Summer 2015: Is it Time for an Improved GDP?

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It is doubtful that there is an economic indicator that is of greater importance than the gross domestic product (GDP). Some have referred to it as the godfather of economic indicators. It is often used as a barometer of a nation's economic health. It is a number that can sway elections, cause stocks to soar (or swoon) and is at the heart of any debate about the economy. It has been called one of the greatest inventions of the 20th century. Many would be surprised to learn that today, the hottest debate in economics is not how useful the GDP is, but instead what should be used to replace it.

The history of the GDP is rooted in the Great Depression and World War II. As the nation was gearing up for war, the U. S. needed a statistic to measure how much the nation could produce during wartime. Charged with the task, economists came up with the idea of a gross national product, which would later be replaced by gross domestic product. To create a statistic to measure the nation's economy, economists had to address two controversial issues. First, before the 1930's, economists generally accepted that government spending was a drain on economic growth. To calculate the GDP, economists needed to determine if government spending added to the growth of the economy, or reduced it. Increased government spending is funded by reducing the private sector (often through taxation.) With the nation at war and in the midst of a depression, the debate was not taken lightly. Second, economists could not agree if a measurement of a nation's economy should include items that affect the welfare of its citizens, or should simply tabulate how much a nation produces.

In addressing the two problems with how to calculate the GDP, economists made two significant decisions. First, they concluded that government spending could stimulate the economy even though it would reduce the income of the private sector. Second, with the nation on the eve of war, the debate of whether to include a measure of the nation's welfare became the victim of realpolitik. The government needed the ability to determine how much the nation could produce to help win the war. Contemplating a nation's welfare was considered a peacetime exercise.

The problem with using the GDP to measure today's modern economy is that it does not take into account the welfare or standard of living of the population. It is not a balance sheet of a nation's wealth. The GDP figure also fails to capture the full extent of the service industry, improvements in the environment, health care, or education. China's GDP may be twice that of the United States, but the number says nothing of the standard of living of its population. When the U.S. and the Soviet Union were in the grips of the Cold War, the battle was not only over geographic territories, but also over which economy was superior. Looking at the GDP data for each country, it would appear that the state-run Communist economy was superior to the “disorganized” free market of the West. From 1950-1978, the Soviet Union reported a GDP growth of 7.6%, while the U.S. languished at 3.4%. Due to the closed society of the Soviet Union, few Americans knew that Soviets often had food shortages. Nor did most Americans know that the Soviet GDP was the product of political decisions, not market forces.

Another issue with the GDP is that each nation uses varying levels of sophistication to calculate it. The Bureau of Economic Analysis calculates the GDP for the United States. Not all nations have such resources. In her recently published book, GDP: A Brief but Affectionate History, Diane Coyle recalls that when Dr. Paola Subacchi, the Research Director of International Economics at the prestigious international think tank Chatham House, went to Greece in 2002 to meet with the team responsible for calculating Greece’s GDP, the address was for a building in a suburban neighborhood with an office that only had a handful of people. Subacchi couldn’t even recall seeing a computer in the office!

Greece is not alone in presenting a GDP number that is less than scientific. It is generally assumed that China’s GDP is inflated to advance a political agenda. It is also not uncommon for a nation to revise its GDP to present stronger economic health than was previously reported. In 1987, Italy surprised the world when it announced overnight that its GDP would be increased by around 20% to take into account its underground economy. By “revising” the nation’s GDP, Italy passed the United Kingdom to become the fifth largest economy in the world!

Beyond the potential for improperly calculating the GDP lies the issue that the 21st-century United States economy is less dependent on producing things that can be easily counted and valued than it was in the 20th century. If Ford produces x number of cars, it is easy to calculate the value of the total cars produced. But what value does one place on products like Google or Facebook, which are free to the consumer and do not enter into the GDP calculation?

In our Summer 2013 newsletter to our clients, we questioned if the government spending shift away from improving the nation’s infrastructure to increased spending on entitlement programs is affecting the GDP. Is it possible that the slower growth we are seeing in the U.S. is partially the result of the reduction in capital spending (building bridges, etc.) and the increase in entitlement programs?

While it may seem obvious, the best way to increase the GDP is to produce more things. While natural disasters and wars can significantly destroy many of a nation’s assets, they require great investment. As perverse as it sounds, natural disasters such as Hurricane

Sandy often lead to an uptick in a nation's GDP. It should be no wonder that the GDP increased significantly after World War II.

Finally, GDP does not measure sustainability, or social welfare. The robust growth seen in China today and in early 20th-century America was due in part to their practices of employing children, exploiting workers, and polluting the air and rivers with reckless abandon.

Many economists believe that the GDP is a flawed measurement that is in need of a radical rethinking, just as Keynes and other economists of his time changed the view on the 20th-century economy. The first step in creating a better GDP is to first realize that it is a very good measurement of what a nation produces, but not a very good measurement of the many things that we take for granted in today's economy. Coyle captures this point succinctly when she writes "The U.S. Commerce Department called GDP one of the greatest inventions of the twentieth century, and so it was."