Section A  What is the Gross Domestic Product?

This section will introduce the Gross Domestic Product and explain its measurement through the expenditure and income approaches.

How to Compute the Gross Domestic Product

Like Alison, we would all like to have more things. However, there is a limit to what we are able to buy. Our nation's income is determined by the amount we produce. In the early 1990s the most frequently used measure of the value of production became the Gross Domestic Product. The GDP is defined as the retail market value of everything produced in the country in a year, regardless of who owns the firm that made the products.

Before 1991 the standard measure of production had been the Gross National Product (GNP). Slightly different than the Gross Domestic Product, the GNP includes interest and the dividends or profits of foreign firms received by residents of this country. The GDP excludes these payments. This may sound complicated, but it isn’t really. Imagine you owned 100 shares of stock in a French corporation that paid you $500 last year in dividends. The value of this income would be included in the GNP, but not in the GDP because it was not the result of production and earnings that took place in the United States. Most economists believe that GDP is a better measure of production than GNP.

The government spends millions of dollars every year measuring the Gross Domestic Product. There are two basic methods that are used to calculate GDP. They are the expenditure approach and the income approach.

The Expenditure Approach

It is possible to compute the value of GDP by adding together all the spending for new goods and services produced in a year. This is called the expenditure approach. It is based on the fact that someone must pay for all new production. Therefore, it is possible to measure production by measuring spending. When Alison bought her new top, her spending became part of the measurement of GDP through the expenditure approach.

In the expenditure approach, spending is organized into four categories: (1) consumer or consumption spending, (2) government spending, (3) business spending, and (4) net spending by foreign purchasers. The spending in all four categories is totaled to obtain the GDP. Figure 8-1 shows how GDP was distributed in these four categories in 1990.

The 18.9 percent on this graph that shows government spending does not include all money the government controlled. Government transfer payments made to individuals for programs such as Social Security and welfare are included in "Consumption Spending."

The Income Approach

We can also calculate the GDP by counting all of the income earned in producing the GDP. As you might guess, this is called the income approach. The idea behind this method is that if income depends on the value of production, then it is possible to measure the value of production by measuring income. When Alison’s father earned the money he gave her, this income became part of the measurement of GDP through the income approach.

The income approach is a relatively easy method of measuring GDP because most income is reported to the Internal Revenue Service. These values include wages, profits, rent, interest, some taxes, and the cost of wearing out capital (machinery). A problem with this method is the underground economy, which will be discussed later in this section.

Problems in Computing GDP

There are a number of problems that must be overcome to measure GDP. In several areas care must be taken to avoid including production that does not actually exist. Double counting is one danger. If a firm buys a wheel for $10, polishes it, and sells it for $12, it only added $2 worth of value. The government must be careful not to count the firm's contribution to GDP as $12. To do so would be double counting. Some other firm produced the wheel's first $10 of value. This value would already have been counted as part of GDP.

Spending for products produced in some other year is not part of GDP. If you bought a used car for $4,000, that spending would not be a part of GDP. The car was not part of this year's production. The same can be said for buying corporate stock that used to belong to someone else. One person's money is traded for the other person's stock. Although the value of the service provided by the broker is new production and part of GDP, the value of the stock itself is not.

Some areas of production are not included in the GDP. Only work that is paid is counted. When you paint your own house, no value is added to GDP. If you paint your neighbor's house for
Why Measure GDP?

Measuring GDP is important because it provides an overview of the size and health of an economy. However, GDP does not account for all economic activity, such as the value of unpaid work, environmental damage, and changes in the quality of life. GDP is calculated based on the value of goods and services produced within a country's borders, and it does not measure economic inequality, environmental sustainability, or social well-being. Despite its limitations, GDP remains a widely used indicator of economic performance.
The Causes of Inflation

Why do we have inflation in the first place? This is an extremely complex question, and not all economists agree on what causes inflation, or how much weight (blame) to assign to each cause. Still, it may be helpful to examine some of the more basic explanations for inflation.

Demand-Pull Inflation

Let us look first at demand-pull inflation, or buyer’s inflation. This kind of inflation occurs when aggregate demand outraces aggregate supply. This causes an “inflationary” gap and the only way to fill the gap is to raise prices. Think back to the days of the California gold rush of 1849. The people who made money were generally not the miners, but the few people who supplied them with equipment, clothing, and food. In those wild days, the miners had plenty of gold. What they needed were all sorts of everyday items like shovels and work pants and flour. The demand for these items was so great that prices rose spectacularly in the areas where mines were located. In other words, demand pulled the prices up.

The same thing happened during the Vietnam War. The government tried to fight a very expensive war without cutting back on private consumer demand. Economists love to describe this situation as a desire to have both “guns and butter.” The economy during the war was at full employment and producing about as much as it could, but the combined demand for “guns” for the war and “butter” for the private economy was too much. There were just too many dollars chasing too few goods. (That is another favorite phrase of economists.) The Vietnam War, like most other wars, created inflation based on excess demand.
Cost-Push Inflation

Cost-push inflation, or seller’s inflation, comes from the supply side. This happens when companies have to pay more for one or more factors of production. Suppose autoworkers get a 10% wage increase. Guess what will happen to the price of a new car? The increased labor costs will be passed on to the new car buyer in the form of higher prices. Notice that it is not an increase in the demand for new cars that causes prices to go up. The demand for new cars usually grows slowly in a rather predictable manner. What changes is the cost of making a new car.

Now imagine that not only autoworkers get a 10% wage increase, but that wage rates in general go up by 10%. Then the price of almost everything will increase as producers try to pass their increased costs on to the consumer. This is the way cost-push inflation works.

Not all wage increases mean that cost-push inflation will be the result. Suppose that all American workers get a 10% raise, but, at the same time, the workers become 10% more productive. Then, despite the wage increase, there would not be any cost-push inflation at all. For example, imagine that the workers were previously producing 1,000,000 units of output a day. Now, they are producing 1,100,000 units of output a day. This 10% increase in productivity means that the labor costs for each unit have not gone up. (Of course, the wage increase itself plus the impact of the multiplier might mean a switch to demand-pull inflation.) If, on the other hand, the workers receive a raise but production stays at 1,000,000 units a day, there will be an increase in cost. The labor cost for each unit will have gone up. The supplier will likely raise the price of the product.

Naturally, labor leaders do not like all this talk about cost-push inflation. It seems to blame American workers for inflation. Labor leaders respond that workers need the raises to keep up with the cost of living, but each round of increased wages often means another round of increased prices. Economists call this the price-wage spiral. Prices go up, then wages go up, then prices go up again. The price-wage spiral is one reason why we have had some degree of inflation every year between 1955 and 1988.
Nearly one-half of the population of the United States belongs to the civilian labor force, and at any given time, millions of these people are without jobs. Being without a job is a problem that has affected almost everyone, and it affects some people more than others. The issue is so important that full employment is one of the seven economic and social goals of the American economy.

**Measuring Unemployment**

To understand the severity of joblessness, we need to know how it is measured, as well as what the measure overlooks. The measure of joblessness is the unemployment rate, one of the most closely watched statistics in the economy.

**The Unemployment Rate**

During the middle of any given month, thousands of specialists from the Bureau of the Census begin their monthly survey of 55,800 households in nearly 1,100 counties in all 50 states. Census workers are asking for the unemployed—people available for work who made a specific effort to find a job during the past month and who, during the most recent survey week, worked less than 1 hour for pay or profit. People are also classified as unemployed if they worked in a family business without pay for less than 15 hours a week.

After the Census workers collect their data, they turn it over to the Bureau of Labor Statistics for analysis and publication. At any given time, millions of Americans are unemployed.

Unemployment also is expressed in terms of the unemployment rate, the number of unemployed individuals divided by the total number of persons in the civilian labor force. As Figure 16.1 shows, the unemployment rate tends to rise dramatically during recessions and then come down slowly afterward. The unemployment rate is very sensitive to downturns in real GDP and is one of the lingering economic costs of a recession.

**Kinds of Unemployment**

Economists have identified several different kinds of unemployment. The nature and cause of each affect how much unemployment can be reduced in the economy.

**Frictional Unemployment**

One kind of unemployment is frictional unemployment—unemployment caused by workers who are “between jobs” for one reason or another. If these workers do not work for one week between jobs, they can be classified as unemployed.

The economy always has some workers who have left one job to look for or to take another. As long as workers change jobs, some frictional unemployment will be present.

**Structural Unemployment**

A second—and more serious—kind of unemployment is structural unemployment. Structural unemployment occurs when a fundamental change in the operations of the economy reduces the demand for workers and their skills.

Consumer tastes sometimes change, and certain goods and services no longer are in demand. In the early 1900s, people reduced their demand for horses, buggies, and buggy whips in favor of domestic automobiles. Later, tastes changed in favor of foreign-made automobiles, causing considerable unemployment in Michigan, Ohio, and the industrial Northeast.

Industries may change the way they operate. During the 1990-1991 recession, a series of mergers and cost reductions trimmed the white-collar labor forces in the banking and computer industries. This change was sudden and left millions of highly skilled people out of work. Many of these workers had to develop new skills before they could find employment in other industries.

Sometimes the government contributes to structural unemployment when it changes the way it does business. Congress’s decision to close military bases in the 1990s is a prime example. Military bases are much larger than private companies, and the impact of the base closings is concentrated in select regions and communities. Some areas may be able to attract new industry that would employ many of the unemployed workers, but most workers will have to develop new skills or move to other regions.

**Cyclical Unemployment**

A third kind of unemployment is cyclical unemployment—unemployment directly related to swings in the business cycle. During a recession, for example, many people put off buying certain durable goods such as automobiles, refrigerators, washers, dryers, and new homes. As a result, some industries lay off
Cyclical unemployment may be mixed with other kinds of unemployment. In 1991 the economy underwent structural unemployment among the white-collar workforce, along with cyclical unemployment because of the recession.

Even though cyclical unemployment is serious, affected workers generally get their jobs back when the economy improves. Accordingly, many try to wait out the recession by living on savings or by taking temporary jobs.

Seasonal Unemployment

A fourth kind of unemployment is seasonal unemployment—unemployment resulting from changes in the weather or changes in the demand for certain products. Many carpenters and builders, for example, have less work during the winter than during the spring and summer because some tasks, such as replacing a roof or digging a foundation, are harder to do when the weather is cold. Other workers, such as cashiers and clerks in retail stores, are especially in demand during holidays when stores register about 25 percent of their annual sales.

The difference between seasonal and cyclical unemployment relates to the period of measurement. Cyclical unemployment takes place over the course of the business cycle, which may last 3 to 5 years. Seasonal unemployment takes place every year, regardless of the general health of the economy.

The Concept of Full Employment

Economists and others have long wrestled with the concept of full employment. Full employment does not mean zero unemployment. Instead, full employment is the lowest possible unemployment rate with the economy growing and all factors of production being used as efficiently as possible.

Economists have also debated whether or not there is an acceptable level of unemployment. During the 1960s, it was thought that full employment meant an unemployment rate of about 4 percent or below. Most believed that efforts to reduce unemployment below this figure would not be successful.

Although President Lyndon Johnson implemented many programs to try to lower the rate, it remained in the 5 to 6 percent range for most of the early 1960s. The rate finally did drop below 4 percent during the Vietnam War when wartime spending stimulated the economy and the draft thinned the ranks of the unemployed.

The unemployment rate returned to the 5 to 6 percent range in the early 1970s. A recession in 1973 drove the rate as high as 9 percent, but for the rest of the decade it remained in the 6 to 7 percent range. By 1980 the unemployment rate rose again and hit a peak of 10.8 percent in November of that same year. It dropped in 1981, and by 1989 reached a monthly low of 5.1 percent. After that, the unemployment rate began to rise again.

As a result of this experience, most economists have given up the idea of a 4 percent unemployment rate as a measure of full employment. Today, most argue that full employment is reached when the unemployment rate drops below 5 percent.