

No. 410 November 2010

A Partial Defence of GDP

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5 November 2010

The human inclination to measure and record the existing state of its economic and social welfare is almost as old as human existence itself.

In 1086 the Domesday Book was completed, providing an account of the worth of land and livestock throughout England. About 600 years later William Petty published *Verbum Sapienti* (1665) and *Political Arithmetick* (1676), early forerunners of national accounts for England/Wales and the Netherlands/France respectively.

During the 20th century the Australian economist Colin Clark and others, including Simon Kuznets and Richard Stone, made formative contributions towards the establishment of that internationally accepted measure of aggregate economic activity that we label today as Gross Domestic Product (GDP).

Yet, perhaps unsurprisingly, ever since the production of the first, preliminary sets of national accounts there have been at least as much ink spilled criticising the GDP measure as there has been ink spilled comparing the performance of regions and nations against this metric.

Many economists have been careful to emphasise (on what should be an obvious point) that the value of market production measure of GDP does not represent a comprehensive measure of human welfare.

Kuznets himself cautioned using GDP as a catch all welfare measure as it does not distinguish 'between quantity and quality of growth, between costs and returns, and between the short and long run. Goals for more growth should specify more growth of what and for what.'

Others have focussed on specific limitations of the GDP measure. The treatment of non-marketable public sector activities that are coercively financed through taxation - and thus not based on the market logic of competitive prices and the profit loss mechanism - is a major case example in point.

Assuming that a government employs a new worker with pay of \$55,000. The national accounts will record GDP as having increased by \$55,000, since any public sector activity is included in the measure 'at cost.' However the recruit might contribute far less in value to the economy than the cost of employment recorded in GDP, and this likelihood is magnified in the absence of competitive prices and the profit loss mechanism applying to the public sector.

As noted by Australian economist Steven Kates, 'in the private sector, expenditure is only recorded after a business goes to all the effort of production and has then found someone to purchase what has been produced. In the public sector, whatever the government spends, on whatever it happens to buy, is put straight into the accounts without making any adjustment to determine whether there has actually been an increase in the community's wealth.'

Such an anomaly enables the likes of Julia Gillard and Wayne Swan to state with near impunity that the government's \$80 billion fiscal stimulus package raised GDP, and hence 'saved' Australia from recession, even though school halls were constructed at more than twice the going industry rate and home insulation subsidies led to lost houses and lives.

Notwithstanding the continuing efforts of economists, statisticians and government agencies to refine the conventional GDP measure - taking into account issues such as the treatment of the growing intangible services economy and the generalised improvement in product quality - the limitations of GDP have been seized upon by an influential minority that have hitched their anti-production wagon to attacking the GDP messenger itself.

As early as 1973 - at the time that neo Malthusian Club of Rome pessimism seemingly reigned supreme - the Commonwealth Treasury summarised the anti production sentiment as follows:

'Though economic growth remains an important object of concern of national governments in all countries, and in its broadest sense retains much of its 'grass roots' support among people generally, it is under increasingly strong attack by articulate and influential minorities. It is held to be responsible for many of the ills of modern industrial society - for the increasing pace and pressure of urban living and for the co existence of 'private affluence and public squalor'; for the creation of 'imagined' wants rather than the satisfaction of 'real' needs; for the relentless exploitation of the earth's non renewable resources; for poisoning of the air and waters; for despoliation of the environment and threats to the biosphere; for ugliness; materialism and acquisitiveness; for crime, violence and drug addiction; and for a variety of other problems and failings.'

Modern calls for the overthrow of GDP have been led by the recent release of the Sen-Stiglitz-Fitoussi (SSF) report commissioned by the French Sarkozy government. According to the report, 'the time is ripe for our measurement system to shift emphasis from measuring economic production to measuring people's well being. And measures of well being should be put in a context of sustainability.'

Other countries are already pursuing the development of substitute or complementary measures to GDP. In 2005 British Conservative Party leader, and now Prime Minister,

David Cameron commissioned environmental journalist (and now Conservative MP) Zac Goldsmith to examine 'quality of life' issues including the replacement of GDP.

The Canadian government has introduced an 'Index of Wellbeing' while, in Australia, the ABS recently released the 2010 edition of its Measures of Australia's Progress publication which seeks to provide a 'triple bottom line' assessment of the state of the nation.

In what follows, I wish to outline three propositions that provide a partial defence of (or, if you will, raising two out of three cheers for) GDP as an indicator of economic success.

Proposition #1: The market value of production, provided by GDP, is a reasonable measure of economic welfare

SSF call for the replacement of the production measure of GDP with a measure of material living standards associated with consumption.

While the authors state that most households associate increases in their wellbeing with consumption, the fact remains that it is the act of production - the combination and transformation of scarce economic resources by producers for sale in the market - that precedes the act of consumption.

Indeed, production provides the impetus for the transformation and growth of the market economy. This is because the livelihoods of producers depend critically upon whether their conjectures about consumer preferences - embodied in the array of goods and services on offer - are confirmed by sufficient sales revenues.

In a competitive economy, a producer that provides an output of a desired quality and reasonable price will stand to acquire profits as a return on initial investments. Profitability provides a spur for additional investment, including the application of technological and scientific advances that not only increase the quantity of production but enhance its quality, and encourages aspirants to enter the market and either imitate or improve upon the successful product.

The galaxy of goods and services available in the market economy today are the product of successful producer conjectures about consumer preferences in the past, as well as producer conjectures about what consumers might want tomorrow.

Growth in the value of market production, measured by growth in GDP, represents a sure sign of economic success in the sense that initial producer conjectures have translated into a material improvement in living standards.

Proposition #2: Economic welfare, as measured by GDP, is highly correlated with other measures of human welfare

While many critics are keen to highlight the limitations of GDP as a measure of overall human welfare, numerous studies have shown strong and robust relationships between GDP (either in terms of levels of growth) and other indicators of welfare.

Whether it be in terms of economic freedom, better health and social outcomes, and levels of happiness, higher levels of, or growth in, GDP are correlated with superior outcomes. Correlation plots are readily available on the internet for inspection (for example, see here).

To be sure, while correlation does not necessarily imply causation, the available evidence is indicative of the notion that wealthier countries are more capable of providing their citizens with a better quality of life.

Proposition #3: Many of the criticisms levelled against the measurement of market activities within GDP are misplaced

Many of the critics of the GDP measure overlook French classical liberal Frederic Bastiat's observations concerning the 'broken window' fallacy, and how economic and other 'bads' might be reflected in GDP. Consider a few examples.

Assume I crash my car, to the extent that it is a write off. My need to purchase a new car, to travel to and from work, is recorded in the GDP measure. While some critics might decry that GDP implicitly rewards careless driving, the fact is that my previous car and its contribution to the economy has been lost to GDP.

One of the great shibboleths of our time is the revived neo Malthusian idea that current generations are consuming resources, and laying waste to the environment, and that such conduct is reflected in increased GDP.

A farmer or miner may wish to lay waste to all land or mineral commodity reserves today, but the absence of resources tomorrow will be recorded as a reduction in GDP. Besides, the inherent incentives for producers to minimise costs (as a way of optimising profitability) suggests that a 'live for today, forget about tomorrow' approach towards production and economic stewardship is an unrealistic one that won't sustain GDP growth.

As noted above, at least with respect to the treatment of public sector activity, GDP is an imperfect measure of economic welfare. Further, no self respecting economist would wish to claim that GDP is an all encompassing indicator of human welfare.

Despite all its flaws, there is arguably no better measure existing today that reflects the value obtained through voluntary market exchange than GDP. Indeed, one suspects that recent calls to alter or expunge the GDP measure represents little more than the continued disillusionment by the confiscatory-left towards economic growth and the empowerment of individuals that this entails.

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This article was published by [The Institute of Public Affairs Australia](#) online on 6 October 2010.

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