

Definitions and measures of national income

Gross Domestic Product (GDP)

GDP measures the total market value of all goods and services produced within an economy in a given time period. It is widely used as a substitute for the level of economic activity and living standards, but it does not capture everything that affects wellbeing (e.g. environment, inequality).

Three ways to calculate GDP

GDP can be measured using three approaches, which should (in theory) give the same result because one person's spending becomes another person's income.

- **Expenditure approach:** adds up spending in the economy ($C + I + G + (X - M)$).
- **Income approach:** adds up factor incomes (wages, rent, interest, profit).
- **Output approach:** totals the value of goods and services produced.

Economic growth

What economic growth means

Economic growth is an increase in **real GDP**. (e.g. Economics growth rate for 2021 was approximately +8.6% , fastest annual growth rate since World War II)

Real vs nominal GDP

Nominal GDP is measured at **current prices** and is not adjusted for inflation. Real GDP is measured at **constant prices** (i.e. adjusted for inflation), so it is better for judging changes in actual output.

Why is nominal GDP not used ?

Nominal GDP is "at today's prices", so it can go up just because prices went up.

Example :

- Year 1: The economy produces 100 haircuts at £10 each .Nominal GDP = £1000
- Year 2: The economy still produces 100 haircuts (no extra output), but price rises to £12 .Nominal GDP = £1200

Nominal GDP says “GDP grew by 20%”. But in reality nothing extra was produced, it's just inflation. That's why nominal can be misleading (and why real GDP adjusts for the price rise and would show 0% growth here).

GDP per capita

GDP per capita = $\text{GDP} \div \text{population}$. This adjusts for population size, so it is usually better than total GDP for comparing average living standards between countries. For example Luxembourg GDP per capita: \$154,120 vs Burundi GDP per capita: \$618

GDP vs GNI

Gross National Income (GNI)

GNI measures the total income earned by a country's residents within a time period, regardless of where it is generated. This can be more useful than GDP when cross-border income flows are large.

The key difference

$\text{GNI} = \text{GDP} + \text{net income from overseas}$. It adds income residents receive from abroad (e.g. dividends, interest, remittances) and subtracts income non-residents earn domestically (e.g. repatriated profits).

Comparing growth and living standards between countries

Purchasing power parity (PPP)

PPP adjusts GDP (or GNI) to account for differences in the cost of living between countries. If prices are lower in one country, the same income can buy more goods and services, so PPP can change the living-standards comparison.

Limitations of using GDP to measure living standards

GDP does not capture key aspects of wellbeing

A rise in GDP does not automatically mean people are better off, because living standards depend on more than output. For example, GDP does not directly measure health outcomes, education quality, environmental quality, or leisure time.

Inequality and averages

GDP per capita is an average, so it can hide large income gaps. A country can have a high GDP per capita while many people still experience low living standards if income is concentrated among a small group.

For example Equatorial Guinea (has some of the richest individuals in Africa due to large oil reserves) .This leads to decent GDP per capita (as if you simply divide the country's oil billions by its small population, every citizen appears to be comfortably middle-class) but in reality the wealth is concentrated in the hands of a tiny number of elites . As we can see : GDP per capita (PPP): \$20,380 Population below poverty line: 67% (approx. 2/3) Gini Coefficient: 0.50 (High Inequality)

Non-market activity and the informal economy

GDP only counts goods and services traded in markets with observable prices. This means unpaid work (e.g. caring, DIY) and large informal sectors may be undercounted, even though they contribute to welfare.

Environmental costs and externalities

GDP does not subtract negative externalities like pollution, even if production causes health problems or damages quality of life. In exam evaluation, this is a strong way to challenge "GDP = living standards."

For Example China : GDP of **\$20.65 trillion** . Pollution and health damage cost between **3% and 10%** of GDP annually

Quality change over time

If the quality of goods improves (e.g. technology becoming more productive), GDP may not fully reflect that improvement if prices do not capture quality changes well. This can weaken comparisons across time.

Differences in hours worked

GDP per capita does not show how long people work to generate that income. Two countries could have similar GDP per capita, but the one with fewer hours worked may have higher living standards due to more leisure time.

National happiness and wellbeing

What national happiness measures

National happiness is a broader measure of wellbeing that looks beyond production to factors like health, relationships, education, living conditions, work satisfaction, and the environment. In the UK, wellbeing is measured by the Office for National Statistics (ONS).

Income and happiness

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Higher real incomes can increase wellbeing because households can afford more necessities and build savings, improving resilience to shocks. However, the link may weaken beyond a certain point because of diminishing marginal utility (extra income adds less extra satisfaction as income rises).