government does not influence how the firms and households carry out their activities. Such interventions are in the form of taxes, price controls among others.

(v) **Closed economy**. Exports and imports do not exist in such an economy.

Factors affecting the circular flow of income

- The factors can either lead to increase in income and expenditure (injections) or lead to a reduction in the volume of flow (withdrawals).

The factors include the following:

(i) **Savings.** This takes place when the households do not spend all their income on the purchase of goods and services. This reduces the income to be received by firms hence savings is a withdrawal from the circular flow of income.

(ii) **Taxation.** Taxation reduces the amount of money available for spending therefore it is a withdrawal/leakage from the circular flow of income.

(iii) **Government expenditure.** The government may buy goods from the firms or provide subsidies. This will translate in to an injection into the circular flow of income.

(iv) **Investments.** When firms put more capital into the production, output will increase hence an increase in income (injection).

(v) **Imports.** When goods and services are bought from other countries, money will be spent hence a reduction in the circular flow of income (withdrawal).

(vi) **Exports.** Through exports, a country is able to receive money from other countries (injections)

Injections

(i) Investments
(ii) Government spending
(iii) Exports

Withdrawals

(i) Savings
(ii) Taxation
(iii) Imports

APPROACHES USED IN MEASURING NATIONAL INCOME

(i) Expenditure Approach.

National income is arrived at summing expenditure on all final goods and services (that have reached the final stage of production). Such expenditure is divided into:

a) Expenditure on consumer goods (C)
b) Expenditure on capital goods (I)
c) Expenditure by government (G)
d) Expenditure on net exports (X – M)

Therefore national income = C+I+G+(X – M)

Problems associated with expenditure approach

- Lack of accurate records particularly in the private sector.
- Approximation of expenditure of the subsistence sector.
- Difficulty in differentiating between final expenditure and intermediate expenditure
- Double counting may exist
- Fluctuating exchange rates may cause problems in the valuation of imports and exports.

(ii) Income approach

- In this method, the national income is arrived at by summing all the money received by those who participate in the production of goods and services.
- Such incomes are in the form of rewards to the production factors (wages, rent, interest and profits).
- Public income is also taken into account i.e. it is the income received by the government from its investments (Parastatals, joint ventures).
- Transfer payments are excluded since they represent a redistribution of incomes from those who have earned them to the recipient's e.g. National insurance schemes.

Problems related to this method

a) Determination of what proportion of transfer payments constitute in the income of a country.
b) Inaccurate data may exist since business people may not tell the truth about their income in order to evade tax.
c) Price fluctuations may make national income determination difficult.
d) Income from illegal activities is not captured.
e) Valuation of income from subsistence economy may be difficult e.g. housewives.

Assignment: Read and make short notes on Output approach (refer to Inventor book three pages 65 – 66).

USES OF NATIONAL INCOME STATISTICS

- **Indicators of standards of living.** If the national income is equitably distributed, then the standards of living will be high.
- **Measuring economic growth.** The statistics of one year are compared with previous year to show whether there is improvement or not.
- **Inter country comparison.** They are used to compare the economic welfare among countries hence knowing which country is better off and by how much. However, the following challenges may be faced when carrying the comparisons: different in currencies, different goods and services, disparity in income distribution and difference in tastes and preferences.
- **Investment decisions.** They assist the government and other investors to know the sectors to put their money. The statistics provide relevant information concerning the performance of each sector.
- **Basis of equitable distribution of income.** The statistics can be used to spread income to the hands of majority of the citizens incase a few individuals control the economy.
- **Planning purposes.** The statistics will show the contribution of each sector thus helping the government in allocating the funds to the various sectors.

Factors which influences the level of national income.

- ✓ **Quantity and quality of production.** If the factors are more in terms of quantity of good quality, the output will be high hence increasing in national income.
- ✓ **State of technology.** A country with high level of technology will produce goods in large volumes hence high national income.
- ✓ **Political stability.** Countries which are relatively stable politically experience high production hence high national income level.
- ✓ **Accuracy of accounting systems.** If the methods used to gather data are accurate, then the overall statistical figures will the accurate hence reliable.

- ✓ **Proportion of the subsistence sector.** Subsistence sector's output is not normally included in the statistical figures. If it represents a large proportion, therefore the national income level will be low.

NB. For other factors refer to Inventor book three pages 68 – 69.

Reasons why high per capita income is not an indicator of a better living standard in a country

- ❖ **Statistical problems.** The collection of the national income data may be inaccurate meaning that the national income figures might be incorrect hence wrong per capita income.
- ❖ **Changes in money value.** If the currency has been devalued, there can be change in the value of money without necessarily representing any changes in the welfare of the people.
- ❖ **Income distribution.** The per capita may be high even though the income is in the hands of very few people thus it is not a representative of the majority.
- ❖ **Nature of products.** If the products are not meant to satisfy immediate wants of the people, then an increase in per capita income may not lead to a higher economic welfare.
- ❖ **Peoples' hard work and attitude.** Increased national income may mean less sleep and more worries. People have no time to enjoy what they produce and their welfare may be low despite the rise in national income.
- ❖ **Social costs.** People may migrate from rural areas to urban areas straining family relationships while an increase in industries may create pollution, congestion and other environmental disruptions.

Questions

1. State four problems encountered in comparing standards of living in different countries using national income statistics
2. Using a diagram, describe the circular flow of income.
3. Explain five factors that may influence the level of national income of a country
4. Outline four limitations of expenditure approach used in measuring national income.
5. Explain five reasons why high per capita income may not translate to better living standards in a country.
6. Describe five factors that affect the circular flow of income.