Q1. Explain output / value added method of calculating national income.

Ans. In this method national income is calculated by summing over the value of all goods and services produced in the economy during a given period. By the following steps we can understand how this method calculates the national income.

Step 1: Under this method, the economy is divided into different industrial sectors like Agriculture, Fishing, Mining, Construction, manufacturing, Trade and Commerce, Transport, Communication, etc.

Step 2: As the economy is divided into different sectors, a no. of firms operating in each sector are identified. Then, the gross value added at Market Prices of each firm or entreprise is calculated.

Value of output of a firm = Sales + Change in Stocks.

In the above equation, Value of output of a firm has two parts Sales and change in stocks. It is so because it is not necessary that the output produced by the firms is to be sold total. Since we are concerned with the value of output produced. Therefore, a part of output produced which is sold reflected in Sales and the remaining part of output produced which is not sold is measured by change in stocks.

As we calculate the value of output of a firm, next we calculate the gross value added of a firm at market prices which is

GVA at Market Prices = Value of output of a Firm − Intermediate Consumption

Intermediate Consumption: The processing of goods into further production is called Intermediate Consumption.

Here, we deduct the intermediate consumption from the value of a output of a firm because when we calculate value of output produced by firms, that output may be a final good or intermediate good. Since final good already includes the value of intermediate good. Therefore if we consider the value of intermediate good separately, there will be double counting.

Step 3: During the production process, the fixed capital like Machines and Tools used in the production process lose their life and productivity due to wear and Tear. This loss must be estimated because we incurred this kind of loss due to production of output. Therefore, we subtract this loss which is known as (Depreciation or Consumption of Fixed Capital) from GVA at Market Prices. This result is called Net Value Added at Market Prices. (NVA at Market Prices)

NVA_{MP} = GVA_{MP} − Depreciation i.e., Consumption of Fixed Capital

Step 4: As we know that National Income is the sum of incomes earned by all factors of production of an economy during a given period. Therefore, we have to calculate NVA at factor cost

Because market prices includes a kind of indirect taxes which is not the income of factor of production. Therefore we deduct indirect taxes from NVA at Market Prices. which is

$$\text{NVA at Factor Cost} = NVA_{MP} - \text{Indirect Taxes.}$$

In this way, for each firm of all sectors we calculated NVA at factor cost. The sum of NVA at factor cost of all firms would give the National Income.