

## Limitations of GDP



# Assessment Objectives

<b>Specific Expectations</b>	
1.B	Define the limitations of GDP.

# Evaluating national income statistics

- **National income statistics** are statistical data used to measure national income and output and other measures of economic performance.
- GDP is a useful indicator of nation's economic performance. It is widely used by economists, politicians, policy-makers, and the media.
  - ▶ GDP allows for the comparison of relative size of different economies.
  - ▶ Dividing GDP by the population results in GDP per capita. This figure tells use how many good and services the average person consumes.
  - ▶ Does not accurately measure the “true” value of output produced.
  - ▶ Economic well-being is closely related to a variety of factors that GDP and GNI are unable to account for.
  - ▶ Per capita figures of GDP and GNI may be misleading when used to make comparisons over time or comparisons between countries.

# Limitations of GDP & GNI

- GDP is a useful measure for means of international comparisons of average incomes. However, GDP does have limitations:

## 1. GDP and GNI do not include non-marketed output

- ▶ Does not include labour of home-makers and value added to an asset by volunteer work in the community or elsewhere.
- ▶ Non-marketed output is likely to be far greater in developing countries compared to more developed ones.

## 2. GDP and GNI do not include output sold in the underground (parallel) markets.

- ▶ “Underground markets” (also known as “parallel” or an “informal market”) exist where buying/selling transaction are unrecorded.
- ▶ Black market transactions are not included in GDP.
- ▶ Some economies have large informal sectors in which transaction are not reported in order to evade taxes.

# Limitations of GDP & GNI (Continued)

## 3. **GDP & GNI do not account for quality improvements in goods**

- ▶ While a country's GDP increases, the living standards of its households could increase by even more if the quality of the country's output is improving faster than its GDP increases.
- ▶ Technological advances often permit improved products to be sold at lower prices.

## 4. **GDP and GNI do not account for the value of negative externalities, such as pollution, toxic wastes and other undesirable by-products of production.**

- ▶ High GDP may be accompanied by environmental degradation, which may diminish the quality of life while increasing incomes.

## 5. **GDP and GNI do not take into account the depletion of natural resources**

- ▶ The depletion of natural resources (rainforests, wildlife, agricultural soil, etc.)

# Limitations of GDP & GNI (Continued)

## 6. GDP and GNI and differing domestic price levels.

- ▶ Goods and services often sell for very different prices in different countries.
- ▶ If international comparisons of GDP do not account for differing price levels across countries, the result is a highly misleading picture of standard of living in different countries.
- ▶ Conversion to a single common currency by using **purchasing power parities** to take into consideration differing price levels allows for international comparisons.

## 7. GDP and GNI make no distinction about the composition of output

- ▶ The GDP figure will not distinguish between “good” output and “bad” output, limiting its effectiveness for communicating information about social welfare.
- ▶ GDP and GNI include the value of all without any distinction about the degree to which they contribute to standard of living.

# Limitations of GDP & GNI (Continued)

## 8. **GDP and GNI cannot reflect achievements in levels of education, health, and life-expectancy.**

- ▶ Countries may achieve higher or lower levels of health and education with a given amount of GDP/GNI per capita
- ▶ Increased life expectancy (the number of years one can expect to live, on average) is another benefit of technological improvements, improved health and higher income levels, but not accounted for in GDP and GNI figures.

## 9. **GDP and GNI provide no information on the distribution of income and output.**

- ▶ How equally or unequally income and output are distributed is another factor underlying society's well-being.
- ▶ Measures of GDP and GNI per capita only provide an indication of average output or average income per person.

# Limitations of GDP & GNI (Continued)

## 10. **GDP and GNI do not take into account increased leisure.**

- ▶ In many countries around the world the average number of hours worked per week has declined significantly, with the number of hours of leisure correspondingly increasing.

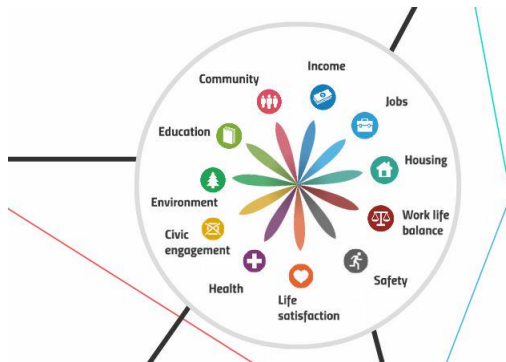
## 11. **GDP and GNI do not account for quality of life factors.**

- ▶ Ignores all social aspects of human life including income distribution, access to healthcare and education, life expectancy, gender equality, religious freedom, and human rights.



# Alternatives measures of well-being

- Several alternative measures have been developed that try to capture more factors that affect well-being and quality of life.
1. **OECD Better Life Index:** an alternative measure of standard national income accounting that measures economic-well being in a number of different dimensions that take into account quality of life.



# Alternatives measures of well-being (Continued)

2. **Happiness Index:** an alternative method to national income accounting that measures economic well-being using numerous quality of life dimensions in addition to real GDP per capita.
  - ▶ Real GDP per capita
  - ▶ Social support
  - ▶ Healthy life expectancy
  - ▶ Freedom to make life choices
  - ▶ Perceptions of corruption
3. **Happy Planet Index (HPI):** an alternative method to standard national income accounting that takes into account environmental sustainability and inequalities.
  - ▶ It is a measure of sustainable well-being based on four dimensions, life expectancy, well-being, inequality of outcomes, ecological footprint.
  - ▶ **Life expectancy** – is the average number of years a person expects to live, based on United Nations data.

# Alternatives measures of well-being (Continued)

- ▶ **Well-being** – is taken to be a population's satisfaction measured by data collected by the Gallup World poll
- ▶ **Inequality of outcomes** – refers to inequalities between people with regard to life expectancy and well-being.
- ▶ **Ecological footprint** – is the impact on the environment of each individual in a society on average. The higher the ecological footprint, the lower the HPI.
- ▶ The HPI is calculated for 140 – 150 countries, depending on data availability. Each country receives a score from 0 to 100.

$$\text{Happy Planet Index (HPI)} = \frac{\text{Life expectancy} \times \text{Well-being} \times \text{Inequality of outcomes}}{\text{Ecological footprint}}$$

# Summary

- **Enduring Understanding**

- ▶ An economy's performance can be measured by different indicators such as gross domestic product (GDP), the inflation rate, and the unemployment rate.

- **Essential Knowledge**

- ▶ GDP is a useful indicator of a nation's economic performance, but it has some limitations, such as failing to account for non-market transactions.