Peter Burgess LinkedIn Blogs

New Improved Calculation of GDP

If you are interested in economic metrics at all, you are probably aware of the new improved reporting of GDP that is being introduced in the UK. The UK is going to include prostitution and drug dealing in the calculation of GDP!

It is rather depressing that this change has been headline news in the mainstream press, but we should not be surprised because it is about sex and drugs. However, when I decided to comment on this topic, I was surprised to learn that the UK Office of National Statistics (ONS) is making a total of seven significant changes to the way the GDP is calculated … not just one … but it is only the one about prostitution and drugs that has been covered in the headlines of the mainstream press. Surprise, surprise!

As a result of including prostitution and drug dealing, the UK GDP improves … that is become larger … by about $16 billion or about 3% of UK's GDP. The other changes to be made to the calculation of GDP relate to changes with:

- Non-Profit Institutions Serving Households (NPISH);
- Financial Intermediation Services Indirectly Measured (FISIM);
- Household expenditure on new cars;
- Own-account construction;
- Exhaustiveness adjustments;
- Gross Fixed Capital Formation (GFCF) methods improvements; and
- Change in Inventories methods improvements.

To be fair, prostitution and illegal drug dealing was the biggest number at $16 billion … but the others added up to $53 billion up and $14 billion down for all the others … which I would argue these numbers are also newsworthy. These are the results for 2009 using the new way of computing the numbers.

According to the ONS, the reason for the changes are to bring the UK statistics a bit more in line with the statistics of other countries in the European Union (EU).

I would argue that there are many other issues with respect to GDP that are worthy of discussion. As a measure of the economic health of a society, GDP is seriously flawed. This has been known for decades going back to Kuznets himself in the 1950s and Robert Kennedy in the 1960s. I am convinced that one of the reasons why GDP stays so widely used is that it suits the management class who are able to deliver better business performance more easily as GDP grows no matter what the impacts are on those issues that are ignored in the calculation of GDP.

There was a time when GDP was a reasonable proxy for quality of life and standard of living, but this changed around the 1970s when rapidly changing technology enabled improved productivity, and more consumption delivered more profits without adding very much to quality of living. At the same time more productivity enabled less payroll, and wages went down while profits went up.

Worse, a creative financial sector enabled aggregate buying power and therefore consumption to remain high even while the buying power of wages was declining. Financing of consumption became a big part of the economic activity of the modern economy, but this creative way of maintaining economic health has now run its course.

Up to a point more consumption is a good thing, but there is a point beyond which more consumption is waste. GDP does not capture the difference between consumption that is good for a person and consumption that is bad for a person. GDP does a poor job of measuring the performance of society and quality of life.

Good accountants think in terms of both balance sheet and the operating statement (P&L account). Some economists work with both stocks and flows. The media and the public work with simplistic economic headlines that do not help very much, and in turn these are used to form public opinion. It should be no surprise that the framing of policy is so dysfunctional.

There has to be a reason why capital markets are booming while people earning wages are stuck in the doldrums, struggling with low wages rates and all sorts of financing burdens whether it is student debt, credit card debt, car loans or home equity debt. The metrics that drive sentiment and drive capital markets are fundamentally flawed … and GDP growth is a big part of this set of metrics.

Worse, GDP growth and other metrics like corporate profits have no way to incorporate risk into the metric. Though risk may be difficult to measure, it is the effective management of risk that is going to be the difference between a society that survives and prospers and one that implodes. The Ken Burn's documentary 'The Dust Bowl' shows what can happen when short term profit takes over and risks are not understood and ignored. Are we repeating history? Surely there are better ways to do the metrics!

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