# Question 2

**Corporate investment, which has been held back due to political uncertainty, is picking up again in Indonesia. Consumption is also likely to pick up further with falling unemployment as the economy continues to expand.**

1. **How far can the information lead you to conclude that the standard of living in Indonesian has risen? (13)**

Introduction (state the economic principles and the requirements of the question)

Standard of living is defined as the quality of life that the citizens of a nation may enjoy and it may be classified in terms of a quantitative or qualitative measurement. The quantitative measurement of standard of living is usually represented by the real per capita income, which reflects the material comfort of the citizens through their purchasing power. The above information may help to explain why standard of living has risen as it can show evidences that the purchasing power of the Indonesian people has risen. However, it may fail to do so when the qualitative measurement of SOL is used and other factors are considered.

Main Body

**Explain why the information may help to explain why SOL has increased**

* 1. Increase in corporate investment will lead to a rise in national income and subsequently, a rise in real per capita income. (Increase I – Increase AD – via K effect – increase NY – increase real per capita income - % of increase in GDP > % increase in price level and population growth)
  2. Consumption is increasing will show that the people are able to enjoy greater material comfort – implies that disposable income has increased – higher purchasing power
  3. Lower rate of unemployment will mean that the Indonesian has the disposable income to make purchase to sustain their livelihood. (low unemployment – demand for labour is higher than supply of labour (tight labour market – increase in wage rate – increase in purchasing power)

**Explain why the information may be insufficient (source : problems in time comparison)**

* 1. Increase in corporate investment may not lead to increase in national income if the economy fails to reap an efficient utilization of resource, national income may not increase to raise the per capita income, undermining the level of standard of living.
  2. Inflationary effect may erode the purchasing power of the consumer and lower down their SOL, especially for those essential goods. This will affect the standard of living of the lower income group more extensively. Real consumption may decrease – decrease in SOL
  3. Increase in employment does not mean an increase in wages of the workers. The wage is likely to be low as production capacity has just increased. Large abundant of previously unemployed will put downward pressure on wage level due to the presence of excess labour supply. This means the workers’ purchasing power is still low.

(problems of time comparison)

* 1. Need to consider how the increase in national income is distributed among the Indonesian people. If the distribution is skewed towards the rich rather than a more equal distribution of income, only a small percentage of the population of the population is enjoying a higher standard of living.

**Explain how the information fails to explain the qualitative aspects of SOL**

1) The information provided does not take into account the negative externalities that undermine the quality of life in areas such environmental problem & traffic congestion.

1. The composition of expenditure is not known and the information is important as it will help to explain whether the goods that are produced will benefit consumers or not. If most of the goods are capital goods, the Indonesian people will not benefit immediately. Or, if the productions of goods are for export, the consumers are not going to enjoy higher level of welfare.
2. The information does not provide an understanding of the qualitative aspects of life such the working hours and stress level of environment.

**Conclusion**

The above information is of little help to explain the level of standard of living of the Indonesian people as it only reflects a limited understanding of the purchasing power of the people, which is only helpful in understanding the quantitative aspects of standard of livings. Therefore, it is not reliable to conclude that the standard of living of the Indonesians is higher based on the above information.

**Question 3**

**It has been reported that ‘in the last 30 years Indonesia has struggled out of poverty into the ranks of the world’s middle-income countries. The average Indonesian is better off than five years ago.’**

1. **If you were asked as an economist to show that the ‘average Indonesian is better off than five years ago’, explain what information you would need.**

**(requirement – economic indicators – impact of the economic indicators)**

**Introduction – state the economic principles used for the question / definitions and why it is used as a means to represent SOL**

To show whether an average Indonesian is now better off compared to the past five years, economists would most probably want to enquire whether their standard of living has risen. Standard of living refers to the average quality of life of a population that includes the material and non-material aspects of life. The material aspect is determined by the quantity of goods and services enjoyed by the individual through its real national income per head, whereas the non-material aspect includes things such as life expectancy, crime rates, education standard, etc. By using standard of living as an indicator, economists are able to obtain a fuller picture so to determine whether one is better off now or not.

To derive the real per capita income, **Gross National Product (GNP)** is needed which is the total money value of all final goods and services produced by resource owned by the citizens of a country, irrespective of whether these resources are located within the country or abroad, before deduction for depreciation, in a year. By dividing the GNP by **the population**, we would be able to determine whether the average income of a citizen has increased as compared to five years ago. The value of GNP per capita must be deflated by the current year price index to reflect the real purchasing power of the real per capita income. If there is an increase in the value of the real per capita income, then it can be said that an average Indonesian citizen is now materially better off compared to five years ago. (Higher purchasing power – higher material level of comfort – higher level of welfare)

However, real GNP per head is not a complete indicator of economic welfare, we would have to refer to other information as discussed in the following paragraphs.

(problems of time comparison)

Other areas that could be taken into account include **income distribution**. Also, by making use of the Gini ratio, we would be able to determine the level of income disparity present in Indonesia. If the Gini ratio value is high, then there is greater disparity and any economic growth would not necessarily mean that the average Indonesian has benefited the past five years. Besides this, the Wage to GDP ratio is also helpful in determining the extent of equality of distribution of the income in the country whereby a higher level of Wage to GDP ratio would be considered more equal and vice-versa. It is only with the information that the standard of living of the Indonesian people can be gauged.

It is also important for economists to take note of the composition of output. If the production of goods and services are mainly for the welfare of the consumers, the increase in the national income will mean a rise in the level of material consumption for the people. This can also be seen in term of the level of public goods and merit goods produced by the government.

Measurable Economic Welfare (MEW) is a measure that seeks to gain a fuller picture of the living standard by adjusting national income statistics to take into account of other factors that have an impact on the quality of people’s lives. Factors that improve standard of living include increased leisure hours and factors that decrease the standard of living include rising crime and pollution. Of course, in practice, this is difficult and expensive to measure the value of non-marketed “goods” and “bads”.

The Human Development Index (HDI) takes into account of the real GDP per head, life expectancy at birth and educational attainment as measured by adult literacy and combined primary, secondary and tertiary enrollment ratio.

To determine whether an average Indonesian is now better off compared to the last five years comprises of a very wide scope. As an economist, the priority would be given into looking at the changes in the standard of living. However, if the data is insufficient, he can also look into other areas such as price level and income disparity and draw a conclusion whether there had been evidence shown that “the average Indonesian is now better than five years ago”.

Limitations of HDI and MEW:

-difficulty in setting yardstick for comparion of SOL for qualitative aspect of measurement – standard of high school education

-monetization of qualitative variable is not feasible and difficult to ascertain as the value of intangible aspect of services is deemed differently under diferent countries – like value of leisure

Unemployment rate – labour market condition – excess demand or supply – wage rate – determine purchasing power – level of material comfort – material level of SOL

CPI – determine price level – reflect the real purchasing power – determine the real level of material comfort – determine SOL.

1. **Comment on the difficulties of making comparisons of living standards between countries and over time. (Problems of time and space comparison)**

Due to the differences in the demographics and structures of different countries, there are bound to be discrepancies when comparing the standard of living. Similarly, if various factors of change were not taken into account when comparing the standard of living over time, inaccuracy would inevitably occur. As such, it would be pertinent to note that issues such as population changes, income distribution, undeclared economic activities, composition of national income, quality of life and the differences in the cost of living between countries are all various factors that affect comparison.

Population changes need to be taken into consideration in calculating national income. This is because although real income tells us about the total output of an economy, it does not tell us what is happening to the standard of living of a representative person of a country. As such, per capita real income or real income per head has to be used to measure material welfare correctly. Real national income per head is determined by dividing the total national income by the country’s population. Hence, if there is a growth in national income that is greater than the growth in population levels, then we can conclude that the standard of living of the country has improved.

Income distribution is vital because even though national income per head has increased, we still cannot say that everyone in the country is better off without knowing how the real income is distributed. To have a more accurate measurement of welfare, we need to supplement real national income per head figures with data on how an increase in real national income is distributed among the members of the population. This said, the distribution of income of two countries might differ widely even if they have similar levels of per capital income. In this case, there will be differences in the actual standard of living for the population for both countries – even though the average standard of living measured by per capita income was equal.

Undeclared economic activities can seriously undermine calculation as the national income figures does not reflect the true change in the quantity of goods and services that consumers can enjoy. Examples of undeclared economic activities includes the evasion of paying tax and illegal activities like gambling, etc. hence, if the underground economy is growing relative to the legal economy, national income figures would understate the material standard of living of the population. If the size of the hidden economy is relatively constant, the rate of economic growth may be calculated reasonably. However, even a stable sized hidden economy makes it difficult to make international comparisons of economic growth rates. This is because the size of the hidden economy differs greatly and may be also influenced by other things such as the rate of taxes.

The composition of national income must also be taken into consideration when calculating the changes in standard of living. This is because a rise in national income does not determine a rise in standard of living. For example, during a war, output may rise due to the production of more weapons but the standard of living cannot be said to have increase. Also, developing countries such as Sri Lanka and India have a large subsistence agricultural based sector that constitutes a large proportion of the countries’ GNP. They grow their own crops for domestic usage but such figures are not captured. Thus, the existence of a relatively large non-monetary sector in such economies may grossly underestimate the country’s NNP compared to developed countries where transactions are based in monetary terms.

Quality of life needs to be accounted for because a rise in standards of living may come with certain negative externalities. For example, if national income were to increase simultaneously with the average number of working hours, then the quality of life has not improved. Other externalities such as rise in pollution, crime, etc, also constitute part of it. Also, national income figures may fail to consider the number of leisure hours enjoyed by the population. For example, though Japan has a very high national income, they work very long hours and seldom take holidays so their actual standards of living may be overstated as compared to other countries. The life expectancy rates, education levels, etc will also be different for different countries, thus, when there is a substantial difference between countries, then national income would not provide an accurate basis of comparing standard of living between countries.

Lastly, there is also the problem of fluctuation of the exchange rate. To compare standards of living between countries, it is necessary to convert real national income per head into a common currency. If a country’s exchange rate strengthens against the common currency, the real per capita income will be over-valued and thus distort the measurement of standard of living. Though this problem can be resolved by the use of Purchasing power parity, which is the exchange rate based on price levels of the two countries.