GS SCORE

IAS FOUNDATION

INDIAN ECONOMY VOL: 1

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PART - I

BASICS OF INDIAN ECONOMY

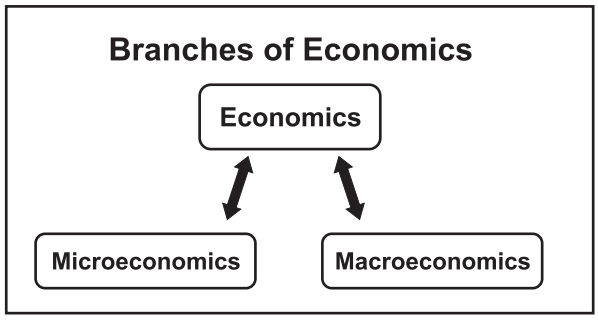
1.1

BASIC CONCEPTS OF ECONOMY

Meaning of Economics

Economics is a social science concerned with the production, distribution, and consumption of goods and services. It studies how individuals, businesses, governments, and nations make choices about how to allocate resources. Economics focuses on the actions of human beings, based on assumptions that humans act with rational behavior, seeking the most optimal level of benefit or utility. The building blocks of economics are the studies of labor and trade. Since there are many possible applications of human labor and many different ways to acquire resources, it is the task of economics to determine which methods yield the best results. Economics can generally be broken down into macroeconomics, which concentrates on the behavior of the economy as a whole, and microeconomics, which focuses on individual people and businesses.

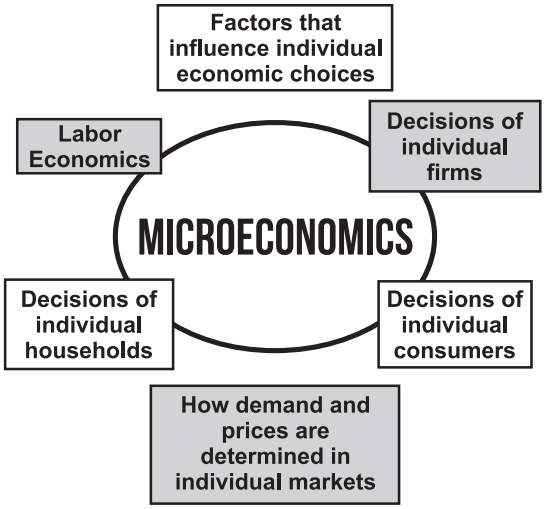
Branches of Economics



Microeconomics

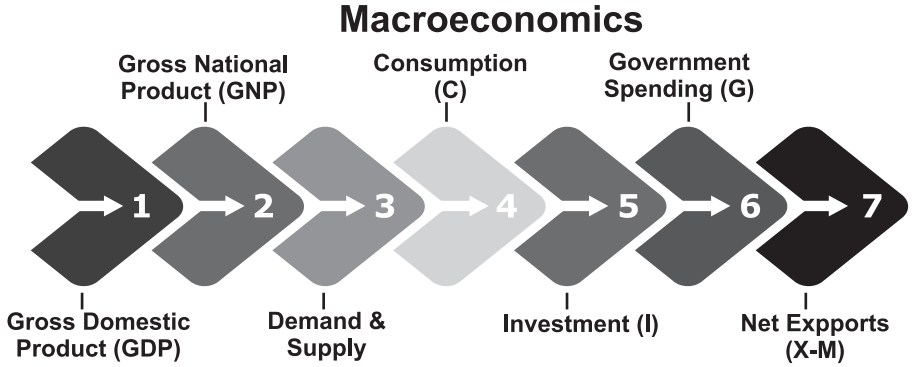
- Microeconomics is a branch of economics that studies the behavior of individuals and firms in making decisions regarding the allocation of scarce resources and the interactions among these individuals and firms.
- One goal of microeconomics is to analyze the market mechanisms that establish relative prices among goods and services and allocate limited resources among alternative uses. Microeconomics shows conditions under which free markets lead to desirable allocations. It also analyzes market failure, where markets fail to produce efficient results.

- While microeconomics focuses on firms and individuals, macroeconomics focuses on the sum total of economic activity, dealing with the issues of growth, inflation, and unemployment and with national policies relating to these issues. Microeconomics also deals with the effects of economic policies (such as changing taxation levels) on microeconomic behavior and thus on the aforementioned aspects of the economy.



Macroeconomics

- Macroeconomics is a branch of economics that studies how an overall economy—the market or other systems that operate on a large scale—behaves. Macroeconomics studies economy-wide phenomena such as inflation, price levels, rate of economic growth, national income, gross domestic product (GDP), and changes in unemployment.
- Some of the key questions addressed by macroeconomics include: What causes unemployment? What causes inflation? What creates or stimulates economic growth? Macroeconomics attempts to measure how well an economy is performing, to understand what forces drive it, and to project how performance can improve.



- Macroeconomics deals with the performance, structure, and behavior of the entire economy, in contrast to microeconomics, which is more focused on the choices made by individual actors in the economy (like people, households, industries, etc.).

Macroeconomic Models

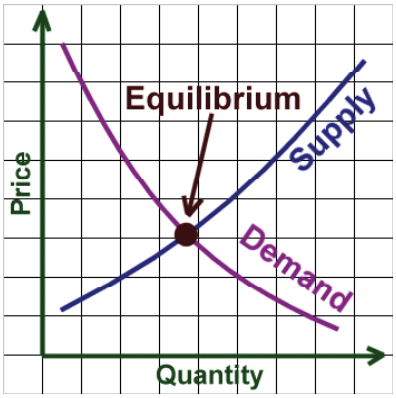
Law of Supply and Demand:

- **Meaning of demand and supply:** Demand refers to how much of a product consumers are willing to purchase, at different price points, during a certain time period. While demand explains the consumer side of purchasing decisions, supply relates to the seller's desire to make a profit. A supply schedule shows the amount of product that a supplier is willing and able to offer to the market, at specific price points, during a certain time period.

- The law of supply and demand is a theory that explains the interaction between the sellers of a resource and the buyers for that resource. The theory defines the relationship between the price of a given good or product and the willingness of people to either buy or sell it. Generally, as price increases, people are willing to supply more and demand less and vice versa when the price falls. The theory is based on two separate "laws," the law of demand and the law of supply. The two laws interact to determine the actual market price and volume of goods on a market.
- Very simply, the law of demand states that if all other factors remain constant, if a good's price is higher, fewer people will demand it. As the price of that good goes down, the quantity of that good that the market will demand will increase.
- Supply is defined as the total quantity of a product or service that the marketplace can offer. The quantity supplied is the amount of a product/service that suppliers are willing to supply at a given price. This relationship between price and the amount of a good/service supplied is known as the supply relationship.

Equilibrium

- Equilibrium is the state in which market supply and demand balance each other, and as a result prices become stable. Generally, an over-supply of goods or services causes prices to go down, which results in higher demand—while an under-supply or shortage causes prices to go up resulting in less demand. The balancing effect of supply and demand results in a state of equilibrium. A market is said to have reached equilibrium price when the supply of goods matches demand.
- Disequilibrium is the opposite of equilibrium and it is characterized by changes in conditions that affect market equilibrium.



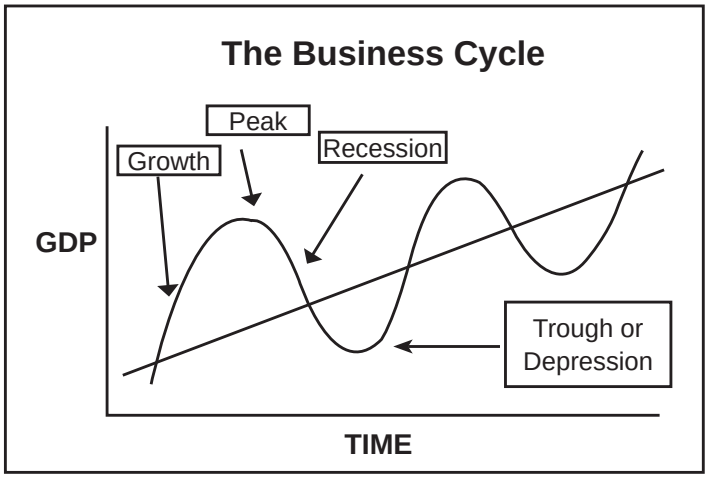
Growth Model

- It is model of economic growth that analyzes changes in the level of output in an economy over time as a result of changes in the population growth rate, the savings rate, and the rate of technological progress. The Solow Growth Model is developed by Nobel Prize-winning economist Robert Solow. The Solow model is the basis for the modern theory of economic growth.

Basic macroeconomic concepts

- Macroeconomics encompasses a variety of concepts and variables, but there are three central topics for macroeconomic research. Macroeconomic theories usually relate the phenomena of output, unemployment, and inflation. Outside of macroeconomic theory, these topics are also important to all economic agents including workers, consumers, and producers.
- **Output and income:** National output is the total amount of everything a country produces in a given period of time. Everything that is produced and sold generates an equal amount of income. The total output of the economy is measured GDP per person. The output and income are usually considered equivalent and the two terms are often used interchangeably, output changes into income. Output can be measured or it can be viewed from the production side and measured as the total value of final goods and services or the sum of all value added in the economy.

- **Business cycle**: The term "business cycle" (or economic cycle or boom-bust cycle) refers to economy-wide fluctuations in production, trade, and general economic activity. From a conceptual perspective, the business cycle is the upward and downward movements of levels of GDP (gross domestic product) and refers to the period of expansions and contractions in the level of economic activities (business fluctuations) around a long-term growth trend.



- **Unemployment**: The amount of unemployment in an economy is measured by the unemployment rate, i.e. the percentage of workers without jobs in the labor force. The unemployment rate in the labor force only includes workers actively looking for jobs. People who are retired, pursuing education, or discouraged from seeking work by a lack of job prospects are excluded.
- **Inflation and deflation:** A general price increase across the entire economy is called inflation. When prices decrease, there is deflation. Economists measure these changes in prices with price indexes. Inflation can occur when an economy becomes overheated and grows too quickly. Similarly, a declining economy can lead to deflation.

Macroeconomic policy

- Macroeconomic policy is usually implemented through two sets of tools: fiscal and monetary policy. Both forms of policy are used to stabilize the economy, which can mean boosting the economy to the level of GDP consistent with full employment.
- Macroeconomic policy focuses on limiting the effects of the business cycle to achieve the economic goals of price stability, full employment, and growth.

Differences	Microeconomics	Macroeconomics
Definition	Microeconomics is the study of economic actions of individuals and small groups of individuals.	Macroeconomics studies the economy as a whole and not a single unit but combination of all.
Concern with	Particular households, firms and industries	National income, general price levels, national output, unemployment and poverty
Objective	On demand side Is to maximize utility whereas on the supply side is to minimize profits at minimum cost	Full employment, price stability, economic growth and favourable balance of payments.
Basis	Price mechanism which operates with the help of demand and supply forces	National Income, output and employment which are determined by aggregate demand and aggregate supply

Assumptions	Rational behaviour of individuals	Aggregate volume of output of an economy, the extent to which its resources are employed
Limitations	Existence of full employment	Iinvolvement of 'Fallacy of Composition' which doesn't prove true

Concept of Price elasticity of demand and price elasticity of supply

- **Meaning of elasticity**: Elasticity is a measure of a variable's sensitivity to a change in another variable, most commonly this sensitivity is the change in price relative to changes in other factors. In business and economics, elasticity refers to the degree to which individuals, consumers, or producers change their demand or the amount supplied in response to price or income changes. It is predominantly used to assess the change in consumer demand as a result of a change in a good or service's price. Simply, elasticity is an economic measure of how sensitive an economic factor is to another, for example, changes in price to supply or demand, or changes in demand to changes in income.
- **Price elasticity of supply**: It measures the responsiveness to the supply of a good or service after a change in its market price. According to basic economic theory, the supply of a good will increase when its price rises. Conversely, the supply of a good will decrease when its price decreases.
- **Price elasticity of demand**: A good's price elasticity of demand is a measure of how sensitive the quantity demanded of it is to its price. When the price rises, quantity demanded falls for almost any good, but it falls more for some than for others.
- **Example:** If demand for a good or service is relatively static even when the price changes, demand is said to be inelastic, and its coefficient of elasticity is less than 1.0. Examples of elastic goods include clothing or electronics, while inelastic goods are items like food and prescription drugs.
- Another extraordinary example of COVID-19's impact on elasticity arose in the oil industry. Although oil is generally very inelastic, meaning demand has a little impact on the price per barrel, because of a historic drop in global demand for oil during March and April, along with increased supply and a shortage of storage space, on April 20, 2020, crude petroleum actually traded at a negative price in the intraday futures market. In response to this dramatic drop in demand, OPEC+ members elected to cut production by 9.7 million barrels per day through the end of June, the largest production cut ever

Concept of Giffen Good

- A Giffen good is a rare type of good, where an increase in price causes an increase in demand. The reason is that the income effect of a rise in the price causes you to buy more of this cheap good because you can't afford more expensive goods. As the price of inferior quality staple foods price increases, their demand also increase, thus violating the law of demand. This is because the staple food becomes such an essential part of a person's consumption that even as the price of such good rises, he cuts down consumption of other luxurious goods just to consume this essential good.
- For example, if the price of wheat rises, a poor peasant may not be able to afford meat anymore, so has to buy more wheat.

Concept of Inferior Goods

- An Inferior good is one which follows the principle: that as income rises the consumption for such good decreases. This is because as the income rises the consumer looks towards consuming a better good than the inferior good. The inferior good does not form a substantial part of the person's income, also it is not as essential as a Giffen good.

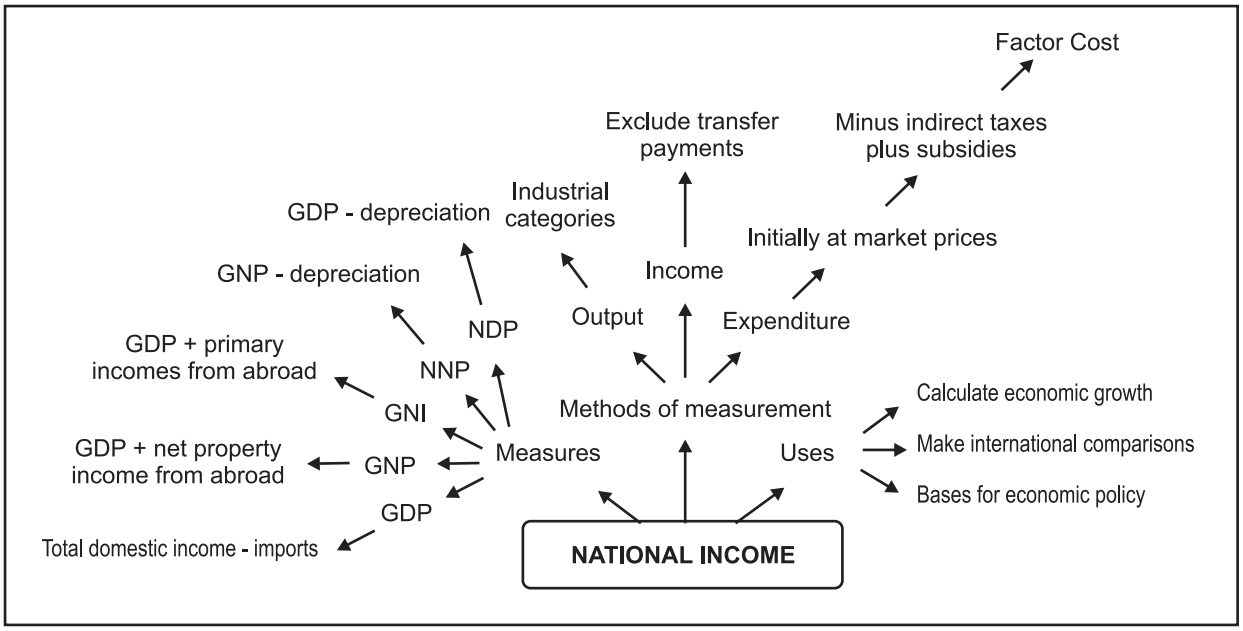
- One thing must be understood is that a Giffen good demand is affected by its price, while a Inferior good reacts more directly to income changes.
- Example: public transportation is an inferior good - as income rises/the wealthier you become, the more likely you are to own a car instead, pay for cabs, etc, and less likely you are to use public transit.

National Income

National income is the total value of a country's final output of all new goods and services produced in one year. According to Central Statistical Organization, "National income is the sum total of factor incomes earned by normal residents of a country in the form of wages, rent, interest and profit in an accounting year."

National Income Accounting (NIA) refers to methods or techniques used to measure the economic activity in the national economy as a whole. As one calculates income at an individual level similar calculation can be done for at the country level as well. NIA is needed for comparing the estimates in the past from those in future and also forecast the growth rates in future. For example, if a country has a GDP of Rs. 103 Lakh which is 3 Lakh rupees higher than the last year, it has a growth rate of 3 per cent.

In economics when a term 'a growing' economy is used, it means that the economy is adding up its income i.e. in quantitative terms. It provides useful insight into how well an economy is functioning and where money is being generated and spent. One can compare the standard of living of different nations. It helps to show the rate of growth or development of different nations.



National Income calculated by three ways:

■ Income Method

Estimated by adding all the factors of production (rent, wages, interest, profit) and the mixed-income of self-employed.

- In India, one-third of people are self-employed.
- This is the 'domestic' income, related to the production within the borders of the country

■ Production Method

Estimated by adding the value added by all the firms.

Value-added = Value of Output – Value of (non-factor) inputs

- This gives GDP at Market Price (MP) – because it includes depreciation (therefore 'gross') and taxes (therefore 'market price')
- To reach National Income (that is, NNP at FC)
  - Add Net Factor Income from Abroad: GNP at MP = GDP at MP + NFIA
  - Subtract Depreciation: NNP at MP = GNP at MP – Dep
  - Subtract Net Indirect Taxes: NNP at FC = NNP at MP – NIT

Expenditure Method

The expenditure method to measure national income can be understood by the equation given below:

Y = C + I + G + (X-M),

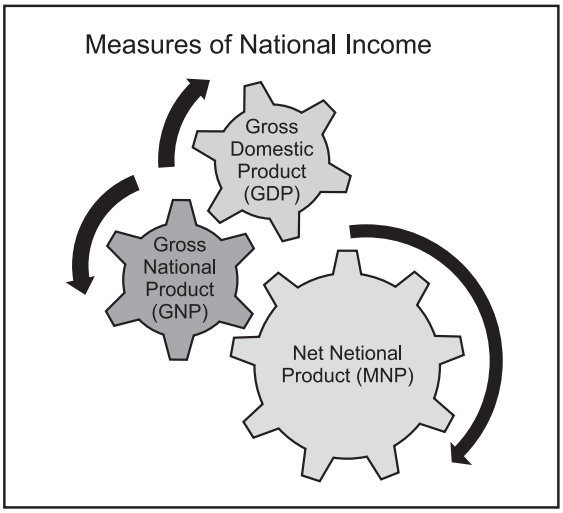
Where Y = GDP at MP, C = Private Sector's Expenditure on final consumer goods, G = Govt's expenditure on final consumer goods, I = Investment or Capital Formation, X = Exports, I = Imports, X-M = Net Exports

Any of these methods can be used in any of the sectors – the choice of the method depends on the convenience of using that method in a particular sector

National Income	
Items Included in National Income	Items not included in National Income
Goods produced for self-consumption	Intermediate goods
Estimated rent of the self-occupied property	Transfer payments (unilateral payments made without expectations of return; like gifts, unemployment allowance, donations, etc)
–	Sale and purchase of old goods and existing services (shares are not included unless they are through an IPO)
–	Windfall gains (lottery income)
–	Black money (cannot be estimated)
–	Work done by housewives

Measures of national Income

A variety of measures of national income and output are used in economics to estimate total economic activity in a country or region, including gross domestic product (GDP), gross national product (GNP), net national income (NNI), and adjusted national income (NNI adjusted for natural resource depletion – also called as NNI at factor cost). All are specially concerned with counting the total amount of goods and services produced within the economy and by various sectors.



Gross Domestic Product (GDP)

- Gross Domestic Product (GDP) refers to total market value of all final goods and services produced in an economy over a period of one year. In India, fiscal or financial year is from 1st April to 31st March i.e. it measures the money value of final goods and services produced within a geographic boundary regardless of the nationality of the individual or firm.

- In calculation of GDP only final output of such goods and services is considered. Counting of final goods is necessary to avoid multiple (double or triple) counting of raw materials, intermediate products, and final products.
- Example - In an automobile industry, value of automobiles already includes the value of the steel, glass, tires, engine and other components that have been used to make them.
  - Final Goods and Services: Goods and Services purchased for final use.
  - Intermediate Goods/ Raw Materials: Products used as input in the production of some other product.
- By calculating the value added at each stage of production, from the beginning of the process to the end. Specifically, it is derived by subtracting the value of the intermediate good from the value of the sale.

Types of GDP

GDP can be divided into:

- **Real GDP -** Real GDP refers to the current year production of goods and services valued at base year prices. Such base year prices are constant prices.
- **Nominal GDP -** Nominal GDP refers to current year production of final goods and services valued at current year prices.
- Real GDP is a better measure to calculate the GDP because in a particular year GDP may be inflated because of high rate of inflation in the economy. Real GDP therefore allows us to determine whether production increased or decreased, regardless of changes in the inflation and purchasing power of the currency.

Potential GDP

- Potential GDP provides an important benchmark for regulators and policymakers to rely on when making decisions about monetary policy.
- The kinds of policies that may be pursued depend on the difference between potential and real GDP. This is called the output gap.
- If real GDP falls short of potential GDP (i.e., if the output gap is negative), it means demand for goods and services is weak. It's a sign that the economy may not be at full employment.
- If the real GDP exceeds potential GDP (i.e., if the output gap is positive), it means the economy is producing above its sustainable limits, and that aggregate demand is outstripping aggregate supply. In this case, inflation and price increases are likely to follow.
- If the output gap is negative—meaning that the economy isn't producing its full potential—then central banks like the Fed may consider lowering interest rates to stimulate the economy.
- The factors inhibiting India from realizing its potential GDP include the global financial crisis, decline in total factor productivity contribution, capital stocks growth deceleration, capital allocation distortions across various economic sectors, financial sector mess and constraints, reduction in disposable income levels, depletion of consumption and fixed investment and the like. However, India could make potential output accelerate with higher level of capital formation and by redistributing the excess capital from over-capitalized places to the under-capitalized entities.

Net Domestic Product (NDP)

Net Domestic Product (NDP) is the GDP calculated after adjusting the value of 'depreciation'. This is, basically a net form of the GDP, i.e. GDP minus the total value of the depreciation that happened in the assets while the goods and services were being produced.

NDP = GDP - Depreciation

- Because of the above, NDP of an economy is always lower than its GDP, since there depreciation can never be reduced to zero. The concept of NDP and NNP are not used to compare different economies because the method of calculating depreciation varies from country to country.

Concept of Base Year:

- Base year is the year used as the beginning or the reference year for constructing an index, and which is usually assigned an arbitrary value of 100.
- Economists use a price index to find the real GNP/GDP to make the calculation of GNP/GDP easier. A Price index is a number showing the changes in the overall level of prices. It shows a change in the general price level of an economy.
- The base year for calculating GDP has been changed to 2011-12 from 2004-2005. The government will change the base year for calculation of GDP to 2017-18.

Base Year selection is made on the basis of:

- Stability of macroeconomic parameters. It has to be a normal year without large fluctuations in production, trade and prices of goods and services.
- Data available for the year should be reliable.
- Comparability so that same parameters should be in use in both the years. Therefore it should be a recent year and not go long back into history.

Concept of Depreciation

- In the process of production a country uses several capital assets such as machinery, equipment, automobiles, etc.
- The assets like machines face wear and tear over a period of time. Its value reduces. This is known as depreciation.
- When the value completely erodes the capital asset in question has to be either replaced or repaired. Expenses incurred for this are called depreciation expenditure.
- The sum of these two amounts is called Gross Investment in economics.
- Gross Investment = Net investment + Depreciation

Gross National Product (GNP)

- GNP is a measure of the value of output produced by the nationals of a country irrespective of the geographical boundaries of a nation. It refers to the output of Indian citizens both within India and in all the countries of world.

  GNP = GDP + (Income from abroad)
- Example: Apple Inc. is a US based firm. When it opens up a production center in India, value of output from that center is added to India's GDP, but it is not added while calculating GNP of India.
- Similarly, when Indian companies such as HCL or Reliance provide services in the US, the value of those services are not added in the Indian GDP but they are considered while calculating the Indian GNP.
- GDP and GNP are measured on the basis of Market Price and Factor Cost.

Market Price:

- It refers to the actual transacted price and it includes indirect taxes such as custom duty, excise duty, sales tax, service tax, etc. (impending Goods and Services Tax).
- These taxes tend to raise the prices of the goods in an economy.

Factor Cost:

- It refers to the cost of factors of production.
- Factors of Production i.e. rent for land, interest for capital, wages for labor and profit for entrepreneurship. This is equal to revenue price of the final goods and services sold by the producers.
- Revenue price (or factor cost) = Market Price - Net Indirect Taxes.
- Net Indirect Taxes (NIT) = Indirect Taxes - Subsidies
- Hence, Factor Cost = Market Price- Indirect Taxes + Subsidies

Net National Product (NNP)

- Net national product or NNP is the market value of all the finished goods and services that are produced by citizens of a nation, living domestically and internationally during a year.
- Net national product is also referred to as the value that is obtained by subtracting depreciation from the gross national product (GNP).
- Net national product considers all the goods, products and services that are manufactured by the country's citizens, irrespective of their location, or in other words, net national product considers products that are produced domestically and also from overseas.
- The net national product can be calculated by the following formula

  NNP = GNP – Depreciation

Net Foreign Factor Income (NFFI)

Net Foreign Factor Income (NFFI) is the difference between the aggregate amount that a country's citizens and companies earn abroad, and the aggregate amount that foreign citizens and overseas companies earn in that country.

Formula

- Net Foreign Factor Income = GNP - GDP

Concepts Related to Nationality

What is Economic territory?

- Economic territory is the geographical territory administered by a government within which persons, goods and capital circulate freely.
- Those parts of the political frontiers of a country where the government of India, does not enjoy the above "freedom" are not to be included in economic territory of that country. One example is embassies.
- Government of India does not enjoy the above freedom in the foreign embassies located within India. So, these are not treated as a part of economic territory of India. They are treated as part of the economic territories of their respective countries.

What is the difference between citizen and resident?

- Citizenship is basically a legal concept based on the place of birth of the person or some legal provisions allowing a person to become a citizen. On the other hand resident ship is basically an economic concept based on the basic economic activities performed by a person.
- A resident, whether a person or an institution, is one whose center of economic interest lies in the economic territory of the country in which he lives. That is NRI are the citizens of India but their economic interest lies in other countries (an engineer working in US thus its economic interest in US) thus NRI are known as Non-Resident Indian.

Personal Income (PI)

- In economics, personal income refers to an individual's total earnings from wages, investment enterprises, and other ventures. It is the sum of all the incomes actually received by all the individuals or household during a given period. Welfare payments are received by households, but these are not elements of national income because they are transfer payments.
- Similarly, in national income accounting, some income is attributed to individuals, which they do not actually receive. For example, undistributed profits, employee's contribution for social security corporate income taxes etc. are part of national income but are not received by individuals. Therefore, they are to be deducted from national income to estimate the personal income. Personal income thus is:
- PI = NI + transfer payments - Corporate retained earnings, income taxes, social security taxes.

Disposable Income (DPI)

- Disposable personal income refers to the amount, which in actual is at the disposal of individuals to spend as they like. It is the amount which is left with the individuals after paying personal taxes such as income tax, property tax, professional tax etc. Therefore:
- DPI = PI -Taxes (Income Tax i.e. Personal Taxes)
- Hence, DPI results into Savings and Expenditure i.e. (Spend and Save). This concept is very useful for studying and understanding the consumption and saving behavior of the individuals.
- Disposable income = Consumption + Savings

GDP Deflator

- The GDP deflator is a measure of inflation and is also called implicit price deflator. It helps to record and measure all the price level changes of an economy in the output of goods and services of one year. Gross domestic product deflator shows the amount of change in GDP due to inflation and not increase in output.

Calculating GDP Deflator

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

$$\text{Nominal GDP} = \frac{\text{(Deflator) x (Real GDP)}}{100}$$

Purchasing Power Parity

- Purchasing Power Parity (PPP) is an economic theory that compares different countries' through a "basket of goods" approach. According to this concept, two currencies are in equilibrium or at par when a basket of goods is priced the same in both countries.
- Some accounts of GDP are adjusted for PPP. This adjustment attempts to convert nominal GDP into a number more easily comparable between countries with different currencies.
- One way to think of what GDP with PPP represents is to imagine the total collective purchasing power of Japan if it were used to make the same purchases in U.S. markets. This only works after all yen are exchanged for dollars. Otherwise, the comparison does not make sense.
- For example, suppose it costs $10 to buy a shirt in the U.S., and it costs Rs. 8.00 to buy the same shirt in Germany. To make an apples-to-apples comparison, the Rs. 8.00 in Germany needs to be converted into U.S. dollars. If the exchange rate was such that the shirt in Germany costs $15.00, the PPP would be 15/10, or 1.5. For every $1.00 spent on the shirt in the U.S., it takes $1.50 to obtain the same shirt in Germany.
- India has retained its position as the third-largest economy in the world in terms of purchasing power parity (PPP), even as it is way behind the US and China. India accounts for 6.7 per cent, or $8,051 billion, out of the world's total of $119,547 billion of global Gross Domestic Product (GDP) in terms of PPP, a measure of relative consumer prices across countries, as against 16.4 per cent in case of China and 16.3 per cent for the United States, World Bank data for reference year 2017 show.

Green GDP

- Green GDP is a term used generally for expressing GDP after adjusting for environmental damage. When information on economy's use of the natural environment is integrated into the system of national accounts, it becomes green national accounts or environmental accounting.
- The process of environmental accounting involves three steps viz. Physical accounting; Monetary valuation; and integration with national Income/wealth Accounts. Physical accounting determines the state of the resources, types, and extent (qualitative and quantitative) in spatial and temporal terms.

Gross Value Added (GVA)

- GVA is defined as the value of output minus the value of intermediate consumption and is a measure of the contribution to growth made by an individual producer, industry or sector.
- It provides the rupee value for the number of goods and services produced in an economy after deducting the cost of inputs and raw materials that have gone into the production of those goods and services.
- It can be described as the main entry on the income side of the nation's accounting balance sheet, and from an economics perspective represents the supply side.
- At the macro level, from a national accounting perspective, GVA is the sum of a country's GDP and net of subsidies and taxes in the economy.
- Gross Value Added = GDP + subsidies on products - taxes on products
- Difference between GVA and GDP
- The difference between GVA and GDP is that GVA is the value added to the product to enhance the various aspects of the product whereas GDP is the total amount of products produced in the country.
- GDP is the sum of private consumption, gross investment in the economy, government investment, government spending and net foreign trade (the difference between exports and imports).
- GDP = private consumption + gross investment + government investment + government spending + (exports-imports)

Some Basic Concepts related to National income:

Economic Territory

Economic territory is derived from physical territory but on economic basis. It crosses marginally the political frontiers of a country. In nutshell, the concept of economic territory is carved out of geographical territory by adding some portions of the rest of the world and by subtracting some portions of geographical territory.

Resident

The term resident is different from the term citizen. Citizenship of a country is linked with birth or some other non-economic criterion. The term 'resident' on the other hand is linked strictly with economic criterion.

Factor Income

Factor income is the income received by a factor owner from rendering services to the production unit. Labour receives compensation of employees, i.e. wages, salaries, etc. Land owner receives rent. Capital owner, i.e. the one who provides finance, receives interest. The entrepreneurship, who is the owner of production unit, receives profit. The sum total of factor payments made by resident production units of an economy territory is termed domestic income or technically, net domestic product at factor cost.

Intermediate Consumption

Intermediate consumption is the value of goods and services that are entirely used up in the course of production during the accounting period.

Final Product

The concept of final product is opposite of the concept of intermediate product. Intermediate products are identified on the basis of 'resale' criterion. Final products are identified on the basis of 'not for resale' criterion. Goods and services acquired not for resale but for own use, are final products.

Closed Economy

An economy which does not have economic relations with the rest of the world.

Open Economy

An economy which has economic relations with rest of the world.

- **Consumption Expenditure**

  Expenditure on goods and services for satisfaction of wants.

- **Per-Capita Income:**

  National income divided by population

National income and welfare

GDP per capita (per person) is often used as a measure of a person's welfare. Countries with higher GDP may be more likely to also score high on other measures of welfare, such as life expectancy. However, there are serious limitations to the usefulness of GDP as a measure of welfare:

- Measures of GDP typically exclude unpaid economic activity, most importantly domestic work such as childcare. This leads to distortions; for example, a paid nanny's income contributes to GDP, but an unpaid parent's time spent caring for children will not, even though they are both carrying out the same economic activity.
- GDP takes no account of the inputs used to produce the output. For example, if everyone worked for twice the number of hours, then GDP might roughly double, but this does not necessarily mean that workers are better off as they would have less leisure time. Similarly, the impact of economic activity on the environment is not measured in calculating GDP.
- Comparison of GDP from one country to another may be distorted by movements in exchange rates. Measuring national income at purchasing power parity may overcome this problem at the risk of overvaluing basic goods and services, for example subsistence farming.
- GDP does not measure factors that affect quality of life, such as the quality of the environment (as distinct from the input value) and security from crime. This leads to distortions - for example, spending on cleaning up an oil spill is included in GDP, but the negative impact of the spill on well-being (e.g. loss of clean beaches) is not measured.
- GDP is the mean (average) wealth rather than median (middle-point) wealth. Countries with a skewed income distribution may have a relatively high per-capita GDP while the majority of its citizens have a relatively low level of income, due to concentration of wealth in the hands of a small fraction of the population.

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