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It has widely been acknowledged that GDP is a misleading measure of human development. Discuss how the primacy that we give to GDP has affected economic policy.

1. Introduction

For much of the last century the Gross Domestic Product (GDP) of a nation and other measures of national income have often been regarded as the only indicators of a prosperous economy. This is as the GDP per capita of a nation is thought to directly reflect the living standards in the nation. This has led to governments pursuing GDP growth above all else in an effort to increase economic welfare in their country.

This primacy in policy however, has led to governments ignoring other indicators of economic well-being and human development in their country. In recent years many have recognised the limitations of such centric policy. In this essay I will examine the shortfalls of GDP and how this GDP centrism has affected economic policy.

2. GDP as a measure of living standards

The main reason for the primacy that we give to GDP is that GDP is seen as an effective measure of living standards. Yet, GDP only measures the economic activity of a country through market production. The problem has arisen in recent years when politicians or governments conflate this measure with a measure of economic living standards or even well-being. Using the wrong indicator has lead to governments making poor policy decisions and over or under estimating how well-off people are economically in a society.

Furthermore, GDP is not even an accurate aggregate of all the goods and services in an economy, as many are unaccounted for. Certain government provided goods or services for example may not be valued correctly. Value added to the economy by certain levels of unpaid care or domestic work, also go unrecorded. Moreover, most measures of GDP fail to measure the value added to the economy by the informal sector (or shadow economy). This also can lead to a massive under- or over- estimate of GDP in an economy, especially in developing nations. Secondly, valuable institutions and political freedoms are often ignored when aiming only for GDP growth. Finally, even when there are market prices given, these can frequently be inaccurate as they reflect the value to the individual rather than to society as a whole. This results in GDP not accounting for externalities that can be created by economic decisions. The effects of this can be seen in the levels of inequality in developed nations or the environmental damage that has occurred worldwide.

3. Government provision of goods and services

Essential goods and services that the government provides such as the police force or good quality health-care tend to be undervalued in GDP. This is as in most cases the cost of the public or merit goods is simply aggregated to the rest of GDP, despite the public good providing relatively much greater value than the price tag merely suggests, or vice versa. The provision of these goods and services, increase the net-welfare of society and add value of the economy as a whole. A government who focuses too much on GDP; therefore, may undervalue the importance of such goods and services and invest little into their provision. A lack of provision of goods such as health care and education can lead to less economic participation as well as less personal abundance; thereby, reducing the economic development and well-being of a nation (Sen, 2001).

4. Institutions and Political freedoms

Other less visible institutions are also essential for a well-functioning developed economy and society. For example legal institutions that keep checks and balances on the concentration of power in a country and also facilitate political freedoms (such as free speech and free elections) are necessary in ensuing the long-term political stability of a country, to avoid political turmoil and promote economic security. An economy with insufficient checks and balances on the separation of power is more exposed to sporadic changes in power and governance. These economies tend to suffer from political turmoil and uncertainty due to the frequent changes in leadership. This instability and uncertainty also disincentivizes foreign investment. Countries who do not do enough to provide sufficient political freedoms, on the other hand, are more likely to have disgruntled unhappy citizens, as the government is not incentivized to work in their best interests. Governments who are focused on GDP may be inclined to ignore the importance of such institutions and often point to successful autocratic governments when putting forward this view yet there is no evidence to suggest that increasing political freedoms harms growth (Bashir and Xu, 2019).

Another important institution that is often ignored in the pursuit of growth is an institution to protect the property rights of an individual. Hernando de Soto, for example argues that one of the reasons capitalism does not ‘seem to work’ in developed nations is due to poor management or protection of property rights. (De Soto, 2007). Large levels of bureaucracy can result in many extra-legal businesses (in the informal sector) that cannot raise funds by selling shares or getting low interest legal credit. They cannot declare limited liability or obtain insurance; thus, cannot protect themselves against risk. This decreases entrepreneurship. A nation such as Egypt where the informal sector is estimated to be worth up to 50% of the economy (EgyptToday, 2019) is a great example of the aforementioned. The government requires an individual who wishes to buy and legally register a lot on state-owned desert land to go through at least 77 bureaucratic procedures at 31 public and private agencies, taking up to 14 years to complete. De Soto argues that bureaucracy such as this can massively hinder economic development due to inefficiencies. A government, therefore, which does not take the informal sector into account or does not recognise the importance of such institutions, is likely to either ignore the problem or favour big MNC’s when selling local land. This could lead to poorer developed industries in the long run as well as economies with worse living standards and working conditions.

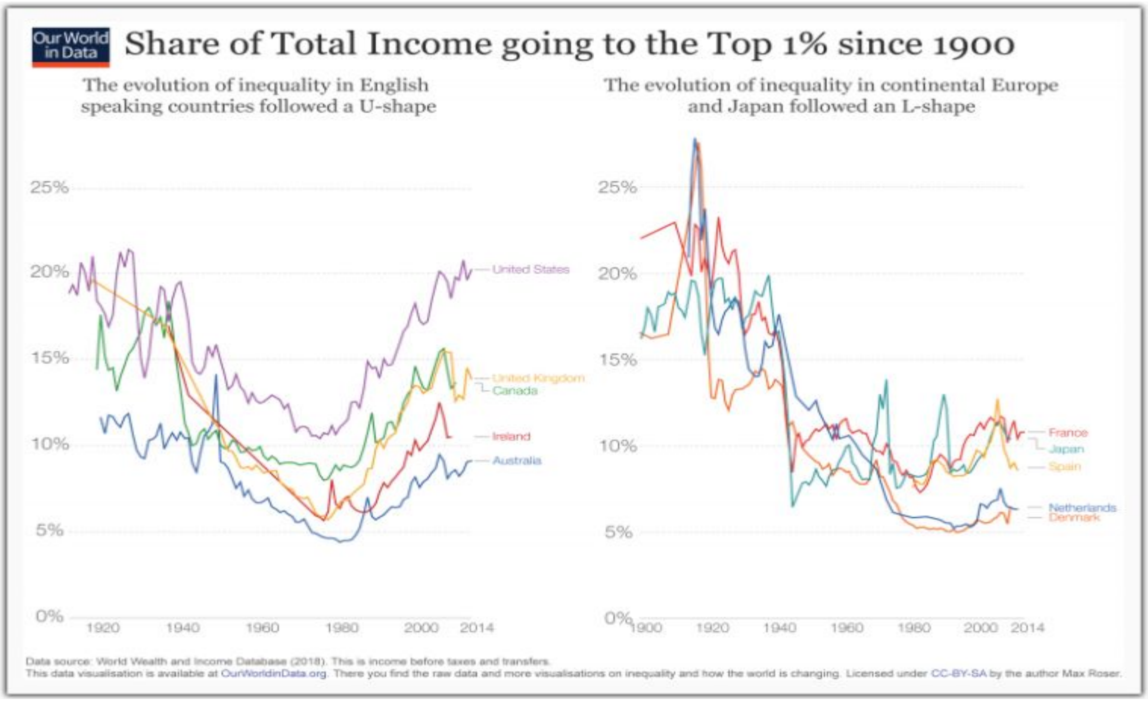
5. Unpaid labour and care

Another problem with GDP as a measure of development, is that it does not take into consideration the value added by unpaid for care or domestic work. Many great thinkers made invaluable discoveries under the unpaid care of another, which according to GDP has no value. Despite this domestic care gets no mention in GDP; ergo, its value to a country is ignored. As the author Katrine Marçal suggests Adam Smith could not even have developed his idea of the ‘invisible hand’ and the power of self-interest, if it were not for the support he received from his mother for most of his life (Marçal, 2016). It is clear that those who provide care such as this add a lot of value to society. Many people even take up the caring of their children or parents with glee despite the considerable loss of time and wages. One could therefore argue that it is in the best interest of society for the government to pursue policies that facilitate or reward the provision of this free care as people are more well-off after it. The problem of unrecorded work is best encapsulated in an awful joke often told by economists, which says that if you marry your car mechanic, GDP would fall. This is as a service you used to pay for is now free of charge and therefore not included in GDP, despite society receiving the same value from before (The Cut, 2019). A government focused on growth, might disincentive this sort of free care to encourage more economically active people, despite the good it brings the economy.

6. Inequality and Instability

One of the effects on economic policy of a myopic focus on GDP growth has been an increase in inequality in developed nations. A short-term focus on growth by developed nations like the United Kingdom, which has pursued 'trickle down' economic growth policies coupled with financial deregulation are the main causes of this (Frisby, 2018). A study by the OECD in 2011 found that "in the three decades to the recent economic downturn, wage gaps widened and household income inequality as measured by GINI increased in a large majority of OECD countries." This occurred despite sustained growth in the economy and employment of the countries (Oecd.org, 2014) and can be seen in figure 2.

Figure 2: Share of total income going to the top 1% since 1900 in some OECD countries (Roser and Ortiz-Ospina, 2013).



Growing rates of inequality are problematic as increasing inequality leads to more unhappiness in the general population (due to being comparably worse off); it increases crime (The Economist, 2018) and also leads to economic instability. As an economy becomes less equal in its distribution of wealth and income a smaller proportion of the population take most of the wealth. This can hinder economic growth as those who are wealthy have a smaller marginal propensity to consume, thus are more likely to save (Dynan, Skinner and Zeldes, 2004). Therefore, more money is taken out of the circular flow of income which results in less economic growth, as there is less production of goods and services. The economy also becomes less stable because consumer confidence is lower due to lower income or wealth. Thus, when a recession or a downturn hits, the economy is more susceptible as more of the population have lower confidence and so are likely to stop consuming quicker.

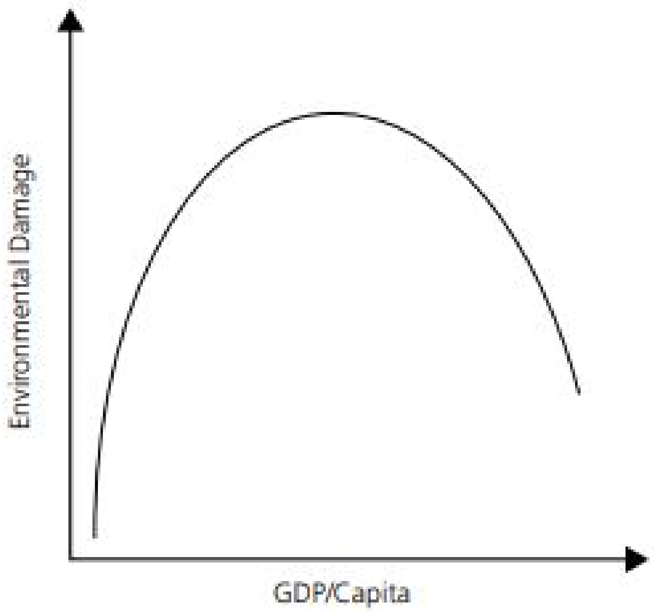
So in summary a policy focus on GDP growth can lead to a government ignoring the level of inequality in a country, considering it unimportant. This can have many negative ramifications for an economy in the long run making it less efficient as well as less stable.

7. Environmental degradation

Another policy implication of focusing on GDP is that it will in most cases lead to the degradation of large areas of the environment. This is as countries who are heavily reliant on natural resources as exports (developing nations), will gladly allow for their environment to be desegregated if living standards are rising. Take for example Ecuador, a country reliant on the export of agricultural products, a research paper (Alvarado and Toledo, 2017) actually found an inverse relationship between real GDP and vegetation cover in the nation. This demonstrates how in nations that rely on the exploitation of natural resources it would be near impossible to pursue a sustainable approach in protecting the environment whilst fixated on short-term GDP growth.

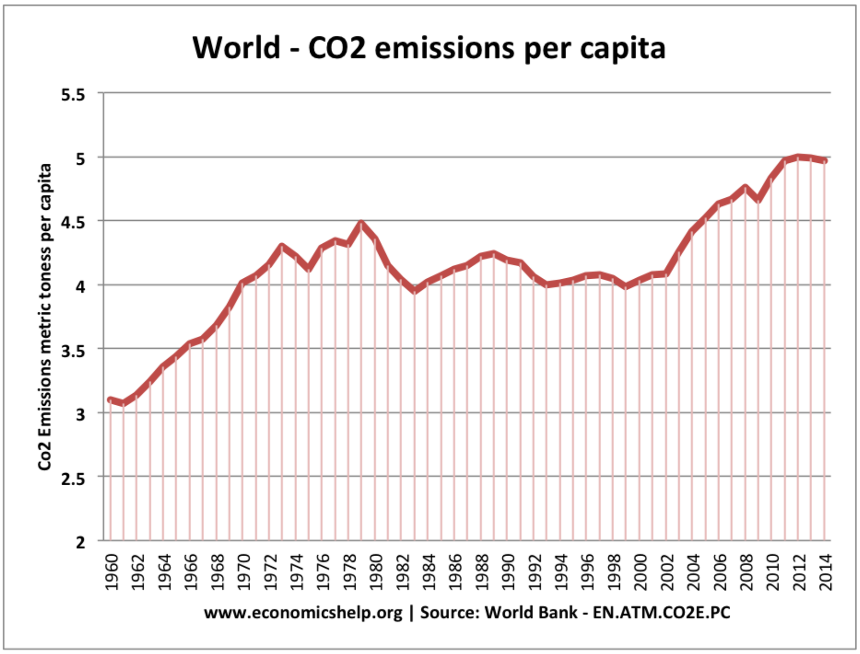
However, many argue that this is just a short-term problem affecting a few countries. Economic growth will only worsen the environment up to a certain point, they argue, as eventually the economy will reach a turning point where any growth will actually lead to a betterment of the environment. This is shown in figure 3. The logic behind the EKC is that at low incomes, pollution abatement is undesirable because people are better off using their income to meet basic needs, however, once a certain income threshold is reached they begin to consider the trade-off between environmental quality and consumption; thus pollution and environmental damage occurs at a slower rate. After this individuals become interested in improving environmental quality further and prefer it over more consumption; the quality of the environment starts to increase with growth.

Figure 3: Environmental Kuznets Curve (EKC) (Rubin et al., 2010)



Yet even if this theory were true it would require most of the nations in the world to reach this ‘post-industrial state’ in which consumers do not care for material goods. Most nations are developing at an ever-growing pace, however, and a focus on GDP by governments globally, will definitely lead to any increase in levels of environmental damage. This is represented in figure 4 by the rise in co_2 per capita worldwide.

Figure 4: World - CO_2 emissions per capita (Pettinger, 2019)



8. Conclusion

In conclusion, GDP is a misleading and incomplete measure of economic well-being and human development and government policy focus can be a detriment to society in many ways. A developing nation which focuses too much on GDP may fail to provide sufficient legal institutions and political freedoms to its populace. Developed nations may, on the other hand, in the pursuit of growth destabilise their economies in their pursuit of growth and result in a more fractured unequal society. All countries also risk damaging the environment in this over pursuit to an unsustainable degree and finally ignoring other more important indicators of well-being.

Word Count: 1,993 words (excluding titles, headings, graphs and references).

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