 FINANCE & ECONOMICS

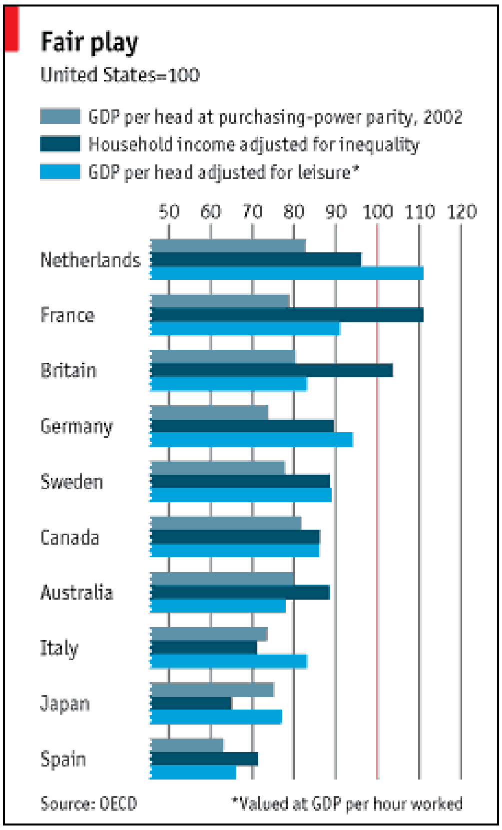
Measuring economies

Grossly distorted picture

Feb 9th 2006
From The Economist print edition

It's high time that economists looked at more than just GDP

THERE has been much hullabaloo about corporate accounting scams in America, yet perhaps the biggest accounting oversight of all time remains hidden in governments' own national figures. GDP per head is the most commonly used measure of a country's success, yet it is badly flawed as a guide to a nation's economic well-being. A new study in the OECD'S 2006 *Going for Growth* report considers some alternatives.



Economists spend much time discussing how to boost GDP growth. The OECD itself drew attention this week to the widening gap between America's and Europe's GDP per head. Yet a nation's well-being depends on many factors ignored by GDP, such as leisure time, income inequality and the quality of the environment. GDP was developed primarily as a planning tool to guide the huge production effort of the second world war. It was never intended to be the definitive yardstick of economic welfare. Would another indicator change the ranking of countries or their relative performance over time?

GDP is not even the best gauge of the monetary aspects of living standards. It measures the value of goods and services produced by the residents of a country. But some of the income earned in Britain, say, is paid to non-residents, while residents receive income from abroad. Adding net income from abroad to GDP gives us gross national income (GNI, also known as gross national product), which is more relevant for the prosperity of a nation.

Most countries' rank by GNI per head is similar to that by GDP. One exception is Ireland: its GDP per head is one of the highest in the OECD, but because of large net outflows of investment income, its GNI per head is merely around the OECD average. Its average GNI growth rate over the past decade has also been about one percentage point less than on a GDP basis.

Another flaw is that GDP makes no allowance for the depreciation of the capital stock. Subtracting this from GNI leaves net national income (NNI), which is probably the best national-account measure of welfare. Awkwardly, the numbers are harder to come by, making it difficult to compare across countries and over time.

But even NNI is an imperfect measure of people's welfare: it excludes the value of such important things as leisure, inequality and the environment. GDP should ideally be reduced to take account of pollution and the using-up of non-renewable resources, but no standard accounts that can do this are yet available.

On the other hand, the OECD has made a brave attempt to adjust GDP for the distribution of income. To most observers, a country where a few families enjoy huge wealth but most live in abject poverty would have a lower level of well-being than one with the same GDP but less poverty. A dollar of income is, in effect, worth more in the hands of the poor—though just how much more depends on attitudes towards inequality. The OECD's calculations suggest if people strongly dislike inequality, the gap between America and most other rich countries, which have a more equal distribution of income, should be greatly reduced (see chart). By this measure, adjusted income per head is higher in France than in America.

Imagestate

Boosting well-being, on a gross basis

Inequality has also risen in recent years in most countries. Assuming again a strong aversion to inequality, average adjusted income per head grew by only 0.6% a year in OECD countries between 1985 and 2002, against 1.4% for GDP per head. But such estimates are sensitive to big value judgments. If, instead, people care little about inequality, then the adjustment will be much smaller.

Longer holidays and shorter working hours increase an individual's well-being, yet conventional national accounts completely overlook such benefits. America is one of the world's richest countries, yet its workers toil longer hours than those elsewhere. As a result, adjusting GDP for leisure also narrows the gap between America and Europe. The OECD uses three different methods to place a value on leisure. Using the highest valuation (based on average GDP per hour worked), Germany's leisure-adjusted GDP per head is only 6% lower than America's, compared with a 26% shortfall in conventional GDP per head. Most European countries' leisure-adjusted GDP has grown faster than the standard measure over the past few decades, as hours worked have declined.

Europeans, don't relax

GDP is clearly not the best indicator of well-being, but the OECD concludes that for most purposes it is the best that is available on a timely basis. However, GDP needs to be complemented by other measures to give a fuller picture. The OECD takes comfort from the fact that most alternative measures yield similar international rankings to GDP per head. It is true that neither the adjustment for inequality nor that for leisure alone overturns America's economic superiority. However, if both adjustments were made, then on certain assumptions, the gap between the United States and several European countries could vanish.

This does not mean that Europe can afford to abandon economic reforms. Leisure time is valuable, but it will not pay for future pensions. Nevertheless, the OECD is to be congratulated for being the first mainstream organisation to challenge the conventional GDP numbers. Its task now is to encourage governments to start producing more relevant statistics.