The Fallacies of GDP
Guests: Mark Skousen and Jeffrey Herbener
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Mark Skousen is an economist, investment analyst, newsletter editor, college professor, and the author of over 25 books. Jeffrey Herbener is chairman of the department of economics at Grove City College.

[This program ran while I was on vacation. I combined a portion of my interview with Mark Skousen on the Peter Schiff Show with a video I did with Professor Herbener, who teaches economics at my Liberty Classroom.]

WOODS: You know, the first time you and I met I brought you my copy of *The Structure of Production*. I told you I thought it was the most important thing you'd ever done, and now it's like I am being vindicated here, because it turns out that—

SKOUSEN: (laughs) 25 years later, Tom. (laughs)

WOODS: That's right. It was a lonely title. It was the one you probably got the fewest autograph requests for. But now it's really the foundation of a very important development over at the Bureau of Economic Analysis. I am going to throw it over to you to explain what's going on.

SKOUSEN: Yeah, in fact, today is the day that the Bureau of Economic Analysis, which is this federal agency under U.S. Commerce that puts out the GDP statistics and other national statistics and regional state statistics and so forth. They are the official group that does this. And I was just delighted to find out just a few months ago that the BEA got the budget to put out a statistic which I think is a better statistic on what's really happening in the economy, called gross output. It's an effort to measure spending at all stages of production, which is an Austrian concept I developed in *The Structure of Production*. I came up with the idea that this is a better indicator because unfortunately GDP, while it's a measure of welfare, of general standard of living, if you will, it suggests that the consumer spending and government spending are the real key indicators because they are the largest part of GDP. A lot of people have probably heard this idea that since consumer spending represents 70% of GDP, therefore, the consumer drives the economy. And the second biggest sector is government spending, about 20% of GDP. And then business investment is a poor third, so business is relatively unimportant according to this model. This is really kind of a Keynesian model that the consumer needs to go into debt. He needs to go out and just keep spending, and spending, and spending, and this is the only way that we're going to stimulate the economy. It's an ole Keynesian notion, and it's completely false. When you measure gross output—and I wrote about this; I got the lead editorial in the *Wall Street Journal* on Wednesday, which I hear people kill to get. So it was really nice to see their support.

So basically I demonstrated with gross output that consumer spending is really 30 to 40% of the economy, while business investment is over 50%. So it's the biggest sector, and we need to encourage the supply side of the economy to really encourage corporations and companies to produce goods and services rather than the consumer just sitting there responding and spending money. So saving, the gross output, this new statistic which I have argued for 25 years needs to be there, is now coming out every quarter, starting today. Every quarter the government will issue a gross output statistic, and it just was released today. It showed only a 1.1% increase in the fourth quarter, substantially less than GDP, and that suggests that the economy remains very sluggish. It's an important indicator that I use in my *Forecasts and Strategies* newsletter. I take this as a personal triumph and a triumph of supply-side Austrian economics that the government, of all people, is finally adopting a Hayekian/Austrian statistic that can help guide us as to where the economy is headed.

WOODS: Mark, to help make this clearer for the layman, let's talk about what we mean by the term the "structure of production," what we mean by stages of production, and then talk about which parts of that structure are left out of GDP.

SKOUSEN: Yes, so the structure of production, the stages of production, refers to the fact that every product, if you look at the shoes that you're wearing, the glasses you're wearing, your cellphone that you might be looking at while you're listening to this program. All of that went through various stages of production. Raw commodities were transformed in the production process, and then it was distributed through wholesalers, and then it ended up in a store, in a showroom, and there you buy that final product. So GDP, what it does is measure just the final product. It's what you bought in the store. It does not count any of the money that was put in the company that moved that product along the final stages, to the final stage or production. So GDP, which is about $17 trillion right now, represents the value of all goods and services that are completed, that are finished. Gross output, which is a measure of spending at all of the stages of production, is about a little over $30 trillion according to today's statistic. So that's almost double GDP. So if you can see it as a structure, the stages of production that keeps getting bigger over time, that's what we're talking about. So GDP leaves out all the intermediate stages and just measures the final stage, and so that's why consumer spending is overvalued while business investment is undervalued in GDP, and what gross output does is it restores that balance.

WOODS: So by leaving out all of these stages, GDP, as you said, gives us a misleading picture of the economy. But of course, the key thing here is without these intermediate stages, without the gross saving that goes in to maintain these stages, there is no structure of production. There is no economy. This is absolutely fundamental, but they excuse this by saying it would be so-called "double counting" to include all these intermediate stages.

SKOUSEN: That's a common criticism. That it's double counting, and double counting should not be included in final output, and they are right. It shouldn't be included with final output. But double counting does count. In other words, as you say, gross savings. This represents capital investment that people with money—think about it if you run a company. Can you run a company with just enough money for the profits of the company? No, you need to raise the capital. You're going to have to borrow money from the bank or you have to use your own capital to buy the supplies to pay the workers, to pay the rent, to pay your taxes, and that's a gross figure. So it does matter. This is economic activity, and we're trying to measure that with gross output, and it's an extremely important issue. Now, there has been criticism that—well, what about accountants who play games, and what if you suddenly merge with another company, doesn't that reduce output? So there—it's not a perfect way of measuring the economic activity, but I think from quarter to quarter, from year to year, it's a really good indicator, and let me just give you an example.

In 2008 into 2009, we all know that was the Great Recession. Well, nominal GDP declined 2%. It declined 2%. It didn't demonstrate at all how severe this recession was, because consumers tended to continue to spend. Government spending went up during that time period, and then business investment was the only thing that really collapsed. So GDP, if you look at that statistic, you say oh, no big deal. It wasn't much of a recession at all. It only fell 2%. But if you look at gross output, it dropped 8 to 9%. It was a much better indicator of how severe the great recession was and that included government spending and so on. It just shows you how big the business sector is and how the business sector really did cut back on spending during the Great Recession. Now, since then the gross output has actually grown faster than GDP. So there's a lot going on that suggests the robustness of the economy, but I will tell you in the fourth quarter that was just announced today, gross output was up only 1.1%, and that indicates a very tepid, sluggish recovery, and it almost suggests we could be going back into recession if the Fed doesn't keep pumping more and more money into this system to try to prop it up.

Now we shift to a discussion with Professor Jeff Herbener.

WOODS: Let's start, Jeff, with just explaining what GDP is. What's the definition?

HERBENER: GDP is the dollar value of all the final goods produced in the economy. So it includes all consumer goods that consumers buy. It includes all the capital capacity the businessmen buy, so-called investment expenditures, and then all of the government expenditures on goods and services.

WOODS: Okay, now is there anything wrong with GDP? Does it give us a misleading picture, and if so, how?

HERBENER: Well, there's nothing wrong *per se* with it. All aggregate measures have some drawbacks and have to be understood with some grain of salt. You can't explain everything with these things. But it's a useful statistic for telling us the extent to which we have a production of final goods. One of the main problems with it is trying to ascertain how much of changes in GDP are based just on the prices of goods and how much on the production, the amount of goods that have been produced. So that tends to be the real problem.

WOODS: But isn't there some way of correcting for price changes to make sure?

HERBENER: Yeah, but there's no perfect way to do this. We can construct all sorts of different price indices and do the adjustment, and we get different answers, obviously, depending on what goods we put into the market basket that we use to calculate the price index.

WOODS: But isn't the fact that government expenditures are just lumped in with the GDP, isn't that a source of difficulties for people conceptually to understand, for example, how well an economy is doing, when there might be good reason to think that government expenditures are not actually a net plus to consumer welfare, right?

HERBENER: Yeah, that's right. So if we take GDP to refer to standard of living, which is what we tend to do, well, then we start to get big problems, right? And the biggest problem is, as you say, we lump together private expenditures that have obviously satisfied our preferences as indicated by a voluntary purchase. With government expenditures, of course, we're totally disconnected from our preferences, and even the expenditures are totally disconnected from the voluntary nature of the exchange, and so even if government officials want these things that they are buying, the amounts that they pay are all inflated and not market determined, and so that's correct. So what we need to do to get some better indication of standards of living is net out government expenditures, and then we would just have private goods produced for the private parties who are voluntarily purchasing these things. There's been some work done on this. So it is useful as long as we realize what meaning we're attaching to it, and then how we should adjust it to capture that meaning.

WOODS: Now, what did Murray Rothbard do with this? He came up with a concept of Private Product Remaining, which he thought was superior. What is that all about? What is Private Product Remaining, and how do you arrive at it?

HERBENER: Well, basically this is what you do. We add up all the GDP, and we net out the government expenditures and this gives us Private Product Remaining. We can do this in different ways, but that's the basic calculation.

WOODS: Now why—this may seem like an easy question, but why do you net out the government spending? After all, spending is spending, right? It puts people to work. It puts money in people's pockets. Why would you think that government spending would be a minus or would not be a net addition to human welfare?

HERBENER: Well, it's that we can't tell, because the only way we can tell whether something is a net addition to human welfare is through voluntary purchase, and so if the government raises taxes from the rest of it and then just spends the money that they've raised in this fashion, then we're not really sure.

WOODS: Right, because we didn't consent to the spending.

HERBENER: Exactly.

WOODS: And we didn't make a decision what to spend it on, how much to spend. There's no way to know that we actually wanted the thing.

HERBENER: That's correct.

WOODS: Yeah, and sending out questionnaires doesn't—

HERBENER: It doesn't help with it because what we're trying to do is calculate this by money demands, by our demands as we express our preferences in the market, and so we have things that are just incomparable, right? We can't add apples and oranges. We can't really add these things together.

WOODS: Right. Is there anything else we need to cover?

HERBENER: Oh, well, the other big thing with GDP is another fallacy that's related to it, where we have to be very careful about the meaning: the GDP only indicates to us at best final goods produced. It's not a measure of all economic production, and a lot of journalists are especially prone to this. They think that GDP is the economy. But if you just think quickly about the production of any particular consumer good, you can see that many other things have to be produced in order for the consumer good itself to be produced.

WOODS: And none of that is captured.

HERBENER: None of that is included. You're producing an automobile, but you have to produce the steel. You have to produce the steel. You have to produce the iron to produce the steel and so on and so forth, and none of those intermediate goods are included in GDP. So this gives us a very misleading picture of the nature of overall production in the economy.

WOODS: Right, and now how exactly is it misleading? What is the major false view that people draw when they look at GDP? It's consumption. Consumption is 70% of the economy.

HERBENER: Yep.

WOODS: But what about all the gross saving that's necessary to carry on all these different stages of production? That's just out because wouldn't that be double counting? Is that what they leave out?

HERBENER: Well, it's double counting if your intention is to find out the value of all the final goods.

WOODS: Right, but if you want to know how the whole economy works—

HERBENER: Then you have to include it.

WOODS: Yeah.

HERBENER: And if you do this, it sort of flip flops the figures. It's hard to estimate this. Nobody actually does the statistics, and we don't really know for sure, but if consumption is 70% of GDP and investment is maybe, say, 15%, if you add in gross investment as you suggest, all the production in intermediate stages, this would radically alter that proportion.

WOODS: But just to help people put some flesh on these bones. Can you give us an example of a product, and give us a sense of what some of the stages that are involved in producing that product that would not be captured in GDP?

HERBENER: Yeah, so let's say it's a house. I want to make a house and so the final sale value of the house—the customer buys the house—and the price of the house would be included in GDP. But of course, the first step would be extracting raw materials out of nature from which you make the products to produce the house. So you have to have lumberjacks. They have to cut down trees in the forest. So that production is not included. You have to have sawmills that mill the lumber for the thing. You have to have trucking, which transports the lumber to the places where it can be worked on some more, and so on, right? Cement, it's the same thing. You have to extract the raw materials and then proceed to a cement plant and then make the cement, and then you have to ship it some place and form it into blocks, and then you'll eventually ship these to the building site. So all those different processes, and you can imagine there are hundreds of them, maybe even thousands of different intermediate production processes, and as you said before, each one has value that gets double and triple counted and quadruple counted when you add all this up, and so who knows what the multiple is, but it's a fairly large, sizable multiple of all this, and it all has to come from businessmen, from entrepreneurs making investment expenditures.

WOODS: Right, but meanwhile people are told or are under the impression that what we need is more consumer spending—spend, spend, spend. But if we follow that advice to a T, and everybody, as soon as he got money, he just spent it on another consumer good—so let's say you bought 10 gallons from milk from me, and I take that money and I buy a shirt, and the shirt guy buys a hat, and the hat guy buys a gallon of gas, and the gas guy—then no wages get paid, all of the production structure we just described grinds to a complete halt.

HERBENER: That's exactly right.

WOODS: But that would be nirvana because you'd have all the consumption you want!

HERBENER: Yeah.

WOODS: All right, well, is that enough fallacies to deal with for one video?

HERBENER: That's pretty good, yeah.

WOODS: All right, we're going to stop right there. Professor Herbener teaches economics at LibertyClassroom.com, which is where all the cool people are learning economics. If you want to learn more about what we were talking about just now, head over to LibertyClassroom.com/GDP.