

# STUDY MATERIALS FOR BA (HONS) ECONOMICS

## PART – 1

## PAPER – 2

## TOPIC – NATIONAL INCOME CONCEPT AND MEASUREMENT

### INTRODUCTION

**2- GDP at Factor Cost:** GDP at factor cost is the sum of net value added by all producers within the country. Since the net value added gets distributed as income to the owners of factors of production, GDP is the sum of domestic factor incomes and fixed capital consumption (or depreciation).

Thus  $\text{GDP at Factor Cost} = \text{Net value added} + \text{Depreciation}$

GDP at factor cost includes:

- (i) Compensation of employees i.e., wages, salaries, etc
- (ii) Operating surplus which is the business profit of both incorporated and unincorporated firms. [Operating Surplus = Gross Value Added at Factor Cost—Compensation of Employees—Depreciation]
- (iii) Mixed Income of Self- employed.

Conceptually, GDP at factor cost and GDP at market price must be identical/This is because the factor cost (payments to factors) of producing goods must equal the final value of goods and services at market prices. However, the market value of goods and services is different from the earnings of the factors of production.

In GDP at market price are included indirect taxes and are excluded subsidies by the government. Therefore, in order to arrive at GDP at factor cost, indirect taxes are subtracted and subsidies are added to GDP at market price.

Thus,  $\text{GDP at Factor Cost} = \text{GDP at Market Price} - \text{Indirect Taxes} + \text{Subsidies}$ .

**3- Net Domestic Product (NDP):** NDP is the value of net output of the economy during the year. Some of the country's capital equipment wears out or becomes obsolete each year during the production process. The value of this capital consumption is some percentage of gross investment which is deducted from GDP. Thus Net Domestic Product = GDP at Factor Cost – Depreciation.

**4- Nominal and Real GDP:-** When GDP is measured on the basis of current price, it is called GDP at current prices or nominal GDP. On the other hand, when GDP is calculated on the basis of fixed prices in some year, it is called GDP at constant prices or real GDP.

Nominal GDP is the value of goods and services produced in a year and measured in terms of rupees (money) at current (market) prices. In comparing one year with another, we are faced with the problem that the rupee is not a stable measure of purchasing power. GDP may rise a great deal in a year, not because the economy has been growing rapidly but because of rise in prices (or inflation).

On the contrary, GDP may increase as a result of fall in prices in a year but actually it may be less as compared to the last year. In both 5 cases, GDP does not show the real state of the economy. To rectify the underestimation and overestimation of GDP, we need a measure that adjusts for rising and falling prices.

This can be done by measuring GDP at constant prices which is called real GDP. To find out the real GDP, a base year is chosen when the general price level is normal, i.e., it is neither too high nor too low. The prices are set to 100 (or 1) in the base year.

Now the general price level of the year for which real GDP is to be calculated is related to the base year on the basis of the following formula which is called the deflator index:

$$\text{Real } GDP = \frac{\text{GDP for the Current Year}}{\text{Current Year Index}} \times \frac{\text{Base Year (=100)}}{\text{Current Year Index}}$$