INTERNATIONAL: GDP's status as benchmark will wane

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Abstract (summary)

Rethinking the appropriateness of GDP in today's economy.

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Full Text

SUBJECT: Rethinking the appropriateness of GDP in today's economy.

SIGNIFICANCE: The primacy of gross domestic product (GDP) as the measure of economic success is being increasingly challenged. It is a measure designed for the 20th century economy of physical mass production, which is arguably less useful for a modern economy of rapid innovation and intangible, increasingly digital, services.

ANALYSIS: Impacts.

Environmental adjustments to national accounts in resource-based economies will lower national income markedly.

Investments in extractive industries will be less attractive to governments using 'green GDP' statistics.

Governments will resist implementing alternatives to GDP.

GDP is the most commonly used measure of the size and health of an economy -- and of comparing how well or badly countries are doing. It is a sum of the monetary value of all the goods and services in an economy.

Measuring GDP .

Measuring GDP can be done in one of two ways:

*Income method.*Adding up what all economic actors in an economy -- consumers and producers -- earned in a given period.

*Expenditure method.*Adding up what all economic actors spent in a year. This is the most commonly used method for official statistics.

Logically, both measures should arrive at roughly the same total. However, estimating the size and growth of the economy is not comparable to measuring the physical world. Ensuring the measurement comes closes to the underlying reality is not easily achieved.

Measurement errors .

The regular announcement of official GDP figures has acquired something of an air of ritual. Commentators in financial markets and media respond immediately to the announcement of the economy's quarterly growth rate, while politicians try to claim credit or lay blame, depending on the outcome.

Yet these small changes every three months are often within the margin of error due to problems such as late data and reporting mistakes. GDP figures are frequently revised by relatively large amounts.

Definition .

Beyond the difficulties of correctly calculating GDP, definitions of what to measure are constantly evolving, in an attempt to keep pace with changes in the economy.

On a single day in 2013, the size of US GDP increased by 3% -- adding over 500 billion dollars overnight. This was due to a change in the calculation method that brought it into line with international standards regarding the way intangible assets -- or intellectual property -- are counted. Prior to this change, the United States treated expenditures on research and development (R&D) as well as such things as entertainment, literary and artistic originals, as intermediate inputs used in the process of producing other goods and services. As a result, the contribution these important and innovative activities made to economic growth and productivity was undervalued. These innovative, intangible assets are now treated as fixed investment in GDP calculations, vastly increasing their value in GDP calculations.

International standards.

Treating intellectual property and intangible goods as fixed investment is the international standard laid out by the UN's System of National Accounts 2008 (SNA). Australia and Canada implemented some of the changes outlined in the SNA, and Europe is expected to act this year.

A product of its time.

The calculation changes that took place last year in the United States highlight the difficulty GDP has in meeting the needs of a rapidly evolving global economy. GDP is extremely good at measuring physical mass output, but less so at rapid innovation and intangible goods.

It was not until the 1930s that economists and statisticians started to work on what ultimately became GDP, and it was not until 1941 that the first GDP estimates were published.

The main motivations for designing GDP in the way we know today were:

The Great Depression. Politicians wanted to understand the extent of excess capacity in the economy.

The Second World War. Governments wanted to know how much slack existed in the economy and could be used to produce war materiel.

However, an intense debate about how best to measure 'the economy' preceded this. Simon Kuznets, often described as the father of GDP, opposed the framework that was ultimately introduced, wanting instead to measure social welfare. He argued for adjusting economic output estimates by subtracting activities that made no contribution to well-being in themselves, such as advertising, finance and weapons expenditure.

Broadened definition .

The debate about what to measure has now re-emerged. It has been argued that excessive focus on GDP has disguised inequality and social disharmony. Similarly, environmentalists believe focusing on a narrow definition of GDP leads to an overemphasis on growth at the expense of sustainability, while 'happiness' advocates believe GDP ought to be replaced with more direct indicators of well-being.

Well-being .

There are good reasons for thinking that the gap between economic activity measured by GDP and social welfare has increased (*see INTERNATIONAL: 'Well-being' research offers insights - August 11, 2009*).

Consumer goods .

There are increasing gains in consumer well-being that are under-counted by GDP. Some of these innovations are extremely significant -- for example, the potential impact of new tailored molecules to fight cancer, or the dramatic changes brought about by broadband and smartphones. Yet even seemingly trivial new variants, such as a new flavour of breakfast cereal, have a surprisingly large estimated impact on consumers' well-being. It is difficult to weigh these positives against the negatives of modern life, whether the environmental costs of activity or the burden of commuting.

'Dashboad' of indicators .

One alternative to devising an 'adjusted' GDP is to use a 'dashboard' of indicators instead. The pioneering efforts, such as the OECD's Better Life Index, have the advantage of demonstrating trade-offs between different elements of well-being.

Dashboards will need more work before they can start to exert any influence over policymakers. Despite this, they are a promising avenue for measuring the 21st century economy, and more useful than such measurements as 'gross national happiness'.

Sustainability .

Perhaps more important is finding a way to report the sustainability, in the broadest sense, of the economy. The sustainability debate has underlined the importance of accounting for depletion of natural resources, pollution, loss of biodiversity and risks of extreme climate change. Measuring what is happening to the economy's physical and human capital, as well as natural capital, is needed to properly report sustainability (*see INTERNATIONAL: 'Green GDP' gauge spreads slowly - August 20, 2012*).

Foundations laid .

Some of the statistical building blocks for measuring well-being and sustainability already exist in the national accounts. Yet broadening the customary horizon of political debate beyond the emphasis on quarterly GDP changes will not come easily, and may not come at all without a change in the way 'the economy' is generally conceived.

CONCLUSION: GDP was a good measure for the 20th century but is increasingly inappropriate for today's economy, which is driven by innovation, services and intangible goods. The status of the economy will always be an important part of everyday politics, but there is a need for a better measure of 'the economy' than today's GDP. GDP is just one way of defining 'the economy'; alternative measures look set to gain ground in the coming years.

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