QUESTION #64516: EXPLAIN THE VARIABLES INCLUDED IN NATIONAL INCOME

ANSWER: First of all let’s give the definition of the national income!

Definition: National income is the money value of all the final goods and services produced in economy during an accounting period of time, generally one year.

It is improtant to understand how we should **measure the national income**!

Bureau of Economic Analysis is responsible for construction and maintenance of national income and product accounts (NIPA).

Measurement began in the 1930s due to frustration of Roosevelt and Hoover trying to design policies to combat the Great Depression. Simon Kuznets (Nobel laureate) was commissioned to develop initial methodology and estimates. In 1947, the process became much more consistent.

Methodologies have frequently been changed (improved?) as a result of advances in economics, accounting, and data collection. Past data are then revised to reflect new definitions.

There are two main measures of national income: Gross domestic product (GDP) and Gross national product (GNP)

GDP is an attempt to measure production in the country and GNP is an attempt to measure income accruing to a country’s residents.

Finally there are three ways to construct GDP data:

- **The expenditure method.**
- **Income method.**
- **Value added method.**

The detailed analyze of these three methods will give us key to the answer to above mentioned general question.

1. **The expenditure method.**

GDP= consumption (C) + investment (I) + govt. purchases (G) + net exports (NX)

Explanation of the variables of the national income for the first case will be the following:

- **consumption (C)**

Spending by households on:

1. New durable goods.
2. Non-durable goods.
3. Services.

- **investment (I)**

Spending by firms on plant, equipment so called fixed investments and building up inventories. It is important to sign that fixed investment divided into

1. Residential: which consists of all new housing bought by firms, households or the government.
2. Non-residential

Be aware that we do not include firm spending on materials (including intermediate processed goods sold to it by other firms) or labor. Doing so, would involve double counting, as these expenditures will also show up in consumer spending on goods that embody these intermediate inputs.

- **govt. purchases (G)**

Government spending on goods and services.

We should mention that Government spending is not equal to total spending, because it does not include transfer payments (welfare).

- **net exports (NX)**

Export of goods and services minus imports.

2. **The income method**

The method attempts to add up the net income of all employees and business, before taxes. The income method represent the sum of the fallowing indicators:

- Wages and salaries (WS)
- Owner’s income (OI)
- Rental income(RI)
- Corporate profits (CP)
- Net interest earned (NIE)

WS is called labor’s share and OI, RI, CP and NIE are known as Profit’s share.

Profit’s shares are quite stabile over time!

3. **Value added method**

The value added by a firm is the difference between the revenue a firm earns by selling its products and the amount it pays for the products of other firms it uses as intermediate goods.

For the best illustration of the value added method I would like to represent this simple Example: A firms buys $1,000 of wheat, mills and bakes it using $1,000 of labor. The firm sells the bread for $2,500, making $500 profit. The value added is $1,500.