Column: Is GDP all it’s cracked up to be?

GDP is arguably the most sought after piece of empirical evidence with which economists and politicians form policy conclusions. But what exactly is it? And is it the best way to measure of market value?

WE’VE HEARD ABOUT it in the pub, read it in the paper or have seen it on the news. ‘GDP is down 0.7 per cent over the third quarter of last year or it’s up 0.2 per cent from the second quarter two years ago or it’s expected to rise or fall next quarter’ – we can’t escape it.

What is this yoke Enda Kenny and Angela Merkel keep raving about? I’m here to explain GDP for those who don’t have the foggiest notion and to offer a critique for those who understand it.

**What is it?**

Gross Domestic Product is defined by Rudiger Dornbusch as “the value of all final goods and services produced in a country within a given period” usually a year or a quarter. That may seem difficult but it’s relatively straightforward, there are four components to GDP:

1. Consumption or household spending on goods and services (C) examples are buying a bag of chips or getting a haircut.

2. Investment spending by households and businesses (I), for example a new house or a new factory.

3. Government spending on goods and services (G) eg teachers wages.

4. Net exports (NX) ie the difference between what we spend on foreign goods (import) and what foreigners spend on our goods (export).

**How do we calculate it?**

C+I+G+NX=Y

This is the algebraic equation of an economy’s Gross Domestic Product. What happens is the Central Statistics Office compile data on the consumption, investment and government spending as well as the imports and exports and they plug it into this equation.

In 2011 consumption was €81bn, investment was €16bn, government spending was €25bn and net exports were €35bn (Central Statistics Office). So we get 81+16+25+35= €157bn as our figure for GDP.

**Now we know what it is, what’s the big deal?**

This simplified view of an economy seems to cover all the bases; however, we must remember its importance. It’s one of, if not, the most sought after piece of empirical evidence with which economists and politicians form policy conclusions. Why is this? GDP is viewed as the biggest indicator of economic growth; this can have a huge bearing on policy changes by government.

Let’s say that GDP fell from €157bn to €155bn this year. “Well, how can we improve that?”, will be the cry of government. They can increase any component of GDP; the easiest way is to borrow money and increase government spending, as it is difficult to force consumers and businesses to spend but the government can do it freely provided it has access to loans. (Bear in mind I am not writing about the current conditions of markets in any country this is a purely hypothetical example)

**The elephant in the room (the fallacy)**

Let’s say we go with the policy of increased spending. We borrow, let’s say, €50bn from the foreign markets. The government will spend it on roads, bridges, construction or some other project on the premise of creating jobs and boosting GDP. That sounds fine; everyone looks to be a winner in this situation.

But what we are looking at is as the great French economist Frederic Bastiat identified “that which is seen” (the new roads or the increased labour force) we are ignoring “that which is unseen” (where is the government getting this money?). The taxpayer is paying for these projects and at a premium (interest must be paid on the borrowing) and how will we pay for it? Tax increases are likely.

The fallacy is that, in actual fact, it doesn’t matter what projects the government take on if its goal is just to boost GDP. It is misallocating resources – by which I mean if the sole purpose is to increase GDP, the government could employ some people to dig a hole and others to fill it in again and the effect on GDP would be the same as if it were to build a road: it rises and economic growth appears to have risen. Is there anyone who would call this prosperity or a better standard of living?

The tax money funding the loan is taken out of the economy which could be put to better use if left to private individuals through new business ventures, thus creating jobs without saddling the taxpayer with debt. My argument is that GDP should not be the judge and jury of the performance of the economy, as among other things it can be raised very easily. Instead, it should be taken with a pinch of salt and we must question the motives of government when they spend our money**.**

GDP may fall as a result of many factors that are not detrimental to the economy, such as an ageing workforce, or new technology that reduces costs of production which leads to lower prices of goods or getting cheaper alternatives from abroad, so we must be wary when GDP has fallen of being told we “must” fix it.

**An Irish perspective**

To put this into an Irish perspective, we are bound by the rules of the Troika and are restricted, but we are set to return to the markets soon, and politicians are talking about stimulating the economy so increasing spending will be back on the agenda.

A word of warning, in my opinion unemployment is the key factor and, yes, the government can increase employment through spending – but do you not think that the local businessman has a better idea of what consumers want than a government official spending money that is not his own?

American economist Henry Hazlitt explains that as a result of a government focused on increasing GDP, the local businessman cannot start his new venture, cannot employ new workers and we lose these jobs where the tax payer actually benefits.

Instead, in order for the government to pay people to undertake these new projects, they increase taxes to pay back the loan that they took out to boost GDP – and who gets saddled with the debt?

The taxpayer.