Good numbers gone bad

Why relying on GDP as a leading economic gauge can lead to poor decision-making.

By Joseph Stiglitz
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(Fortune Magazine) -- Gross domestic product, the leading economic measurement, is outdated and misleading. Long the standard scorecard for any national economy, GDP has become deficient as a measure of long-term economic health in our resource-driven, globalizing world.

Think about it. It's like grading a corporation based on one day's cash flow and forgetting to depreciate assets and other costs.

In today's business reality, where intangible assets have become increasingly important, cash flow can be a particularly bad indicator of a company's value. A startup can have no cash flow and yet be creating a software program of immense value. A company with positive cash flow can be running itself into the ground as its capital depreciates. Economies are no different.

That's why economists looking for an alternative accounting framework to supplement the use of GDP are considering a new measure: green net national product.

The "green" means that GDP must be reduced to take into account the depletion of natural resources and the degradation of the environment - just as a company must depreciate both its tangible and intangible assets. "Net" national product (NNP) means that there has to be an adjustment for the depreciation of the country's physical assets.

A country that gives away its natural resources will see gross domestic product rise, but gross national product - which focuses on income earned by those inside a country as opposed to what is produced inside a country -- may not rise much, since the value of what is produced accrues to foreigners.

When GDP goes really bad

For developing countries opening themselves up to foreign investment, this is an important distinction. A nation that grows by borrowing will see GDP rise, but much of the increase in income may go back out of the country to pay the interest.

Papua New Guinea is a prime example of the trouble with GDP calculations. When Anglo-Australian mineral company BHP Billiton (Charts) opened the Ok Tedi gold and copper mine in 1984, it was considered a national victory.

The value of the extracted ore showed up in Papua New Guinea's GDP, but scarce comment was made of the fact that almost all income from the mine went to its foreign owners.

Worse still, the mine inflicted huge environmental damage. Its operators discharged 90 million tons of tailings into the local river system, polluting the main source of livelihood for the 40,000 people living in the 120 villages downstream. BHP was sued in the 90s by indigenous landowners and settled for millions of dollars, but the agreement also indemnified BHP from future damages. The burden of much of the environmental repair was left to the country.

The U.S. is no exception.

America's energy policy has been based on "drain America first"; as we have used up a significant share of our scarce oil reserves, the country has become poorer, even if GDP has done well.

As oil is used up, America may turn increasingly to coal, which has large environmental costs that should be reflected by green accounting. In the case of carbon dioxide and other greenhouse gases -- now traded in Europe -- we can, for instance, put a dollar value on the emissions. Such mechanisms can help us evaluate environmental damage and quantify its impact on the economy.

Bad accounting frameworks are likely to lead to bad decisions. A government focused on GDP might be encouraged to give away mining or oil concessions; a focus on green NNP might make it realize that the country risks being worse off.

But new ideas always meet resistance.

Just as those who benefited from bad corporate accounting practices - like ignoring the cost of stock options - wanted to continue them, the same is happening here. A greener, more balanced accounting framework is an old idea whose time has come, especially if we are going to make globalization work.

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