Growing Pains: Strengths and limitations of Gross Domestic Product (GDP)

Gross Domestic Product (GDP) is an inherent part of the growth agenda. But many of us don't understand this metric, or what its strengths and weaknesses are. We urgently need to develop awareness about GDP: What is it? Why is it so important? And what are its limitations?

Key messages

- GDP was **never intended to be a measure of wellbeing or progress** – it was developed in the 1930s to fill gaps in information available about the state of the economy.
- There are many **things that GDP does not measure at all** which contribute significantly to our collective wellbeing, such as caring, domestic activities, and the natural environment.
- GDP does not take into account **current inequalities** nor the **long term impact** of actions, such as environmental impact.
- Focusing policy-making on the pursuit of increasing GDP and economic growth is to the detriment of other social, environmental and democratic priorities.
- Decisions which give everyone what they need to live a good life, now and into the future, should be made on more than GDP.

What is Gross Domestic Product?

GDP is the sum of everything spent by **consumers, businesses and the government** within a country within a year (plus exports, minus imports) with two important caveats:

- It only counts **finished goods and services**: these are goods and services that will not be sold again as part of another product.
- It only counts **goods produced**: it counts new things that have been produced, not all goods that are sold.

Where did Gross Domestic Product come from?

GDP was designed in the 1930s to provide information about the impact of the Great Depression in the USA and subsequently how much money could be raised for fighting the Second World War.

Over time, **GDP has become the most important number in the world:**

- It is embedded in domestic and international structures: GDP is the basis for government loan eligibility as well as within-country accounting.
- It provides useful economic information, helping governments to justify public spending on interventions and infrastructure that contribute to GDP growth.
- The core political narrative of the late 20th Century was 'Growth is Good': economic growth has contributed to increases in living standards for many since the end of the Second World War and funded public investment in social goods
- It has communications power: it is one figure that signals improvement, the faster and higher it grows the better things are.

While other statistics can be debated and brushed off, the cumulative effect of these factors is that increases and decreases in GDP create the core narrative around which governments operate.

Limitations of GDP

Criticisms have been levelled for as long as GDP has been calculated. Many of these stem from the fact that GDP is often used as a proxy for things that it does not represent.

- **GDP isn't a measure of assets**: it is a measure of spending, not of wealth, and does not fully reflect the assets of a country (including both financial assets but also natural, human and social assets).
- **GDP isn't objective**: though represented as objective fact, GDP includes a number of value judgements, for example the exclusion of unpaid care and inclusion of illegal activity.
- **GDP creates perverse incentives**: an increase in GDP doesn't necessarily mean an increase in anything valuable - if we pay people to dig holes and fill them in again, GDP will go up.
- **GDP doesn't automatically mean we can afford more public spending**: an increase in GDP doesn't translate directly into an increase in taxable goods and services - illegal activity is counted towards GDP, but it doesn't bring in tax revenue.
- **GDP includes the profits gained from, but not the cost of, environmental damage**: Measuring economic activity using GDP incentivises environmentally damaging practices like fossil fuel extraction, rather than more sustainable development.

There are also a **number of things that GDP does not measure at all** which contribute significantly to how we live:

- **Non-financial activities:** such as the power of our communities, our trust in institutions and governments and other types of social capital. It does not include caring or domestic activities carried out within the family.
- **Economic inequality**: GDP does not tell us anything about how resources are distributed within countries. GDP growth can reflect concentration of wealth for the richest in society while median income does not increase or even decreases in real terms.

- **Future assets**: GDP does not calculate the costs of goods in terms of the 'drawing down' of future wealth: natural, social, human or financial. So, for example, higher GDP could be driven by higher personal debt.
- **Costs of externalities**: GDP does not measure costs to society caused by activities that generate GDP, like the contribution of increased pollution to poor health outcomes.

Summary

At Carnegie UK, we believe that focusing on the economic output of the UK should not be done at the expense of other aspects of economic wellbeing (like the quality of jobs and decent incomes) or other social, environmental, and democratic priorities.

Too often the GDP debate is seen as binary - you are either for or against. But there is no reason that the indicator used for government loan agreements needs to be the same one that we use within the UK to set the political narrative on social progress.

To tackle this, we recommend:

- International action to amend the UN System of National Accounts to provide a means for accounting for the environmental and social harms associated with pursuing economic output at all costs.
- UK action - from all spheres of UK Government - to develop new measures of social progress that allow us to measure whether things here are getting better over time.
- Civil society and academia need to work together to make the case to the UK Government to carry out a broader review of how economic and non-economic measures are used in budget setting and policy-making within the UK.

We will continue our own work in this field, with plans to relaunch our Gross Domestic Wellbeing index in 2023.

Acknowledgement

This briefing was developed following a detailed review of literature carried out for Carnegie UK by Dr Cressida Gaukroger. The full literature review will be published soon.

More information

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