There's GDP, and Then There's GDP

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When is Gross Domestic Product not Gross Domestic Product? Intriguing question. There will be a short, single question quiz at the end of this note in which the answer will be revealed.

The state of the art, so to speak, of economic policy debate pits the statists against the statists in a fascinating display of pure Keynesian brawn. What it fails to do is to illuminate the actual issues at stake. The issue, from a statist perspective, is whether governments should run even bigger deficits now, or should they attempt to get their deficits under control in order to pay down the public debt. The latter camp – the neo-Puritan Keynesians – like to dress up their side by actually proposing to lower tax burdens. The other side – the neo-Salvation Army Keynesians – seem to see Admiral Dewey as their role model in this. Both sides in any case seem fixated somewhere between Shaw's Major Barbara and her worldly wise industrial capitalist, and part time father, Andrew Undershaft.

We are all painfully aware of what the problem is. The Greek case is illustrative. The Greek government took advantage of the cover provided by the rest of the European Union to borrow vast amounts of money. As it turns out, they borrowed far more than they can repay from their own resources, and they have been forced to appeal to their partner governments to relieve them of a large part of the burden. Now, from the sound of the throaty grunting and the gnashing of teeth we know that we are on the field of combat. What to do when a government profligately borrows a lot of money and uses it to subsidize the lifestyle to which their citizens would like to become accustomed to? The neo-Salvation Army side says that the cure is to borrow more, unless some rather rich targets can be found to bear big tax increases. This is supposed to provide a smooth landing of sorts – they do not propose to accelerate spending – with as little social dislocation as possible. The government payroll continues to be met and so families that depend on it for their sustenance are spared. Less directly but still importantly all the shops and services they depend on continue to be employed and their workers and owners paid. Life goes on with a minimum of trouble. The only weakness of this pleasant reverie is that the life that we suppose will go on involved bankrupting the government. This reads like a smooth transition to vastly deeper debt and vastly more painful crisis later on.

Can other nations, fearing perhaps that their indiscretions may also come out in public once the reckoning begins, step in to cover the losses? That is the hope of the Greek government of course, and at the moment it is the promise of their E.U. partners. There is no way around the conclusion that the tension raised by this commitment will tear the E.U. apart, as the citizens of the partner countries ask each other why they should subsidize further profligacy on the Mediterranean.

So at this pivotal juncture the neo-Puritans have gathered in solemn congress in Toronto to commit their countries to penance. Penance is both good and necessary as an end in itself. The question at hand however is whether in this situation it is prudent. It is, after all, one thing to fast but quite another thing to cut off the hand to stop the penitent from earning his living. The one act is penitential but the other is wasteful. The unsurprising message from Toronto is that in the future, the various governments involved are determined to spend less. It is left to their ingenuity to decide exactly which oxen are to be carved up, but the early indication is that income support for older folks is a prime candidate, both because there are so many old folks and because they have few options, few ways to avoid their penance. The cause of neo-Puritanism is not made any easier to sell by the appearance that one obvious pool of candidates – the rich folks who lent the profligate governments all that money – are being visibly bailed out. It has moreover not escaped anyone’s attention that they more-or-less own the governments whose officials are meeting in Toronto. No one is surprised that the rich lending community is not being asked to share the burden.

The neo-Salvation Army Keynesians have a very compelling point in this regard. Any attempt to honor the existing debts in full is a plan for ongoing servitude for the unfortunate countries who owe. Greece cannot afford to pay its debts. Any sort of thoughtful lender would have anticipated that outcome and would not have lent them so much, or would have charged so high an interest rate that they would reluctantly have restrained their greed. It is understandable that the lenders were seemingly so short sighted. They were lending other peoples' money. The serpent in the garden of high finance is cousin to the one that brought down the housing bubble in America: huge pools of wealth combined into professionally managed common or mutual funds that separated ownership from control: that erected a wall between the many whose money it was and the few who were paid to lend it out. I will forebear at this juncture however to delve any further into the matter of regulation of finance, in order to keep the focus on the financial embarrassments of modern governments. The best course of action for any government that, like Greece's, finds itself in the crosshairs of a debt dilemma is default. They owe it to their citizens and to their neighbors to default. The lenders took excessive risk. Too bad. No outcome could be worse for everyone involved than to trap the citizens of Greece in a perpetual debt trap which amounts to little better than peonage. This advice, by the way, is not the anti-free market heresy that it might seem. No less a pillar of the old University of Chicago Department of Economics than Harry Johnson decried the tendency of central banks to cover the mistakes of bankers at the expense of the public and of the needs of the broader economy, and his colleague Milton Friedman was sympathetic.

This advice fails however to address the most important issue that needs to be addressed. Quite simply put, the essential question is how virtually all Western nations, including Japan in the sweep of that generalization, were ever so foolish as to get themselves into this debt trap? Why did they borrow so much in the first place? Why is public debt so irresistible to our Solons?

The natural neo-Puritan reaction – at least in public; their deeds may not in this case conform exactly to their words – is to denounce debt as something approximating the work of the Devil. On the other hand most borrowers repay their debts with a comfortable cushion of gratitude to the cash-rich lenders who made it possible for them to buy what they needed when they needed it. So lending and borrowing are not evil. What is wrong, and may be evil, is borrowing for unproductive purposes. The fault of the Greek government was, after all, not that it borrowed. Their fault was that they spent it. Again, spending is not an evil in itself. Their fault is that the wasted it. That's why they are now poor. Borrowing does not cause poverty. Waste causes poverty. Borrowing only makes it possible to ignore the connection between them for a period of time. The debate, such as it is, between the neos is wrong because it is fixated on borrowing and spending: between those who want to borrow and spend less and those who want to borrow and spend more. But this is not about borrowing or spending. It is about wasting.

Individual examples of waste are easy to find. My favorite, because it is so clearly a model of the whole genus, comes from Massachusetts in the 1930s. As part of a program ostensibly to "create jobs," then-Governor James Michael Curley – the great man himself – launched a public works project of laying granite curbs on the streets of Massachusetts. An ever-ready public works department took to the job with vigor. They just didn't limit themselves to actual curbs. When a shortage of available roads threatened to crimp their style, they ordered the men to lay new curbs right through any available stretch of territory, including state and federal woodlands. The rather sharp granite curbs represented quite a hazard for hikers and woodsmen for decades.

Borrowing is obviously good when it is used to create value greater than the cost incurred. In that way, whatever it is that the borrowing buys produces a benefit from which to pay off the debt. Sometimes the benefit is not financial, but aesthetic or moral or anything else that the public recognizes as real. In that case they have to make up the difference from their taxes, but in principle they will be willing to do so. But not every sort of spending creates comparable value. It is not enough that it create some value. Governor Curley's curbs produced some value, but not enough to prevent the state from going bankrupt. The millions of new houses planted on converted farm land in the housing bubble of the last decade have some value, but not enough value to cover the cost. The subsidies necessary to make them seem like good investments ultimately bankrupted the Federal mortgage-lending giants Fannie Mae and Freddie Mac. It is impossible to separate indefinitely economic activity and the costs it incurs from value it creates. That is just as true of the cost is borne out of current income – by current tax revenues – or by borrowing, but in practice it is only when the borrowing spigot is running high that government managers are tempted to overlook the obvious. Keynes notwithstanding – whether wearing his Salvation Army cap or his Puritan helmet – the state provides no service to the community simply by spending money. Its service comes from the value of the services it provides. Not from how much they cost or how many of our fellow citizens it employs but from how much better we live when we harvest the profits.

Now for the quiz. So, should the Greek government borrow and spend more or less? Well, if they have some worthwhile investment that will pay for itself, they should borrow more. If they don't, they shouldn't borrow at all. It never happens that we – whether citizens or governors – spend our way into prosperity. The lesson to take away from the recent sad history of public finance is that squandered wealth is truly gone forever, leaving us not better off, but worse off.

These homely realities have been to some extent obscured by the fraudulent concept called Gross Domestic Product. We agree that the tally of GDP does truly address the Gross, which is to say that does not net off the cost of economic activity but looks to the purchase and sale of goods on a gross basis. We agree that it is Domestic, which is to say that it looks to just those exchanges that occur within whichever jurisdiction we want to count. The fraud is calling it Product. By far most of it is product, which is to say goods and services – including public goods like police and public education – of real productive value. The fraud is not in what the citizens of that jurisdiction do for a living, it is in calling this particular measure of it Product. As we actually tally GDP, we don't pay any attention to the value created. We instead count only the expense incurred. If A is paid \$500 per day to design new computer chips while B is paid \$500 per day to lay granite curbs through the Blue Hills National Forest, the GDP register totals up \$1000 of new GDP per day, although the value created is about \$500. (That is not the full, gross value of A's work, it is the value of his personal contribution to the work). So GDP is a misnomer. It should be called Gross Domestic Expense, GDE.

Mr. Andrew Undershaft should be given his due here for defending the profit motive. He is depicted as a thoroughly disreputable industrial baron, profiting on the need for Britain to arm her army and navy in order to perpetuate her exploitive empire for a little longer, but profit is not the problem. (In truth, with WWI looming, the need for armaments was also rather easily justified.) If the Greek government had been disciplined by the need to borrow for all those public uses that produce a profit, the Greek nation would not be financially bankrupt today. It isn't, in general, the activities that earn a profit that impoverish us, it is the ones that operate at a loss that do.

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