Gross domestic product – is it misleading

Economics

GDP, which stands for Gross Domestic Product, is the most common abbreviation in economics. It has become widely used as a reference point for thehealthof national and global economies. No number is quite so central to public life as the gross domestic product. Political scientists build formulas around it to predict who will win the presidency. The stock market trembles at the approach of new quarterly figures. Other economic statistics, like budget deficits or health-care spending, are quoted as percentages of GDP. It has become the common measure of economic well-being.

But GDP’s broad dominion has long had its critics. It was never meant to be the measure of our well-being, but only the measure of our production—literally, the total value of the goods and services produced within the national borders in a given year. While the quest for some broader measure of progress has been going on for a while it may finally be gaining traction at a time when people understand, as never before, how easily GDP and well-being can diverge. There are many flaws and ways in which GDP, Gross Domestic Product, can mislead us in estimating the size of an economy.

It is also important to understand what GDP cannot tell us. GDP is not a measure of the overall standard of living or well-being of a country. Although changes in the output of goods and services per person (GDP per capita) are often used as a measure of whether the average citizen in a country is better or worse off, it does not capture things that may be deemed important to general well-being, such as the depletion of non-renewable natural resources. The first big way of misleading GDP is Environmental Degradation. Certain economic activities such asair pollutionadversely affect the real economic value ofenvironment.

A part of growth of many countries comes with a destruction of value. This value is not deducted from that growth. For example, if you create Rs 1000/- of chemicals, but in so doing you pollute a nearby river to the extent that future economic production associated with the river is reduced by Rs 500 (there will be less fishing, perhaps, or less agricultural production, or less usable water, or more health care costs), then the net value you created is 500, not Rs 1000, although of course you as the polluter might earn Rs 1000 today while the rest of the country loses Rs 500 over the future.

The value of environment degradation aggregated for a nation may be too big and there is no objective way to figure out how much of GDP should be reversed because of environmental degradation. But the result is that we are overestimating the country's GDP growth today and will underestimate GDP growth tomorrow. In other words environmental degradation simply causes us to take future growth and count it today. The second big flaw is " Misallocated Investment".

Mal-investment is when investment spending occurs (Investment spending adds to GDP), such as construction, but the investment is in poorly chosen assets that will not be needed later. For example, if you invest Rs 5000 today to create only Rs 4000 of value, you will show an increase in today's GDP that is lower than the reduction in tomorrow's GDP as you pay the capital cost of the investment. In that case if you really wanted GDP to account for changes in a country's wealth, your investment should have shown up as an actual reduction in today's GDP.

This means, once again, that you would overstate growth today and understate it tomorrow. Every country wastes investment, but some countries do it on a massive scale. An example closer to home of mal-investment would the large tracts of new housing construction built between 2000-2006 in the area around Yamuna Bank. At the time, the construction added to GDP as Investment spending (I). But much of the housing was never used or occupied due to fear of floods– we didn't need it and now have write it off as loss.

On the whole, economists argue that at least 1-2 percentage points of Chinese growth, perhaps even more, might consist of this kind of misallocated investment-driven growth. The third flaw is that the GDP it doesn't measure the quality and sustainability of economic development; it makes no distinction between unproductivemoneytransfers as opposed to wealth creating endeavours. A dollar spent at a blackjack table where money disappears like candy in an elementary school counts the same towards a nation's GDP as a dollar spent to maintain an oil refinery, school district or car manufacturing plant.

Money invested in the educational system or industry of a nation is much more beneficial to its economy than cash spent gambling, however the GDP does not measure this; instead all money transactions, regardless of economic usefulness is added to GDP. Consequently, GDP statistics have failed to register the US shift from a sophisticated world-leader in high-technologyproduction to a third-world exporter of raw resources and importer of a majority many of our finished manufactured goods.

One another flaw in considering GDP as the growth index is that a lot of growth these days occurs in Stock Market only. When we hear that GDP is going up we generally think that wages, jobs, the stock market, all go up in tandem. But in today's market it would appear that the only thing that had a significant rally is the stock market. More directly, profits in big investment banks have been soaring and this does skew GDP up but this key doesn't examine government transfer payments.

We could in fact make GDP soar by funnelling trillions more into the economy but all this would be diluted by inflation. So the GDP rises but the growth or the development does not happen. Hence the person does not experience any well-being. There is one another flip side in using GDP as the standard measure. Deceptive accounting by banks and governments has been seen recently. Banks are able to move things off balance sheets to get their profits up. So the GDP is bloated by fictitious numbers. Market prices don't affect what is really going on in the economy.

In the end GDP is a flawed and misleading economic indicator, one that is not the true measure of a country's economic health and yet most continue to use it as a barometer of our economic growth and progress. It should be discarded as it distorts the true condition of our economy. Already World Bank and other economic organisation are working on creating a better economic index. Even before 1990, the standard measure was not GDP, which focuses on what is produced in a country, it was the income received by the people in that country.