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What GDP doesn't tell us about our well-being

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By Louis D. Johnston | 11/02/11

REUTERS/Kevin Lamarque
Secretary of State Hillary Clinton inspects a GM "Spark" while touring the GM Powertrain plant in Tashkent, Uzbekistan in October.

The U.S. Department of Commerce reported last week that "real gross domestic product increased at an annual rate of 2.5 percent in the third quarter of 2011."

Many economists were raising the possibility that the U.S. was slipping into another recession, so the increase in GDP growth from 1.3 percent in the second quarter to 2.5 percent in the third quarter was welcome news. It probably bodes well for the Minnesota economy because state-level economic activity general follows the ups and downs of the U.S. economy. And real GDP growth and job growth are positively related, so the news means that the unemployment picture should brighten, albeit slowly.

But let's not get ahead of ourselves. Fresh employment numbers come out Friday, so we'll wait and see if there's good news. In the meantime, it's important to keep in mind what GDP measures — and what it doesn't.

Let's start with the definition of gross domestic product: GDP is the market value of all final goods and services produced within a country during a given period of time. By taking apart the definition, we can understand what counts and what doesn't in GDP.

Market value

"Market value" involves putting a dollar value on the goods and services produced. This is straightforward since we can identify the prices of the goods and the quantities sold in markets.

But what about goods and services not sold in markets? The Commerce Department does try to calculate the value of some of these goods by estimating the market price. Others, unfortunately, are excluded, among them cooking, cleaning and child care that are done at home. In fact, as more and more families purchase meals rather than cook for themselves, hire people to clean their homes, and send their children to formal day-care facilities, GDP will rise.

Does this reflect actual growth in the economy? It's not clear that it does.

Further, GDP includes only legally produced goods and services and excludes underground market exchanges.

Final goods and services

These are the end products of the production process, not the intermediate goods used to produce other goods. For instance, a pound of flour bought by a household and used to make bread at home is a final good since the flour is not used to create other goods sold in markets. On the other hand, when a bakery purchases a pound of flour this is not counted in GDP. Instead, the value of the bread produced by the bakery is included in GDP since the bread is the final product and the flour is used in the production of the bread.

Within a country during a given period of time

All production of final goods that takes place within a country's borders during a given time counts in that country's GDP. Toyotas built in 2011 the United States count in 2011 U.S. GDP, but 2011 Toyotas made in Japan count in Japan's 2011 GDP.

A big problem with the way we've defined GDP so far is this: It could rise solely because the prices of goods and services rise. Economists avoid this problem by calculating inflation-adjusted, or real, GDP. This involves choosing a set of prices for a starting year, say 2005, and then valuing each year's production using these prices. (The actual procedure, called chain-weighted GDP, is more complicated but harder to explain; a complete explanation is available here.) The resulting series squeezes out price changes and measures the economy's true production of goods and services.

What GDP doesn't measure

Real GDP is a measure of production in a market economy; it is not a measure of our well-being.

Sen. Robert F. Kennedy put it well: "It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials. It measures neither our wit nor our courage, neither our wisdom nor our learning, neither our compassion nor our devotion to our country, it measures everything in short, except that which makes life worthwhile. And it can tell us everything about America except why we are proud that we are Americans."

On the other hand, real GDP is correlated with many outcomes we value. For instance, when we look across countries we see that higher levels of real GDP per person are associated with greater literacy, decreased infant and maternal mortality, and longer life expectancy.

This relationship varies with income: When a country reaches a GDP per person of $20,000-$25,000 this correlation breaks down. Life expectancy is longer in many European countries even though they have lower levels of real GDP per person, for example.

So it's good that real GDP grew during the third quarter, but growth isn't everything.

Economists know this, and we need to do a better job of getting across this message.

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