

SECTION 6.5 PROBLEMS WITH GDP AS A MEASURE OF ECONOMIC WELFARE

- n Real GDP is often used as a measure of the economic welfare of a nation. What it actually measures is the value of output that is exchanged in market transactions. As a result, the accuracy of real GDP as a measure of welfare is questionable. Several important factors are excluded from real GDP, including nonmarket transactions, the underground economy, leisure, externalities, and the quality of goods purchased.
- n **Nonmarket transactions** include the provision of goods and services outside of traditional markets for which no money is exchanged. We simply do not have information on this output that is reliable enough to include it in the GDP. The most important nonmarket transaction omitted from GDP are services provided directly in the home. (One example is that a woman marrying her tax accountant causes reported GDP to fall, although output does not change.) In less-developed countries, where a significant amount of food and clothing output is produced in the home, the failure to include nonmarket economic activity in GDP is a serious deficiency.
- n It is impossible to know for sure the magnitude of the **underground economy**, which includes unreported income from both legal and illegal sources. The reason these activities are excluded results from the fact that most payments made for these services are not reported to governmental authorities or go through normal credit channels. The estimates of the size of Canada's underground economy vary from less than 5 percent to more than 15 percent of GDP, with a good portion of this unreported income from legal sources, such as self-employment.
- n The value that individuals place on leisure is omitted in calculating GDP. This omission in GDP can be fairly significant in international comparisons, or when one looks at one nation over time, because the amount of work and leisure varies considerably, usually falling with rising GDP.
- n Positive and negative externalities can result from the production of some goods and services. As a result of these externalities, the equilibrium prices of these goods and services—the figure used in GDP calculations—does not reflect their true values to society (unless, of course, the externality has been internalized). GDP does not decrease to reflect pollution resulting from production, or increase to reflect external benefits to others in society. While GDP measures the goods and services that are produced, it does not adequately measure the “goods” and “bads” that result from production processes.
- n GDP can also miss important changes in the quality of goods and services.

Debate - *Should the Government Worry About the Underground Economy?*