National Income Accounting

FOR RBI SEBI & NABARD EXAMS

National Income Accounting

National Income (NI) – Definition

i. It is the **net value of all the final goods and services** produced by the nationals during a financial year. In India, financial year starts from **1st April and ends on 31st March** every year.
ii. In other words, the total income of a country from the economic activities in a year's time is known as national income.
iii. It includes payments made to all resources in the form of wages, interest, rent and profits.
iv. National income can also be defined as the net output of products and services flowing during the year from the country's productive system in the hands of the ultimate consumers.
v. The growth of National Income aids in knowing the progress of the country.

National Income Accounting (NIA)

National Income Accounting is a **method used to measure the economic activity** in the country as a whole.

National Income Accounting (NIA) is mainly done to achieve the following objectives:

i. **Policy Formulation:** NIA helps in comparing the estimates of the NI in the past with the future and also forecast the growth rates in future. For example, if a country has a GDP of Rs. 105 Lakh Crore which is 5 Lakh Crore Rupees higher than the last year, this means that the economy has a growth rate of 5%.

ii. **Assessing the current standard of living:** NIA helps in knowing the current living standard of the population or the distribution of income within a population.

iii. **Effective Decision Making:** NIA helps in estimating the contribution of each of the sectors (Primary, Secondary and Tertiary Sectors) of the economy. It helps the businesses to plan for the production activity.

iv. **International Economic Comparison:** It helps in comparing the level of development of countries and 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 and its growth rate.

As per the National Income Committee a National Income estimate measures the volume of commodities and services turned out during a given period counted without duplication.

Calculation of National Income:

NI = C+G+I+(X-M) + (R-P) – Depreciation – Indirect Tax + Subsidies.

Where,

C = Total Consumption Expenditure

I = Total Investment Expenditure

G = Total Government Expenditure

X = Export

M = Import

(R-P) = Net Factor Income from abroad

National Income at Constant Price:

When NI is measured at the base year price, it is NI at constant year price.

National Income at Current Price:

When NI is measured at the current year price, it is NI at current year price.

Factor Cost

It is the cost of factors of production i.e. rent for land interest for capital, wages for labour and profit for entrepreneurship. This is equal to revenue price of the final goods and services sold by the producers.

Market Price

It refers to the actual transacted price which 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.

When the NI is calculated at the factor cost (FC) it is called National Income (NI).

NI = NNP(FC) = NNP(MP) – Indirect Taxes + Subsidies + Government Surplus

NI = NNP + Subsidies – Indirect Taxes

NI = GNP – Depreciation – Indirect Taxes + Subsidies

The CSO released the 'New Series' of national accounts with base year 2011-12 instead of the base year 20014-05. This revision happens every five years.

GDP Definition

GDP is the value of all final goods and services produced within a certain geographic region in a given period of time.

Real vs. Nominal GDP - A price index of GDP

The price level of all newly and domestically produced final goods and services in an economy is measured by an implicit price deflator for GDP, the GDP deflator:

$$GDP\ deflator = \frac{Nominal\ GDP}{Real\ GDP} * 100$$

$$\Leftrightarrow \quad Real\ GDP = \frac{Nominal\ GDP}{GDP\ Deflator} * 100$$

There are three different ways to measure GDP:

Product Method, Income Method and Expenditure Method.

These three methods of calculating GDP yield the same result because

National Product = National Income = National Expenditure.

1. The Product Method:

In this method, the value of all goods and services produced in different industries during the year is added up. This is also known as the value-added method to GDP or GDP at factor cost by industry of origin. The following items are included in India in this: agriculture and allied services; mining; manufacturing, construction, electricity, gas and water supply; transport, communication and trade; banking and insurance, real estates and ownership of dwellings and business services; and public administration and defence and other services (or government services). In other words, it is the sum of gross value added.

2. The Income Method:

The people of a country who produce GDP during a year receive incomes from their work. Thus, GDP by income method is the sum of all factor incomes: Wages and Salaries (compensation of employees) + Rent + Interest + Profit.

3. Expenditure Method:

This method focuses on goods and services produced within the country for one year.

GDP by expenditure method includes:

(i) Consumer expenditure on services and durable and non-durable goods (C),

(ii) Investment in fixed capital such as residential and non-residential building, machinery, and inventories (I),

(iii) Government expenditure on final goods and services (G),

(iv) Export of goods and services produced by the people of country (X),

(v) Imports (M).

That part of consumption, investment and government expenditure which is spent on imports is subtracted from GDP.

Similarly, any imported component, such as raw materials, which is used in the manufacture of export goods, is also excluded.

Thus,

GDP by expenditure method at market prices = C+ I + G + (X – M),

where (X-M) is net export which can be positive or negative.

Concept of National Income

There are various concepts of National Income. These are the various metrics used to measure National Income in an Economy. These are explained below one by one:

1. Gross National Product (GNP).
2. Net National Product (NNP)/National Income.
3. Gross Domestic Product (GDP).
4. National Income at Factor Cost.
5. Personal Income.
6. Disposable Personal Income.

Let us start understanding them in detail one by one:

1. Gross National Product (GNP)

Definition and Explanation of GNP:
The concept of Gross National Product (GNP) is comprehensive. It enables us to measure and analyse as to how much is the aggregate economic production of a country in a given period. The gross national product of a country (GNP) is defined as:

"The total money value of all final goods and services produced by the residents of a country in one-year period".

Gross National Product may be defined as the current market value of all final goods and services produced by the economy during an income period **regardless of where the output is produced**.

Remember the following aspects of GNP:

GNP is a flow concept: GNP represents a flow. It is a quantity produced per unit of time. It is the value of final goods and services produced in a country during a given time period.

GNP measures final output: While calculating GNP, the market value of only final goods and services produced in a year are added up. Final goods are those goods which are purchased for final use in the market.

GNP is the output produced by the citizens of a country: Gross national product is the final output of goods and services produced by the citizens and businesses of a country during a given time period which is usually a year. For example, the economic activity carried out by the American citizens and businesses outside the country is counted in GNP. While the income of the residents who are not USA citizens is subtracted from GNP.

Components of Expenditures in GNP:

For **measuring GNP at market price**, the economists use the **Expenditure Approach**.

According to this approach, there are **four categories of expenditures** which are added together to measure Gross National Product (GNP) at Market Price,
(i) Consumption,
(ii) Investment
(iii) Government Expenditure and
(iv) Net exports.

These four types of expenditures are explained in brief:

(i) Consumption Expenditure (C): It includes all personal expenditure incurred by the citizens of a country on durable and non-durable goods in a period of one year.

(ii) Investment (I): It is the total expenditure incurred by firms or households on capital goods.

(iii) Govt. expenditures (G): It includes all types of expenditure incurred by Federal, Provincial, Local Councils on the purchases of goods and services such as national defence, law and order, street lighting etc.

(iv) Net Exports (X – M): Net exports of goods and services are the value of exports minus the value of imports.

Formula for Gross Profit:

GNP = C + I + G + (X – M)

Where:
C = Consumption, I = Investment, G = Government Expenditure and X – M = Net exports

2. Gross Domestic Product (GDP)

"Gross domestic product (GDP) is defined as the total market value at current prices of all final goods and services produced within a year by the factors of production located within a country".

The labour and the capital of a country working on its natural resources produce a certain aggregate of commodities, material, and non-material every year. In addition to this, there may be foreign firms producing goods in the various sectors of the economy like mining, electricity, manufacturing etc.

If we add up the money value of all the final goods produced both by domestic and foreign-owned factors annually in the country and valued at market prices, it will be called gross domestic product (GDP).

Gross Domestic Product is the value of aggregate or total production of goods and services in a country in one year.

If we make a detailed list of all such commodities produced annually or measure the total goods produced during a year by weight or by volume, it will not give us any clear and concise impression about our total national output.

So, what generally done is that the money value of all final goods and service produced during a year at current market prices is added up. This total current market value of all final goods and services produced in an economy in a year period is called gross domestic product (GDP).

While calculating the gross domestic product (GDP), the value of only those goods are added which have reached their final stage of production and are available for consumption. The primary or intermediate goods are not counted in GDP.

Distinction Between GDP and GNP:

Here it is necessary to distinguish between Gross Domestic Product (GDP) and Gross National Product (GNP).

Gross Domestic Product (GDP) is the total market value of all final goods and services produced by factors of production within a nation's border during a period of one year. In other words, GDP is a flow of products produced within the country by domestically located resources in a year.

Gross National Product (GNP) on the other hand, is the measure of all final goods and services produced by the citizens within their own country as well as outside the country during a period of one year. In other words, GNP expresses the money value of the flow of goods and services produced within the country and the net income received from abroad during a period of one year.

Thus, when we move from GDP to GNP, we add factor income receipts from foreigners and subtract factor income payments to foreigners.

GDP = GNP – Net Foreign Income From Abroad

3. Net National Product (NNP)/National Income

Net National Product or National Income at Market Prices is the net market monetary value of all the final goods and services produced in a country during a year.

It is found out by subtracting the amount of depreciation of the existing capital in a year from the market value of all final goods and services.

If we deduct depreciation allowance from gross national product, we get Net National Product at current market price.

NNP at Market Price = GNP at Market Price – Depreciation

This fund which is set aside for covering the wear and tear, deterioration and obsolescence of the machinery is named as Depreciation Allowance.

NNP = GNP – Depreciation

4. National Income at Factor Cost

National Income can be estimated in terms of either output or total income. When national income is measured by adding together all income payments made to the factors of production in a year, it is called national income at factor cost.

National income thus is the sum total of all income payments made to the factors of production.

The main components of national income at factor cost are as follows:

The factor incomes are generally divided into four categories:

(i) Compensation to employees – It is the largest component of national income. It consists of wages and salaries paid by the firms to the workers for their labour services.

(ii) Interest – Interest is the payment for the use of funds in a year. The payment is made by private businesses to households who have lent money to them.
(iii) Rents – Rent is all income earned by individuals for the use of their real assets such as building, farms etc.

(iv) Profits – Profit is the amount, which is left after compensation to employees, rent, interest has been paid out. The sum of compensation to. employees, interest, rent, and profit is supposed to equal national income at factor cost.

5. Personal Income

National income is the sum of factor income. In other words, it is the income which individuals receive for doing productive work in the form of wages, rent, interest and profits.

Personal Income, on the other hand, includes all income which is actually received by all individuals in a year.

It includes income which is not directly earned but is received by individuals.

For example, social security payments, welfare payments are received by households, but these are not elements of national income because they are transfer payments.

In the same way, in national income accounting, individuals have attributed income which they do not actually receive.

For example, undistributed profits, employee's contribution to social security corporate income taxes etc. are elements of national income but are not received by individuals.

Hence, they are to be deducted from national income to estimate the personal income.

PI = NI + Transfer Payments – Corporate retained earnings, income taxes, social security taxes.

6. Disposable Personal Income

Disposable Personal Income is the amount which is actually at the disposal of households/persons to spend as they like.

It is the amount which is left with the households/persons after paying personal taxes such as income tax, property tax, national insurance contributions etc.

Disposable personal income = Personal Income – Personal Taxes

DPI = PI – Personal Taxes

The concept of disposable personal income is very important for studying the consumption and saving behaviour of the individuals. It is the amount which households can spend and save.

Disposable Income = Consumption + Saving

DI = C + S

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