The VOTE Textbook
Student Notes
Chapter 2: The Power of Definitions

Opening Story: Reading the newspaper

Everyone wants material well-being (a decent standard of living). That's why the news focuses on:

- Are we making enough products that people want and need? "Gross Domestic Product"
- Are there enough jobs for the people who want them? "Unemployment"
- Are prices stable enough so people can afford what they need? "Inflation"

Human beings have made up every single definition that exists. Whether we're defining endangered species, wetlands, life, unemployment, GDP, inflation, or anything else, we invented it. Those definitions weren't handed down from on high. When assessing economic data, we need to know the definitions to know what was counted and what was left out.

Gross Domestic Product (GDP): The total market value of all final goods and services newly produced within a nation's borders during a given period of time.

Market value

- No do-it-yourself projects
- No illegal activities or unreported activities
- No financial transactions or income transfers
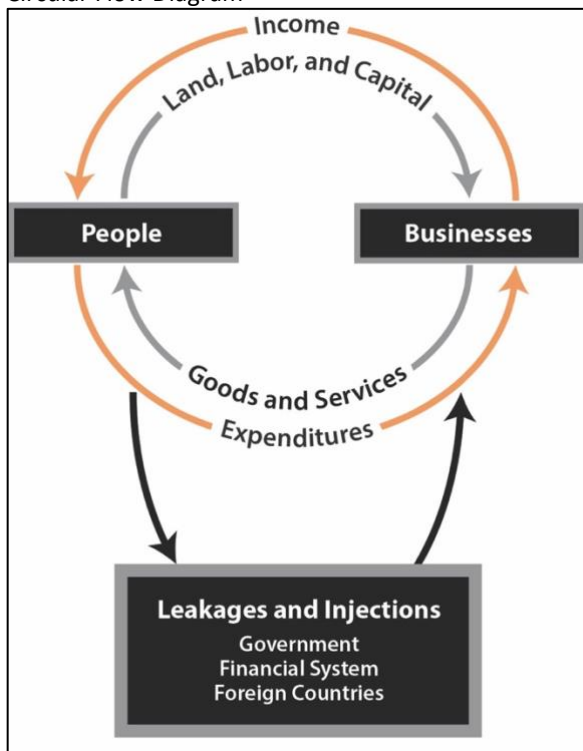
Final

- No intermediate products

Newly produced

- No used products

Given period of time

- Calculated quarterly
- No products produced at other times

Circular Flow Diagram

GDP counts four types of final goods and services:

1. Consumer spending (C)
   Final goods and services (largest)
2. Investment spending (I)
   Business equipment and new homes (most unstable)
3. Government spending (G)
   Federal, state, regional, local goods and services
4. Net Export spending (X-M)

Exports minus imports

$$GDP = C + I + G + (X-M)$$

GDP is <u>not</u> a measure of HAPPINESS because it ignores:

- The amount of leisure time
- Pollution caused by production
- The "bads" versus the "goods"
- Distribution of output
- Non-market production

Gross National Happiness (GNH) <u>is</u> a measure of HAPPINESS that includes:

- Psychological well-being
- Health
- Education
- Time use
- Cultural diversity and resilience
- Good governance
- Community vitality
- Environment
- Living standards

<u>Unemployment</u>: When people don't have jobs and want them, actively seek them, and are eligible and available to take a job.

Employment is when people work for pay (not as a volunteer), either part time or full time.

In the labor force: All employed and unemployed people

Not in the labor force:

- Stay-at-home parents
- Undocumented workers
- People in long-term care facilities

- Military personnel
- Jail and prison inmates
- Others

Two Ways Unemployment Is Measured

1. Establishment Survey: Uses payroll data from the largest U.S. corporations

2. Household Survey: Uses data collected from 60,000 random households

Unemployment Rate = Unemployed ÷ Labor Force

Two Limitations of the Official Unemployment Rate

1. Ignores discouraged workers (called "marginally attached" workers)
2. Ignores underemployed workers

   - Part-time workers who want full-time work (called "involuntary part-time workers")
   - Skilled workers who work at lower-skilled jobs

Three Types of Unemployment

1. Frictional unemployment
   Normal turnover rate in the labor market (natural)
   Examples: moving, changing occupations, bad fit

2. Structural unemployment
   Changes in the structure of the economy (natural)
   Examples: change in demand, automation, outsourcing

3. Cyclical unemployment
   Decline in the economy's total production (not natural)
   Examples: pandemic, stock market crash, weather event

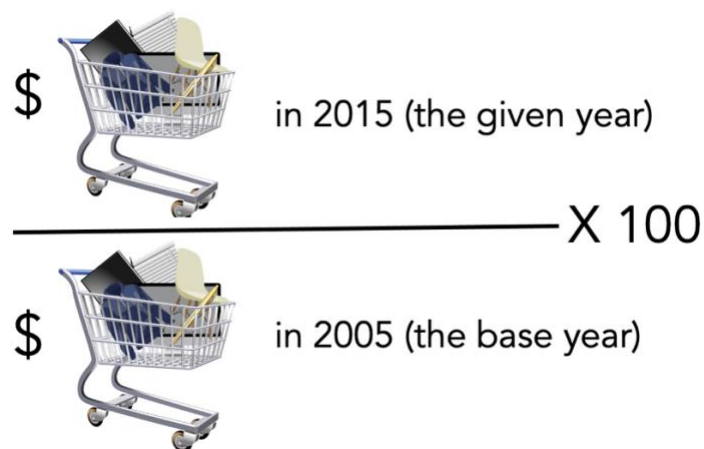Inflation: It's when prices on average go up.

Deflation is when prices on average go down.

Disinflation means there's still inflation, but the rate at which prices are rising is starting to come down.

Three Ways to Measure Average Price Changes

1. Consumer Price Index (CPI) tracks changes in consumer prices.

2. Producer Price Index (PPI) tracks changes in producer prices.

3. GDP Deflator tracks changes in all prices.

CPI (Consumer Price Index) is calculated by dividing the price of a basket of goods in a given year by the price of the same basket of goods in a base year, and multiplying the result by 100.

The base year is the year against which we compare prices to see how they have changed. The CPI for the base year always equals 100.

CPI is used to calculate Cost of Living Adjustments (COLAs). These affect the minimum wage, pensions, Social Security, public benefits, and more.

Controversies with the CPI

- CPI used for COLAs is based on a basket of goods relevant to Urban Wage Earners and Clerical Workers. But that is not appropriate for people in rural areas, retirees, and others.

- The basket used for the CORE CPI—which is used to determine COLAs—does not include food or energy.

- Using a chained CPI, substitutions are taken into account; however, consumers might continue to buy the original product instead.

- It can take years to integrate new items into the basket, so the CPI is often outdated.

- Changes in the quality of products from one period of time to another are not factored into the CPI.

There are two ways to think about things measured in money terms such as GDP, interest payments, and income.

1. Nominal value is the face value of money.

2. Real value is adjusted for inflation.

Beware of Money Illusion!

If you mistakenly believe that what's important about money is the face (nominal) value instead of the inflation-adjusted (real) value, you could run into problems.

- Income and salary: In negotiations with your employer, focus on "real" income because inflation will decrease your real income (purchasing power) and deflation will increase your real income (purchasing power).

- Interest payments: In negotiations with your lender, focus on "real" interest rates because inflation will decrease the real interest rate you pay, and deflation will increase the real interest rate you pay.