The Slippery Art of Measuring Living Standards

Interview with Robert J. Gordon

Gross domestic product per capita, even when adjusted for purchasing power, is not an adequate way to make comparisons of standards of living across nations. This economist has long been interested in determining how best to measure just that. In this interview, he compares the U.S. and European way of life and says he believes that differences in GDP per capita exaggerate differences in the standard of living.

Q There is a widespread view that the rate of growth of European incomes is falling behind America's and may continue to lag for years to come. What have the traditional data been telling us?

A. For many decades there was a relaxed view that Europe had been held back by the two wars and the chaos at the end of war. All it would take, it was thought, was the process of time for Europe to catch up. Indeed, Europe grew faster than the United States both in income per person (GDP per capita) and in productivity for the whole period from the end of World War II until the late 1980s. But at that point, Europe began to stall, and the United States continued to grow,

---

ROBERT J. GORDON is Stanley G. Harris Professor in the Social Sciences at Northwestern University.

Challenge, vol. 47, no. 2, March/April 2004, pp. 70–80.
© 2004 M.E. Sharpe, Inc. All rights reserved.
ISSN 0577–5132 / 2004 $9.50 + 0.00.

if slowly. After 1995, U.S. growth picked up its pace, and even more so in the last three years. But Europe did not. Over almost the past ten years, the United States has been pulling ahead.

Q In terms of GDP per capita, what is the size of the gap now?

A. If we talk about France, Germany, Belgium, the Netherlands, Luxembourg, Italy, and the United Kingdom, the original Common Market, per capita income has stalled at about three-quarters of the U.S. level and, in fact, is slipping back a little bit. Yet, in France, Belgium, and the Netherlands, productivity has fully caught up to the U.S. level, and productivity, or output per hour of work, is a key determinant of income levels. So one of the most fascinating questions is what explains the discrepancy in GDP per capita. By definition, that discrepancy is explained by lower hours of work per person in Europe than in the United States.

Q To clarify, because GDP per capita is defined as productivity times hours per capita?

A. Right. There are three basic reasons for the difference in hours per capita, roughly all of equal importance. First, Europe has higher unemployment. Second, it has lower labor force participation—that is, a lower proportion of the population seeks a job. Third, it has lower hours per employee, partly due to their famous long vacations.

Q Let us return to that in a moment. You step back in a recent analysis and say, in terms of the actual way we all live, that the difference in GDP per capita exaggerates the difference in the standard of living.

A. That's right. Few Americans realize how much more energy in the form of gasoline, heating oil, and electricity U.S. citizens consume than do Europeans. This higher consumption is part of GDP, but it is

not clear it adds to the welfare of Americans. Part of it is due to our extreme climate. We have both colder winters and hotter summers on average. With the exception of last summer's heat wave, most Europeans get along quite well without air conditioning. The same thing is true of the extremely cold climate in the winter in much of the northern United States compared to, say, in England or France.

The other big cause of America's enormous energy consumption is a set of policy decisions that go way back. We have pursued policies that have starved public transport, subsidized interstate highways, and encouraged low-density suburbs with zoning laws that require lots to be above a certain size. We therefore have metropolitan areas that are spread out and cover even thousands of square miles. Our jobs, and usually the best-off people, keep moving farther and farther from the center of the city. As we all know, by contrast, the richest people in England and France tend to congregate in the center of London and Paris. All this means that we are a society where most families have to have two or more cars—they have few, if any, public transport options to get to work and to do shopping. So we consume a lot of gasoline and a lot of heating fuel for these two general reasons.

We also have 2 million people in prison, triple the number that we did only fifteen to twenty years ago, and that is arguably a waste of resources, given that the majority of those people are there for petty, minor drug offenses, just using drugs rather than actually trading in them. There are other ways of organizing society to be more tolerant of drugs, as in the Netherlands, that save a lot of money. All this adds to our measured GDP without adding to our welfare compared to Europeans. Probably the dispersion of the metropolitan area is the biggest core of controversy over the standard of living between Europe and the United States.

Q. Of course, we also change the way we live on this account.

A. Yes, but also tastes evolve differently. We in the United States say, Oh, I couldn't possibly imagine taking my kids to the grocery store on a public bus. And the Europeans say, I couldn't possibly imagine being stuck in a car in traffic jams in the suburbs without being able to sit on the Metro and read. So that's one theme. In sum,

only using a ballpark measure, I speculate that about half the difference in GDP per capita between these western European countries and the United States can be explained because U.S. GDP exaggerates our true welfare.

Q. To summarize, these factors include energy costs, commuting time, and maintaining prisons.

A. Yes.

Q You have also talked about the size of housing stock as a measure of welfare.

A. The reason I do not think you can get past one-half in closing this gap is that the average size of a housing unit in the United States is roughly double that in western Europe. We are talking about the median house; we're not even taking into account the upper tail, where American houses are enormous, especially to European eyes. The median newly constructed house in the United States is now well above 2,000 square feet, and the typical apartment in a country like Germany, I learned at a recent conference, is on the order of 900 to 1,000 square feet, less than half. In addition, there has to be some value placed on private property—that is, the fact that most American homeowners are living, if not in a single-family detached house, then in townhouses that have yards and property around them. Each European country, as you well know, has quite a different style of housing. The English have row houses with their own gardens. In Germany the typical style is to have a block-like structure with maybe four units in it detached from the next unit. But there's no doubt that people are willing to pay money for bigger housing units, they are willing to pay money for backyards and swimming pools—there has to be a welfare translation that the Americans are truly better off from that standpoint.

Q How much of this could be a matter of taste and valuing other benefits, however? People might take a smaller apartment in

Paris, or even Manhattan, because of all the amenities available to them in a central urban area that enhances their welfare.

A. There is a trade-off, I agree. It is hard to measure. Where there is good public transit, many Americans are voting with their feet and moving back into the center city. There has been a housing boom in central Chicago for the past fifteen years, with many more central city lofts and condo conversions and other new residential construction, for example.

Q Let us return to the question of hours worked. How much is the difference in GDP dependent on the desire of Europeans to work less?

A. Well, that is an interesting and controversial question. Take those three contributions to the low hours per person—they were the unemployment rate, the labor force participation rate, and the low level of hours per employee. Much of the higher unemployment in Europe consists of long-term unemployment. So, it is hard to say, where young people are apparently unemployed for years on end, that unemployment is a voluntary choice. It is an outcome of a particular way of organizing a society. Much of the low labor force participation consists of youth dropping out of the labor force through what we would call discouraged-worker effects. Others take early retirement and are not able to "retool" in the same sense that they can in the United States. Now moving on to the third issue, work hours per employee: Of course, there is a voluntary choice by Europeans to have longer vacations. But I do not think it is all voluntary. I think part of it is the outcome of a political process. Take, for instance, the thirty-five-hour workweek in France. That is not necessarily something the French population actually chose.

Q. On the other hand, some of America's higher hours of work are not voluntary either.

A. I would not take it all to be voluntary choice on the European side, and I certainly would not take it all to be voluntary choice on the American side, where people have shorter vacations and work long

hours. You have what economists call multiple equilibria—societies get settled down in quite different outcomes. We have a number of other instances of "American exceptionalism" that go beyond economics. We have higher fertility and a distinctly greater role for immigration, which has always been true of the United States. We have had this steady upward march in the percent of the population represented by new immigrants, legal and illegal. While there is a substantial fraction of foreign-born in France, Switzerland, and Germany, the flow or change is not nearly as great as it is in the United States. So the dynamism that comes from these differences is significant.

Q Do you think one of the wild cards in the future funding of social security could be the flow of immigration?

A. I was on a so-called technical panel on social security assumptions and methods, and we had a big debate, which I lost, on immigration. The official social security financial projections are based on a ludicrous assumption that immigration will be a fixed number forever—a number that is substantially less than it has actually been in the last five years. They are projecting a totally implausible sharp halt in the recent growth of immigration for no good reason.

Q. So, in your view, immigrant labor would reduce the future funding pressures because we would have more young workers to support the liabilities.

A. Yes, absolutely.

Q In summary, you believe the gap in the standard of living is about half of what the GDP data show, but there still is a gap in favor of the United States. Let us talk about some of the broad economic reasons why. One reason you offer that is especially important is the large single U.S. market.

A. The single market going far beyond the narrow perspective of customs duties. There is a single market in electric plugs and all sorts of standardization that goes back over time. Here are two very simple

examples. Compare the United Kingdom and western Europe. They have a completely different system of electric plugs, and they also have automobiles that have steering wheels on the right instead of on the left. That means that you cannot be as efficient because you are going to have to make two different kinds of cars and two different kinds of electric appliances, instead of having economies of scale. Maybe in some cases, the advantage of standardization is small, but the lack of it has got to reduce overall economic efficiency.

Q So we have had this one market since the 1800s, and often one currency and one language and so forth.

A. Yes, another example is language. Different languages are an impediment to labor mobility in Europe. Not so in the United States. We are becoming more and more a bilingual country but in a sort of economically driven way. Everybody who tends a cash register at a store at O'Hare Airport is Hispanic, for example. But because they are bilingual, they can deal with both kinds of customers. As an aside, this is one of the real handicaps to employment of central-city blacks. They cannot speak Spanish. There are many Hispanics who cannot speak English, but there are certainly enough of them who speak English that they then become the high-income, entrepreneurial type of immigrant.

Q In the single market, then, does the United States still retain a serious advantage, in your view, because it has this enormous continent-wide market?

A. Yes. Let us think about an interplay that I have not seen discussed explicitly. When there was the debate about the euro, say ten years ago, one standard argument against it was that Europe lacked labor mobility due to language differences—thus, the inability of those areas that had high unemployment to cure their problem by outmigration. The other was that there is much less fiscal integration in Europe. Now we have the euro in place, but that means that the weaker economies in

Europe do not have the stabilizing mechanisms that exist in the United States. Germany is the biggest example of that, clearly having an overvalued exchange rate and no ability to fix it. The Germans partly created their own problem by integrating eastern Germany with its excessively higher wage rate, but the euro has cemented these mistakes in stone, and the lack of flexibility is profound.

Q There are a couple of other issues that you bring up—one is political union itself, which is related to what we have been talking about.

A. The importance of political union goes beyond economic standardization, labor mobility, and fiscal centralization. That concept is more important for understanding the nineteenth century and how the United States surged forward in those decades. My rhetorical device in my recent paper is to say, OK, let us say that Europe was politically unified in 1870. Look at all these advantages Europe would have acquired that the United States already had. Europe probably would have avoided both world wars almost by definition. In those earlier years, there was also a lot of inefficient innovation geared toward import substitution instead of economic integration. For example, the United States developed this very smoothly operating process to get iron ore from Minnesota—put it on barges and send it to steel mills in Indiana and Pennsylvania. We would not have done that if there was an imminent risk of war between Indiana and Minnesota, just as there was between Germany and France. It is fun to talk about those analogies, but they are not as relevant now as they were a century ago.

Q Let us talk, then, about the relevance of technology in the modern period—say, post-1913. You argue that the United States has been able to exploit new technologies better than Europe.

A. The numbers are obvious and startling. The diffusion of electricity and automobiles in France in 1948 was the same as in the

United States in 1912. They were thirty to forty years behind. That is partly because of the vast distances within the United States. There was no such incentive in Europe, given the smaller distances. I am not exactly sure why electrification got going faster in the United States except for the interruption of World War I.

Q. Wasn't the size of the market itself a factor?

A. Definitely, especially when you go back to the late nineteenth century. You have an entire continent with one set of rules, no customs, unified transport systems, unified rail gauges, a single kind of electric system, a single kind of telephone system, and all linked together instead of stopping at borders. All these were enormously important. Europe began to catch up as it became more united.

Q. You also talk about the value of trade barriers in some of America's development.

A. By cutting itself off from the rest of the world through high tariffs and very tight immigration laws, the United States went into this period of the "great compression," to use Claudia Goldman's terminology in the period 1930–1960. This was the period that all of us on the political left sort of look back to with fondness. It was when high school dropouts could get highly paid union jobs and have a decent standard of living. It is remarkable to remember that you could buy a thousand-square-foot house for $3,500 in the 1920s or 1930s. I do put a lot of emphasis on this trilogy of tight immigration laws, absence of trade through high tariffs, and the role of labor unions as a way to force-feed productivity in what I call one big wave of productivity growth of the 1940s and 1950s. The erosion or gradual disappearance of those three things is part of the cause of the productivity decline of the 1970s and 1980s.

Q What is the bottom line? On the one hand, the gap in the standard of living is not as big as we keep saying it is, but on the other hand, you seem to think the United States has almost permanent advantages, or at least advantages as far as the eye can see, that will keep the gap fairly wide.

A. Let us put it this way—the American gap is real. Yes, it is true that some of it is in the eye of the beholder. The European skeptic does have some good arguments for chopping it down in magnitude from 25 to 15 or 10 percent. But if we switch over to thinking about the rates of change rather than the levels, then the United States looks better. Concerning the rate of change of how technology is affecting raw productivity and GDP numbers, there is a growing gap that favors the United States. By the way, that gap to some extent is related to the old central European cities. How productive can you make the cute little cheese shops and brasseries on every corner when they are essentially doing everything the way they were doing it twenty years ago? The only exception I have seen is the little portable credit card readers that Parisian waiters bring to your table. That is about the only thing I have noticed where European retailing is ahead of the United States.

Q. There is a lot of sophisticated cell phone use.

A. That is true. We have been behind on that because of multiple standards. I notice more and more cell phone companies are selling phones that will work in Europe.

But then you get back to the disadvantages of having a common currency without labor mobility and without fiscal centralization. Europe cannot fix that. Labor is much more mobile in Europe than it used to be. You always had Italian and French restaurants in London, but you need something more profound than that. How is Germany going to prosper when all the incentives are for its companies to invest in Poland and Czechoslovakia with lower wage rates? The giant sucking sound of jobs going overseas is more relevant for Germany than for the United States.

Q. So what is your prognosis?

A. We have an extraordinary productivity boom going on in the United States at the moment. It goes well beyond what I call the early-recovery productivity bubble, which typically occurs when a recovery begins. This has now gone on at least a year longer than it usually

does. There are two main arguments about why, although none is backed up with any serious numbers. One is that the pressure to cut costs due to the collapse of profits in 2001 was much more intense in this business cycle than previously. In fact, profits hardly fell at all in 1990–91. So we may still be having the spillover of drastic cost cuts. United Airlines, for example, cut its capacity by 20 percent but cut its employment by 30 percent. The other is that you cannot, without limit, cut your employment without reducing output unless you figure out some way of making the employees more productive. One hypothesis is that we created a lot of unmeasured intangible capital in the form of worker retraining and business process reorganization. After the IT [information technology] investment boom went away—we had a big slump in IT investment—the intangible capital was still there producing things. The ability of many companies to continue to produce at high rates with many fewer workers is the tangible result of this intangible capital. Yet, in speculating about this, let me caution that it is difficult to come up with numbers that are large enough to explain much of what is going on.

Q. Why not remain skeptical?

A. I do think we are at least moving back to a more normal time. In putting the numbers together, it looks to me like we are no longer going to have 8 and 9 percent annual productivity growth. But I am looking to a future over the next twenty years that has faster productivity growth than at any time since the 1960s.

To order reprints, call 1-800-352-2210; outside the United States, call 717-632-3535.