LESSON - 21
Economic Welfare and National Income

Learning outcomes

After studying this unit, you should be able to:

- Define welfare
- Know different types of welfare
- Distinguish between economic welfare and non-economic welfare
- Relate national income and economic welfare
- Know per capita as an indicator of economic welfare

INTRODUCTION:
Now we are doing a very interesting lesson which is related to the welfare of the economy. This lesson will give an idea about the economic welfare and its relationship with national income. Apart from this you will also be able to distinguish between economic welfare and non-economic welfare.

We all know that National income is treated as an index of the economic performance of a country. A country with higher levels of national income and per capita income will be more advanced and developed than the country which has a low level of national income and per capita income. An increase in the national income of the country implies that there is increasing availability of goods and services in the country. More goods and services mean higher levels of consumption and standard of living. Therefore it is believed that economic welfare depends on national income.

What is Economic Welfare?

Before knowing the relation between economic welfare and national income, it is essential to define economic welfare. Welfare is a state of the mind which reflects human happiness and satisfaction. In actuality, welfare is a happy state of human mind. Pigou regards individual welfare as the sum total of all satisfactions experienced by an individual; and social welfare as the sum total of individual welfare. He divides welfare into economic welfare and non-economic welfare. Economic welfare is that part of social welfare which can directly or indirectly be measured in money. Pigou attaches great importance to, economic welfare because welfare is a very wide term. In his words: "The range of our enquiry becomes restricted to that part of social (general) welfare that can be brought directly or indirectly into relation with the measuring rod of money." On the contrary, non-economic welfare is that part of social welfare which cannot be measured in money, for instance moral welfare.

But it is not proper to differentiate between economic and non-economic welfare on the basis of money. Pigou also accepts it. According to him, non-economic welfare can be
improved upon in two ways. First, by the income-earning method. Longer hours of working and unfavorable conditions will affect economic welfare, adversely. Second, by the income-spending method. In economic welfare it is assumed that expenditures incurred on different consumption goods provide the same amount of satisfaction, but in actuality it is not so, because when the utility of purchased goods starts diminishing the non-economic welfare declines which results in reducing the total welfare. But Pigou is of the view that it is not possible to calculate such effects, because non-economic welfare cannot be measured in terms of money. The economist should, therefore, proceed with the assumption that the effect of economic causes on economic welfare applies also to total welfare. Hence, Pigou arrives at the conclusion that the increase in economic welfare results in the increase of total welfare 'and vice versa.

But it is not possible always, because the causes that lead to an increase in economic welfare may also reduce the non-economic welfare. The increase in total welfare may, therefore, be less than anticipated. For instance, with the increase in income, both the economic, welfare and total welfare increase and vice versa. But economic welfare depends not only on the amount of income but also on the methods of earning and spending it. When the workers earn more by working in factories but reside in slums and vitiated atmosphere, the total welfare cannot be said to have increased, even though the economic welfare might have increased. Similarly, as a result of increase in their expenditure proportionately to income, the total welfare cannot be presumed to have increased, if they spend their increased income, on harmful commodities like wine, cigarettes etc. Hence, economic welfare is not an indicator of total welfare.

**Relation between Economic Welfare and National Income**

Pigou establishes a close relationship between economic welfare and national income, because both of them are measured in terms of money. When national income increases, total welfare also increases and vice-versa. The effect of national income on economic welfare can be studied in two ways:

1. Changes in size of national income and economic welfare
2. Change in the composition of national income and economic welfare
3. Changes in the distribution of national income and economic welfare.

(i) The change in the size of national income and economic welfare:
There is direct relationship between size of national income and economic welfare. The changes in the size of national income and economic welfare may be positive or negative. The positive change in the national income increases its volume, as a result people consume more of goods and services, which leads in increase in the economic welfare. Whereas the negative change in national income results in reduction of its volume; People get lesser goods and services for consumption which leads to decrease in economic welfare. But this relationship depends on a number of factors.

Is the change in national income real or monetary? If the change in national income were due to change in prices, it would be difficult to measure the real change in economic
welfare. For example, when the National income increase as a result of increase in prices, the increase in economic welfare is not possible because it is probable that the output of goods and services may not have increased. It is more likely that the economic welfare would decline as a result of increase in prices. It is only the real increase in national income that increases economic welfare.

Second, it depends on the manner in which the increase in national income comes about. The economic welfare cannot be said to have increased, if the increase in national income is due to exploitation of labour, e.g., to increase in production by workers working for longer hours, by paying them lesser wages than the minimum. Thus, forcing them to put their women and children to work, by not providing them with facilities of transport to and from the factories and of residence, and their residing in slums.

Third, national income cannot be a reliable index of economic welfare, if per capita income is not borne in mind. It is possible that with the increase in national income, the population may increase at the same pace and thus the per capita income may not increase at all. In such a situation, the increase in national income will not result in increase in economic welfare. But from this, it should not be concluded that the increase in per capita income results in increase in economic welfare and vice versa.

It is possible that as a result of increase in national income, the per capita income might have risen. But if the national income has increased due to the production of capital goods and there is shortage of consumption goods on account of decrease in their output the economic welfare will not increase even if the national income and per capita income rise. This is because the economic welfare of people depends not on capital goods but on consumption goods used by them. Similarly, when during war time the national income and the per capita income rise sharply; the economic welfare does not increase because during war days the entire production capacity of the country is engaged in producing War material and there is shortage of consumption goods. As a result, the standard of living of the people falls and the economic welfare decreases.

Often, even with the increase in national income and per capita income the economic welfare decreases. This is the case when as a result of the increase in national income, income of the richer sections of the society increases and the poor do not gain at all from it. In other words, the rich become richer and the poor become poorer. Thus when the economic welfare of the rich increases, that of the poor decreases. Because the poor are more than the rich, the total economic welfare decreases.

Last, the influence of increase in national income on economic welfare depends also on the method of spending adopted by the people. If with the, increase in income, people spend on such necessities and facilities, as milk, ghee, eggs, fans, etc., which increase efficiency, the economic welfare will increase. But on the contrary, the expenditure on drinking, gambling etc. will result in decreasing the economic welfare. As a matter of fact, the increase or decrease in economic welfare as a result of increase in national income depends on changes in the tastes of people. If the change in fashions and tastes takes place in the direction of the consumption of better goods, the economic welfare
increases, otherwise the consumption of better goods, decreases. It is clear from the above analysis that though the national income and economic welfare are closely inter-related, yet it cannot be said with certainty that the, economic welfare would increase with the increase in national income and per capita income. The increase or decrease in economic welfare as a result of increase in national income depends on a number of factors such as the rate of growth of population, the methods of earning income the conditions working; the method of spending, the fashions and tastes, etc.

(ii) Changes in the composition of national income and economic welfare: composition of national income refers to the kind of the goods and services produced in the country. Change in the composition of national income may sometimes increase economic welfare and may at another time decrease it.

Changes in the distribution of national income and economic welfare:

First, by transfer of wealth from the poor to the rich, and
Second, from the rich to the poor. When as a result of increase in national income, the transfer of wealth takes place in the former manner, the economic welfare decreases. This happens when the government gives more privileges to the richer sections and imposes regressive taxes on the poor.

The actual relation between the distribution of national income and economic welfare concerns the latter form of transfer when wealth flows from the rich to the poor. The redistribution of wealth in favor of the poor is brought about by reducing the wealth of the rich and increasing the income of the poor. The income of the richer sections can be reduced by adopting a number of measures, e.g., by progressive taxation on income, property etc., by imposing checks on monopoly by nationalizing social services, by levying duties on costly and foreign goods which are used by the rich and so on. On the other hand, the income of the poor can also be raised in a number of ways, e.g., by fixing a minimum wage rate, by increasing the production of goods used by the poor, and by fixing the prices of such goods. By granting financial assistance to the producers of these goods, by the distribution of goods through cooperative stores, and by providing free education, social security and low rent accommodation to the poor. When through these methods the distribution of income takes place in favor of the poor, the economic welfare increases.

Pigou has expressed this in these words: "Any cause which increases the absolute, share of real income in the hands of the poor, provided that it does not lead to a contraction in the size of national dividend from any point of view will, in general increase economic welfare."

But it is not essential that the equal distribution of national income, would lead to increase in economic welfare. On the contrary, there is a greater possibility of the
economic welfare decreasing if the policy towards the rich is not rational. Heavy taxation and progressive taxes at high rates affect adversely the productive capacity, investment and capital formation, thereby decreasing the national income. Similarly, when through the efforts of the Government the income of the poor increases but if they spend that income on bad goods like drinking, gambling etc. or if their population increases, the economic welfare will decrease. But both these situations are not real and only express the fears, because the government while imposing different kinds of progressive taxes on the rich, keeps particularly in view that taxation should not affect the production and investment adversely. On the other hand, when the income of a poor man increases he tries to provide better education to his children and to improve his standard of living. Thus we arrive at the conclusion that as a result of the increase in national income, the economic welfare will increase provided that the income of the poor increases instead of decreasing and they improve their standard of living and that the income of the rich decreases in such a way that their productive capacity, investment and capital accumulation do not decline.

National Income 'as a Measure of Economic Welfare

**GNP** is not a satisfactory measure of economic welfare because the estimates of national income do not include certain services and production activities which affect welfare. We discuss below some of the factors which affect human welfare but are not included in the **GNP** estimates.

Leisure. One of the important things that affects the welfare of a society is leisure. But it is not included in **GNP**. For example, longer working hours may make people unhappy because their leisure is reduced. On the contrary, shorter working hours per week may increase leisure and make people happy. More or less leisure enjoyed by the community as such may affect the total output of the economy. But the value of leisure is excluded from the national income estimates.

Quality of Life. **GNP** estimates do not include the quality of life which reflects the community's welfare. Life in overcrowded cities is full of tensions. Roads are overcrowded. There is loss in time. Accidents occur daily which cripple or kill people. Environment becomes polluted. There are the problems of water, power, housing, transportation, etc. Crimes spread. Life becomes complex and the quality of life deteriorates. Consequently, social welfare is reduced; But all these stresses and strains of city life are not included in the national income estimates. Strangely, the efforts made by governments to remedy the ills of the city Life are included in the **GNP** because they involve public expenditure.

On the other hand, in places where there is no congestion, people enjoy fresh air and the beauty of nature, the quality of life tends to increase. But this is not reflected in **GNP**.

Non-market Transactions. Some of the non-market transactions increase, welfare but they are not included in national income estimates. The services of housewives within the home and community activities such as religious functions, affect the welfare of the
people but they are excluded from the estimates of **GNP** because no market transaction is involved in providing these services.

Externalities. Similarly, there are externalities which tend to in crease or decrease welfare but they are not included in GNP estimates. "An externality is a cost or benefit conferred upon second or third parties, as a result of acts of individual production and consumption." But the cost or benefit of an externality cannot be measured in money terms because it is not included in market activities. "An example of an external benefit is the pleasure one man derives from his neighbour’s fine garden: An example of an external cost is environmental pollution caused by industrial plants." The former tends to increase welfare and the latter tends to reduce it. Since externalities are "untraded interdependencies", they are excluded from national. Income estimates.

**Nature of Production.** GNP estimates do not reflect the capacity of different goods to provide different levels of satisfaction to the community. The same amount of money spent on a nuclear bomb or on building a dam across a river adds equally to the national income. But they provide different levels, of satisfaction to the community. A bomb does not increase welfare while a dam increases welfare.

**Standard of Living.** National income estimates also do not reflect standard of living of the community which determines its welfare. If more national expenditure is incurred on the production of arms and ammunitions and on capital goods and less on producing consumption goods, this difference is not reflected in GNP estimates. But the reduction in the production of consumption goods tends to decrease the welfare of the people, while the increase in the expenditure on armaments and capital good does not increase welfare.

Keeping the above limitations in view, GNP cannot be used as a measure of welfare. However, a few economists have tried to broaden the definition of GNP so as to make it a measure of economic welfare. A pioneering attempt toward this direction has been made by Professors Nordhaus and Tobin in 1972. They have constructed a 'Measure of 'Economic Welfare' which they call **MEW**. Professor Samuelson calls it 'Net Economic Welfare', or **NEW**.

According to Nordhaus and Tobin, in MEW they have tried 'w measure all consumption that leads to human welfare. To estimate the value of MEW, they deduct from consumption certain items which do not contribute to welfare and add other items that contribute to welfare but are excluded from GNP estimates.

The deductions which they make are of three types: (1) Those public and private expenditures that do not yield utility directly. They call them "regrettable necessities", such as government expenditures on national defence, police force, road maintenance, and sanitation services, and expenses by consumers on commuting (i.e., traveling regularly by train, scooter, car or bus between one's residence and place of work). (2) All consumer expenditures on durable household goods such as washing machines, cars, TV sets, etc. which yield utility over their lifetime. (3) Estimated costs arising from "negative
externalities" which are disamenities arising from urbanisation" congestion and pollution. All these reduce human welfare.

Having made these deductions, Nordhaus and Tobin add three items to consumption: They are: (1) the value of non-market activities; (2) the estimates of the value of the services of durable consumer goods actually consumed by the owners- both households and government; and (3) the estimates of the value of leisure.

In estimating MEW, Nordhaus and Tobin devote more attention to the valuation leisure. For this they adopt two approaches: the opportunity cost approach and the intrinsic-value approach. The first approach is based on the principle that when a person chooses to enjoy more leisure, it is always at the cost of foregoing more income. An hour's leisure means an hour's wages foregone, They estimated that the value of leisure measured by the opportunity cost approach has been steadily rising over the years because of the steady rise in the real wage rate per hour over the years. The intrinsic-value approach measures the value of leisure in terms of the actual enjoyment (utility) provided by, say, an hour's leisure.

By using such valuation devices, Nordhaus and Tobin estimated that the figure of MEW in the United States for 1965 was dollars 1200 billion which was twice the GNP, for the same year. Their estimate of the growth of per capita MEW for the period 1929.65 averaged 1.1 per cent a year, as against 1.7 per cent a year for per capita GNP for the same period. The estimates reveal that there was mark able increase in economic welfare. At the same time, the regrettable necessities had also been growing rapidly.

From the above discussion, it should not be inferred that MEW is ant to replace GNP. It is at best an attempt to supplement GNP order to include non-market activities in the latter for relating it to economic welfare.

**Question for self assessment:**

1) What do you mean by economic welfare?

2) Differentiate between economic welfare and non economic welfare?
3) Give some examples of economic welfare and non economic welfare?

4) Discuss the effect of changes in the size composition and distribution of national income and economic welfare?

POINTS TO PONDER

**Welfare**

It consists of both Economic and non economic welfare.

Total welfare = economic + non economic welfare
Types of welfare

Two types of welfare:
- Economic welfare
- Non economic welfare

Economic welfare

Meaning of economic welfare:
That part of social welfare that can be brought directly or indirectly into relation with the measuring rod of money.
i.e. part of welfare which can be measured directly or indirectly in terms of money.

Non economic welfare

That part of total welfare which can't be measured by money price constitutes non economic welfare.
Economic welfare as an index of total welfare
Economic welfare is a part of total welfare and any change in the part should reflect the whole. An increase in the economic welfare must be reflected in the increased total welfare.

Economic welfare can be studied under the following three headings
• Changes in the size of national income and economic welfare.
• Changes in the composition of national income and economic welfare.
• Changes in the distribution of national income and economic welfare.

Percapita income as an index of economic welfare