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Economics Revision Focus: 2004

A2 Economics

Standard of Living and Economic Progress

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Revision Focus on the Standard of Living and Economic Progress

A2 Syllabus Requirements:

The Use and Limitations of National Income as an Indicator of Changes in Living Standards

Candidates should be able to interpret different types of economic data and use it to compare the **living standards of the residents of different countries**. They should be able to discuss the **limitations of using such data** to arrive at conclusions

Our material well-being

- The **standard of living** is simply a measure of the economic or **material welfare** of the inhabitants of a country, a region or a local area.
- The baseline measure is **real national output per head of population**.
- Real income per capita is an **inaccurate** and **insufficient** indicator of living standards

Per Capita National Incomes

National income data can be used to make **cross-country comparisons**. This requires

1. Converting GDP data into a **common currency** (normally the dollar or the Euro)
2. Making an adjustment to reflect differences in the average cost of goods and services in each country to produce data expressed at a '**purchasing power parity**' standard

Per capita national incomes for the 25 European Union countries are shown in the table below

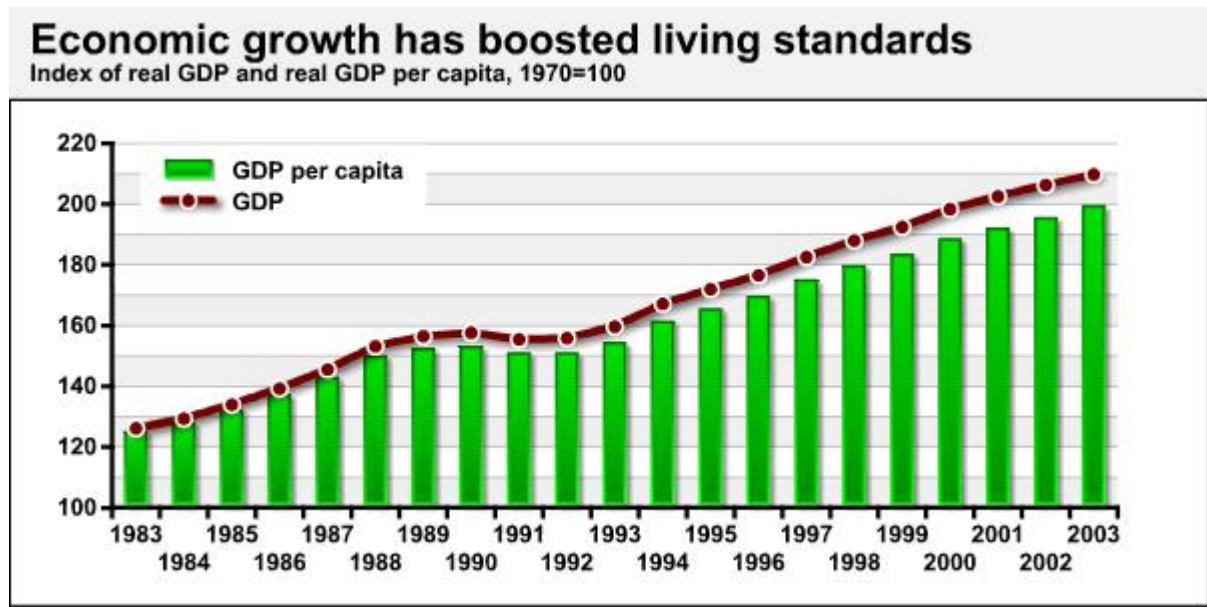
Per Capita GDP	1994	1999	2004
EU(15) = 100			
Luxembourg	164.8	189.2	186.5
Ireland	84.1	111.2	118.2
Denmark	112.6	115.8	110.5
United Kingdom	99.4	103	109.8
Austria	115.2	113.7	108.5
Netherlands	108.2	109.7	106.1
Belgium	108.5	105.3	104.3
Sweden	105.4	107.7	102.2
France	104.9	103.9	101.8
Finland	94.6	101.5	99.2
Germany	108.5	103.1	96.8
Italy	103.5	101.9	95.7
Spain	78.6	83.5	86.3
Cyprus	77	74.5	76.1
Greece	66.5	65.3	73.7
Slovenia	62.5	67.2	70.3
Malta		70.5	66.8
Portugal	64.9	70.2	66.5
Czech Republic			63.1
Hungary	46.3	47.8	55

Slovakia	45.4	42.9	47.6
Lithuania	27.8	34.9	45.3
Estonia	30.8	35.2	44.7
Poland		41.8	42.6
Latvia	26.6	30.1	37.7

Problems of accuracy:

Officially data on a nation's GDP tends to understate the true growth of real national income per capita over time e.g. due to the **expansion of the shadow economy** and the **value of unpaid work** done by millions of volunteers and people caring for their family members. There may also be **errors in calculating the cost of living**

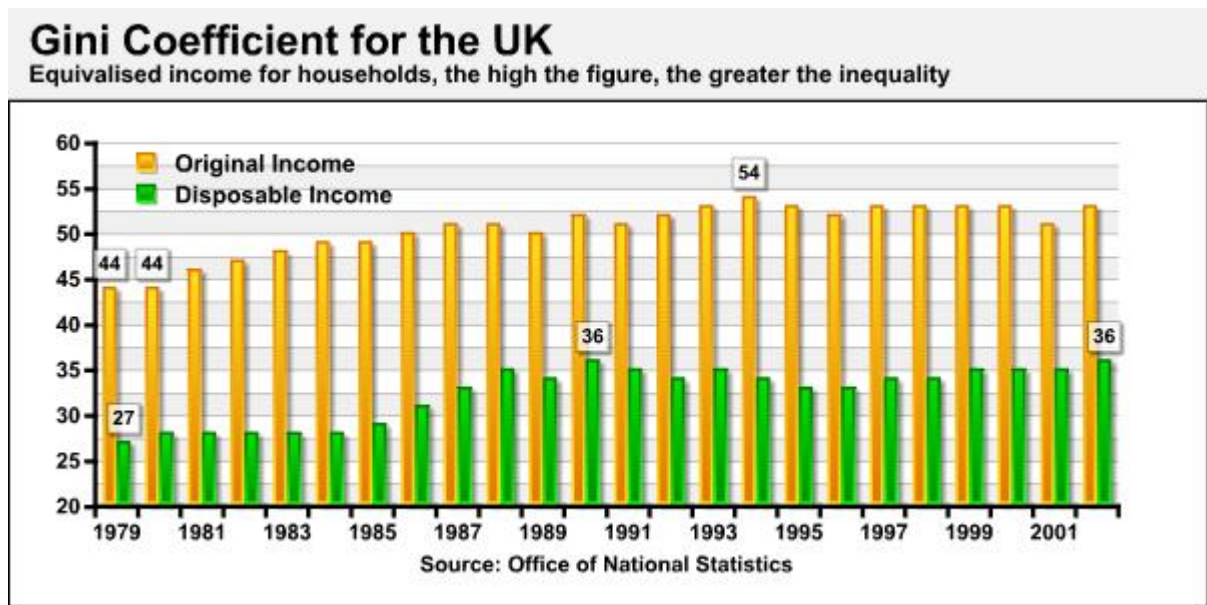
The scale of the informal "shadow economy" varies widely across countries at different stages of development. According to the IMF, in developing countries it may be as high as 40% of GDP; in transition countries of central and Eastern Europe it may be up to 30% of GDP and in the leading industrialised countries of the OECD, the shadow economy may be in the region of 15% of GDP



Limitations of GDP data – problems of interpretation

Here are eight reasons why GDP data may give a distorted picture of living standards in a country:

1. **Regional Variations in income and spending:** National GDP data can hide regional variations in output, employment and income per head of the population
2. **Inequalities of income and wealth:** Wages and earnings may be unequally distributed among the population and rising prosperity can co-exist with rising relative poverty. The **Lorenz Curve** and the **Gini-coefficient** are two measures of inequality and relative poverty– an outward shift in the Lorenz Curve would indicate a widening of income and wealth inequality. The chart below tracks the Gini coefficient for the UK since 1979.



3. **Leisure and working hours:** An increase in real GDP might have been achieved at the expense of leisure time if workers are working longer hours. Several reports have highlighted the fact that British workers have the longest working week in Europe, with full-time workers putting in an

average of 44 hours – which can cause stress and damage family life – two social indicators that create negative externalities for society

4. **Imbalance between consumption and investment:** If an economy devotes too many resources to satisfying the short run needs & wants of consumers, there may be insufficient resources for capital investment and over-consumption can lead to an over-exploitation of scarce finite resources thereby limiting future growth prospects
5. **Changes in life expectancy:** Improvements in life expectancy have a huge impact on people's living standards but don't always show through in the GDP accounts. Reductions in infant mortality have been accompanied by the prevention or cure of diseases that might have led to the premature death of even the richest of our ancestors at any time. Putting a monetary value on the benefits of increased longevity is difficult, but surely it must be factored into any overall assessment of living standards and the quality of life
6. **Innovation and the development of new products:** One of the problems in comparing and contrasting living standards and the quality of life across different generations is that new goods and services become available because of competition, investment, invention and innovation that simply would not have been available to the richest person on earth less than fifty years ago. About half of what we spend our money on now was not invented in 1870. Examples include air travel, cars, computers, antibiotics, hip replacements, insulin and many other life-enhancing and life-saving drugs
7. **Environmental considerations:** Rising output might have been accompanied by an increase in air and noise pollution and other externality effects that have a negative effect on our social welfare. Faster economic growth may cause long term damage to our eco-systems, threatening the long-term sustainability of the economy.
8. **Defensive expenditures:** Much spending in an economy is on defensive expenditure – not spending on tanks and armaments! But spending to defend yourself against an “economic or social bad” e.g. crime, or spending to recover the damage from externalities (e.g. cleaning up the effects of pollution, managing the huge and growing volume of waste; driving long distances to and from work. This spending adds directly to our GDP but does it really add to our material welfare? Some economists believe that adjustments should be made to officially published data for GDP to take into account items of this defensive spending.

Alternative measures of economic and social welfare

The Human Poverty Index (HPI): The Human Poverty Index (HPI) published annually by the United Nations focuses on four basic dimensions of human life -- longevity, knowledge, economic provisioning and social inclusion. The latest published data shows the UK ranked only 16th out of 18 leading industrialised countries with the United States and Ireland below us.

Measure of Domestic Progress

The MDP is published by economists at the New Economics Foundation and is supposed to reflect progress in Britons' quality of life and progress towards a sustainable economy by factoring in the **social and environmental costs of economic growth**, and **benefits of unpaid work** such as household labour, that are currently excluded from official GDP. According to its supporters, the MDP bears a closer resemblance to measures of life satisfaction than GDP. According to their data, over the last thirty years UK GDP increased 80 per cent, but MDP fell sharply in the 1980s and has never regained its 1976 peak. Social costs have increased 600 per cent, with a 13-fold increase in the costs of crime and a four-fold increase in the costs of family breakdown

The Gross National Happiness Index

Bhutan, the Himalayan kingdom the size of Switzerland with no McDonalds, no ATM machines, no traffic lights, and until five years ago no TV, is for many people a species of Shangri-La. Bhutan is ranked 130th in the UN Development Program's ratings, close to Haiti and Bangladesh. Most visitors rate it almost infinitely higher, however, and the measure they use is one let fall by the country's king in 1987 "Gross National Happiness." This is no joking contrast with Gross National Product, but a serious measure of how any place might be assessed - not by per capita income, the number of concrete roads, dams and parking lots, but by the simple quality of life. This most observers believe Bhutan's is enviably high.