Our Mismeasured Economy

By LEW DALY  JULY 6, 2014

TODAY'S polarized debates about the role of government often boil down to a single issue: the size of government compared with the size of the overall economy, as measured in gross domestic product.

This is true on both sides of the debate. One recent proposal featured in The Wall Street Journal argues for a “golden fiscal rule” that the size of government as a percentage of G.D.P. should always be shrinking; liberals frequently cite the higher ratio of government spending to G.D.P. in many European countries.

But such comparisons are not very meaningful: The way we measure government’s role in the economy is limited, inaccurate and unrealistic. If we want to understand how government and the overall economy interact, knowing the size of government tells us little if we are not measuring how government activities contribute to our economy over time.

The problem is that most government goods and services are provided free, so they do not have market prices like, say, mouthwash or financial planning. Standard national accounting — in G.D.P. and related economic indicators — addresses this by assuming that the value of government is exactly equal to what government spends, without any consideration of what government actually produces or of the value of this public output.

In a report released by my organization, Demos, this week, we make the case that, in at least four critical ways, this G.D.P. framework ignores or obscures public value in our economy, leaving us ill equipped to fashion policy to drive national success in the 21st century.

The first problem is that much of what G.D.P. measures as personal, private spending — which counts for two-thirds to 70 percent of the economy — is highly
socialized consumption. It is not financed directly from households’ private earnings, but from public sources or from publicly subsidized private sources.

Government benefits through social insurance and the social safety net — about $2.3 trillion in 2012 — fund a large part of personal consumption. The same goes for nonprofit services and employer-provided benefits; these are counted directly as personal consumption. This is a huge oversight: In a 2011 Bureau of Economic Analysis study, the share of consumption from these “indirect” — mainly public or social — sources was found to be 30 percent in 2009, having quadrupled over the last five decades.

Returns on public investment are another form of unmeasured public value. Take infrastructure. Using a very conservative model, the economists Robert J. Shapiro and Kevin A. Hassett estimate annual private gains of roughly $800 billion from our surface transportation infrastructure, compared with annual costs of roughly $185 billion. These significant gains are captured “downstream” in G.D.P., largely as personal consumption. But they should not count as such; they are public gains, not private.

A third form of mismeasurement is the benefit of regulation, or what might be termed our regulatory saving. In its first 20 years, the Clean Air Act generated health savings and other benefits valued at $22 trillion, compared with $500 billion in compliance costs. Arguably, net regulatory gains on such a scale should be considered a form of national saving, but they’re not. Indeed, across many areas of regulation, we have a saving rate that matches and at times dwarfs the national saving rate as it is usually measured.

Finally, there is the ever expanding realm of nonmarket capital, including human, social, intellectual and natural capital. Nonmarket capitalization, which significantly depends on government activities like education spending, public safety, research investments and environmental protection, is much larger than market capitalization as measured in private investment; it is also more significant for long-term prosperity. Yet it is ignored in our national accounts, jeopardizing our future prosperity.

Human capital is the most closely linked to government activities, as it is mainly an output of public educational investments, combined with student and parental investments. The public money we spend on teachers’ salaries helps produce high school graduates, many of whom become college graduates (indeed,
mostly public-college graduates); these graduates, in turn, have been our country’s most important asset for growth since the mid-20th century.

In one leading model, gains from educational investment added $3.7 trillion to our national wealth in 2009, more than four times the value of public education as measured in G.D.P. that year. The return on educational investment is clearly enormous, yet it is nowhere to be found in the G.D.P. story of growth.

In obscuring the value of government, the G.D.P. story is leaving us in the dark about potentially crippling trade-offs between fiscal and regulatory austerity and our needs as a society. If we ignore public value in our economy, we will be unable to craft effective policies for a better economic future. If we ignore the economic contribution of regulation, we are less likely to want more of it, exposing our children to greater social risks and costs.

To develop a sustainable growth path, we should heed the business adage: You get what you measure. Fixing the measurement problems surrounding government activities is a good place to start.

Lew Daly is the director of policy and research at Demos, a public policy research organization.

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