Good and bad GDP: Output fall in transition economies and the dead rat effect

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The Worker and Kolkhoz Woman, Moscow. Photo credit: Bigstock, filin72,

Good jokes should be funny, but more importantly, should carry a message. The following is one of the most famous jokes in economics, and helps to comprehend the important economic controversy over GDP:

Two economic professors – one seasoned, another young – had exhausted all topics for conversation while walking over a deserted road. The older one sees a dead rat on the road and makes an offer to his young colleague: “if you eat it, he says, I’ll pay you $10,000”. The younger professor makes a quick cost-benefit analysis, figures that he is better off with $10,000 than without and eats the rat. As they walk further, the young professor suffers from the bad aftertaste and wants his senior colleague to experience the same. When he sees another dead rat on the road, he dares his older colleague to eat it, promising to pay him back the $10,000. The senior professor decides to get his back money and eats the rat.

After several more hours of walking in silence and experiencing the bad aftertaste, the younger professor finally speaks his mind: “Well, it looks like we were eating dead rats for free”! The older professor replies, “yes, my young colleague, but do not forget that the GDP increased by $20,000 dollars”.

So, did the GDP really increase? Some would say that this example fits the definition of GDP precisely – new goods and services produced and sold on the market. In this case a rat-eating performance for the benefit of the viewer. If taxes were paid from these two transactions, it is an increase in official GDP, if not – an increase in output of the shadow economy (unofficial GDP). Others would say that it is foolish to include these types of transactions into the calculation of GDP.

Do not rush to conclusions, though. Consider the real debates that are going on today. In the recent Report of the Club of Rome (2017) the authors point out ‘the paradoxical cases’: GDP increase due to oil spills because there is spending associated with the clean up, GDP increase due to diseases, disasters, and accidents, even though these events evidently reduce the welfare of the populous.

About two decades ago this argument was applied to the case of the ‘transformational recession’: a deep and protracted decline in output that occurred in the 1990s during the transition from a centrally planned economy to market economy in former communist countries. This decline was unprecedented in peacetime history; the recession lasted for several years and output fell by more than 50% in some countries. The popular explanation at a time was that there was a reduction of ‘redundant output’, such as tanks or statues of Lenin, which did not affect the real welfare. If this redundant output is excluded from GDP, there was no decline at all.

Åslund (2001) argued that the actual decline in output has been much smaller than perceived. “Socialism”, he wrote, “was a system of waste. Soviet production usually needed three times more inputs than a Western factory since costs were irrelevant to managers. Some of these losses represented inefficiency, others theft ... The investment that was sheer waste should preferably be deducted from GDP”.

He also claimed that the fall in output during the transformational recession was “a myth” in part due to the unusually high share of defense spending in many socialist countries (about 15% to 17% of GDP in the USSR in the 1980s) and the reduction of this share afterwards. After the transition period this share fell to an “internationally normal level of about 3 percent of GDP. So, he suggested to deduct 10% of GDP from the statistically recorded output loss during the transformational recession (Åslund 2001, p. 11).

Gaddy and Ickes (2001) insisted that “we need to know whether measured GDP is accurately reflecting true value produced in the economy” and that “value added can rise in the economy even as domestic consumption, investment, and standards of living appear to decline”. They also made an argument that a fall in output caused by a reduction of defense expenditure is in fact a welfare gain: “This is an output fall, but welfare is certainly higher with lower defense production given that the CPSU [Communist Party of the Soviet Union] is no longer the measure of value”.

Today GDP as a measure of economic and social progress is criticised by virtually everyone on many grounds: it does not take into account other dimensions of development (education, health, crime, inequality, human rights, etc.), it does not capture the depletion of resources and damage to the environment that needs to be compensated to ensure sustainable development. This criticism is often constructive and leads to the development of other indicators of economic and social progress that are increasingly accepted in research and the statistical practices of national governments and international organisations. Examples include the Human Development Index, computed since 1990 by UNDP, and the Genuine Progress Indicator developed by researchers and certain national and regional governments.

But the attempts to exclude some economic activities from a country’s GDP are counterproductive. Unfortunately, we cannot agree on what type of economic activity is good for welfare and what type is bad. Statues of Lenin that were produced in the former Soviet Union are regarded as value subtraction by some, but as value added by others. Communist memorabilia and weapons designed and produced during the Soviet period turned out to be among the few internationally competitive goods of new independent states and clearly have market value.

If we start to exclude particular economic activities when calculating GDP, it would be impossible to determine the criteria for what to include or exclude. Defence spending was always counted as part of GDP, no matter whether the country was an aggressor or a victim. The share of defence expenditure included the GDP of the US was 40% in 1945 (World War II), 15% in 1953 (Korean War) and 10% in 1968 (Vietnam War). Shall we exclude the ‘excess’ over “the internationally normal level of about 3 percent of GDP” (Åslund 2001) from total output or shall we accept the newly recommended threshold of 2% of GDP for NATO countries?

What about the slave trade that created a considerable portion of GDP in many countries? And what about the ‘whites only’ or ‘coloured’ signs that were still produced in the US during the segregation era just over 50 years ago, and in South Africa – just 30 years ago? And the public burnings during the Inquisition, the electrical chairs and the injections of ‘sweet death’ used in countries that still exercise capital punishments?

Some would have a problem recognising activities of clerics and fortune-tellers as value adding, others would question whether criminal activities create value in the shadow economy (even more so that drugs, prostitution, pornography, and other similar activities are legal in some countries, but not in others).

In short, it is impossible to agree on ‘good’ and ‘bad’ activities, so the economic definition of GDP avoids this issue by counting all activities, good and bad, as GDP creation. This approach has an important economic rationale. GDP is the measurement of production capacity, or economic potential of the country; it allows for the evaluation of the ability of a nation to produce a particular amount of goods and services.

If a country produces all the ‘bad’ goods, like opium and armaments, valued at $1 billion, this is quite informative. It actually tells us that with the same amount of capital, land, labour, and levels of technology, it can produce roughly the same amount of ‘good’ outputs, like food and machinery. It will take some time and effort to carry out the conversion of ‘bad’ production activities into ‘good’ ones, and there is likely to be a transformational recession during this transition, but eventually the country will restore its previous level of output.

Evaluation of GDP, no matter what goods and services a country produces, makes a lot of sense because it can tell you how the country will perform internationally. Higher GDP per capita may not bring more happiness or justice, but it leads to a greater economic competitiveness. Countries with higher GDPs per capita are more competitive in the short run and can drive other countries out of business (make them economically bankrupt). The result is that countries with greater justice and happiness (and higher life expectancy, literacy, better ecology and environment, lower crime, better use of resources, etc.) will disappear in economic competition with the irresponsible countries that care only about GDP.

To make a comparison, imagine a pedestrian crossing an intersection on a green light and being hit by a truck that passed on a red light, breaking the law. The moral and legal rights are with the pedestrian of course, but the truck driver is the one who survives the accident. If there is rule of law the truck driver is jailed. But in the international arena there is still no authority (world government) that could punish rich, but immoral countries, not to mention protecting the poor and weak, but morally superior countries from disappearing in the competitive struggle.

Of course, in the 21st century we should hope that we could limit the ruinous consequences of economic competition and ensure that the survival and development of societies and civilisations is not determined by their economic, political, and military might. But unfortunately GDP and GDP per capita do matter a great deal at the moment.

References

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