Dropping a bad habit

The virtues of ignoring GDP

It is now widely recognized that GDP has many shortcomings as an indicator of social welfare. It is time for macroeconomists and policy makers finally to take action.

The gross domestic product (GDP) is a basic measure of a country's overall economic output. Over the years it has also come to be used as a measure of social welfare and progress. Indeed, information about GDP (per capita) growth has a major influence on decision-making by individuals, businesses and governments. In fact, politicians and macroeconomists can become noticeably nervous when there is little or no GDP growth.

There is mounting evidence, most recently from 'happiness research', that the use of GDP must be regarded as a serious form of information failure. But reports detailing the shortcomings of GDP do not seem to have got through to government economists, educators, policy makers, politicians and journalists, who continue to use it as if nothing has changed.

This apparent paradox is the result of an ambivalent attitude among many economists. While they accept the criticism, they claim it is irrelevant. Such denials come in two basic forms:

- *GDP information has only a modest impact on economic reality*. Yet there are many indications that its influence is significant. For banks and financial markets, GDP is a core indicator. For companies, GDP growth indicates a favourable investment climate. GDP growth expectations even affect consumer confidence. Low GDP growth in particular worries politicians, who are constantly haunted by the spectre of not being re-elected.
- *Despite its shortcomings, GDP still provides useful information.* One possible benefit of GDP growth is that it creates confidence and economic stability. But the downside is that a decline in GDP generates negative expectations that reinforce the decline. Moreover, GDP per capita is widely seen as a useful measure of productivity. And while the less frequently reported GDP *per hour worked* is a much better and internationally comparable indicator of productivity, it is not a good proxy for social welfare.

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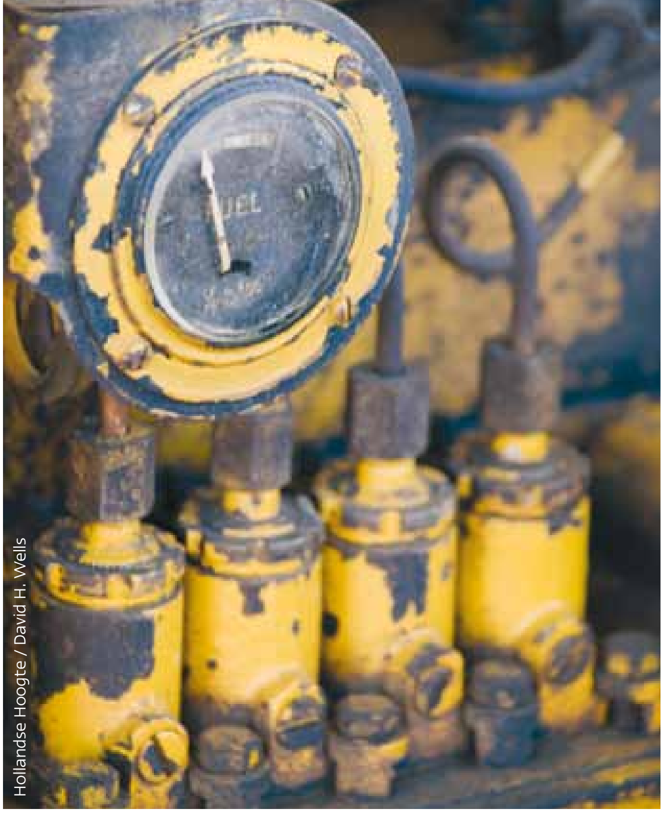
Policy relevance

Ignoring GDP essentially means removing systematic and cumulative errors resulting from individual and public responses to it. It creates a new perspective for judging alternative public policies, including regulatory taxes on overtime, consumption of luxury goods, restrictions on commercial advertising and cutbacks in temporary contracts. While such policies may seem unattractive from the perspective of GDP growth, they are more appealing from the perspective of real social welfare.

Policies promoting social welfare at the expense of GDP would receive less resistance if there was less impetus for unconditional GDP growth. Take the economic assessment of policies designed to avert climate change. Most view the problem as a trade-off between a policy's benefits and its costs as measured in terms of reduced GDP growth. In rich countries, however, the latter is a not a good measure of lost prosperity (happiness). From a happiness perspective, the real social cost of such policies is lower, while the costs of climate change, notably for poor countries, are more serious than when expressed in terms of the effects on GDP. Stringent, 'safe' climate policies would therefore be much more welcome from the perspective of happiness or real welfare. In effect, this means GDP growth would carry less weight in the evaluation of climate policies.

Ignoring GDP information would also influence our response to the current economic and financial crisis. Crisis management should focus on two main aims. First, minimize unemployment ('crisis malaise'), since it entails a huge loss of welfare for affected individuals and families. And second, restore economic confidence.



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Continued GDP growth is not a prerequisite for achieving either aim. While lower unemployment is likely to increase GDP, a higher GDP does not necessarily lead to more jobs. Constant media reports about disappointing GDP growth merely serve to reinforce a negative spiral of confidence. The pursuit of growth consequently becomes an obstacle to finding a way out of the crisis. Economists should invest more intellectual energy in studying full or nearly full employment – and devise policies for achieving this – in an economy that isn't constrained by the onus of 'constant growth'.

Putting all our eggs in the GDP basket unnecessarily blinds us to what might effectively solve the most worrying problems of our time. More generally, GDP growth fetishism, i.e. the relentless pursuit of growth, constrains us in our attempts to find ways of improving human welfare.

It should be stressed that ignoring GDP information, i.e. diminishing the role of GDP, does not imply being against growth. The message is more subtle. Ignoring GDP in public policy implies that governments have to be neutral or indifferent to economic growth. If a government had no GDP information and could not gauge whether its economy was growing – or by how much – its only possible response would be to show no concern about growth at all. Instead, the focus should be on real changes in welfare. If such changes go hand in hand with growth, it might make some people happy, but those in the know would not give it a second thought.

Alternatives

GDP was never intended as a measure of welfare, but it has come to be used that way almost by default. Most economists, investors and politicians, whether left or right, seem completely unmoved by GDP's shortcomings. They consider irrelevant arguments that point out its failings. But the truth is that supporting the GDP indicator is a bad habit, nourished by the uncritical treatment of GDP information in economics courses and in the media.

Most economists believe that we should not abandon GDP until a suitable alternative has been identified. Some proposed alternatives represent a considerable improvement as indicators of social welfare, but none of them is perfect. However, regardless of the availability of a credible alternative, if the use of any indicator represents a serious information failure, as is the case with GDP, this practice should be altered as soon as possible.

Macroeconomists in particular, and development economists to a lesser extent, seem reluctant to abandon GDP. They cling to it almost instinctively and dogmatically. It seems that GDP information is so central to their training and work that it is emotionally difficult for them to criticize or detach themselves from it. To do so would be tantamount to questioning the relevance of their own studies and publications, and perhaps even the relevance of the broader field of economic research.

There are many other economists and non-economists, however, who are much more willing to take GDP information with a grain of salt in light of its many shortcomings. Macroeconomists need to adopt a more critical and honest attitude. They need to seriously consider whether the current body of macroeconomic knowledge really justifies assigning any kind of normative role to GDP. If not, there is only one course of action. Drop the habit. Ignore GDP as a measure of social welfare. ■

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