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Sex, Drugs and GDP: the Challenge of Measuring the Shadow Economy

THE WALL STREET JOURNAL. By **Josh Zumbrun**
June 8, 2014 2:29 PM



New methods of measuring economies sometimes raise eyebrows. Even more so when they involve prostitutes and mounds of cocaine.

The U.K., Ireland and Italy are among the nations now moving to include illicit doings when tallying their gross domestic product, the broadest measure of goods and services across an economy.

The U.K. could add as much as \$9 billion to the value of its GDP by including prostitution and about \$7.4 billion by adding illegal drugs, by one estimate, enough to boost the size of its economy by 0.7%. Not to be outdone, Italy will include smuggling as well as drugs and prostitution. Both changes will begin later this year.

Other nations in Europe are also poised to fall in line with a European Union call to standardize and broaden GDPs. The EU is following a "best practices" directive laid out in 2008 by the United Nations.

Some economists question the merits—and methods—of measuring the shadows. Criminals go to great lengths to hide transactions usually conducted in hard-to-trace cash. Because the activity is beyond the easy reach of tax authorities, it isn't something that can bring in revenue to help a nation pay off its debts. All of which complicates measurement.

Claus Vistesén, chief euro-zone economist for Pantheon Macroeconomics, says there is "a trade-off between taking in as much information as you can, and accuracy." Weighing the underground economy, he says, could end up making GDP measures "less accurate."

The argument in favor is simple enough. If drug sales aren't counted in a place where people spend half their income on drugs, one could conclude, wrongly, that the population saved half its money.

The U.N. is blunt in extolling the need to expand GDP definitions. "Accounts as a whole are liable to be seriously distorted" if governments don't tabulate all transactions, it said as part of its 2008 directive.

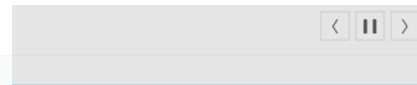
The overall changes from adding illicit activity may prove small, as

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drugs and prostitution, and capital formation and inventories, which will shrink its GDP.

Some European countries have extra incentives to inflate the size of their economies. In addition to bragging rights, a higher GDP helps keep a nation's debt and deficits within the EU's prescribed targets.

If a nation's deficit must remain below 3% of GDP, a profligate government would want the largest possible estimate of GDP. For others, a higher GDP may end up costing governments more. The 28-nation bloc uses measures of GDP to determine how much each country contributes to the EU's collective budget.

Across Europe, Finland and Sweden, hardly nations characterized by vast criminal economies, would see the biggest boosts. The main changes result not from drugs but from technical adjustments such as how to capitalize expenditures on research and development and how to account for pension programs and most types of insurance policies.

The Bureau of Economic Analysis, which calculates U.S. GDP, has "no plans for now to include spending on illicit activities," according to spokeswoman Jeannine Aversa. U.S. GDP would expand by about 3% if all the changes being made in Europe were adopted, according to Eurostat estimates.

The U.K.'s own methodology shows how haphazard it can be to measure activity far from the reach of cash registers and accountants.

The U.K.'s Office for National Statistics says it will estimate consumption of six drugs: crack cocaine, powder cocaine, heroin, cannabis, ecstasy and amphetamines. Officials will first calculate the number of drug users based on crime surveys, and then multiply by an estimate of the average amount of drugs consumed per user.

Then, a series of estimates will hold the accounts in balance. For example, to avoid distorting the statistics on imports, the percentage of cannabis that is homegrown must be estimated. Then, an assumption is made about the volume of seeds and amount of electricity used in production.

For prostitutes, the statisticians will begin with an estimated tally of on-street prostitutes from the London Metropolitan Police and an estimate of off-street prostitutes from a nongovernment group that studies violence against women and girls. The number of prostitutes will be assumed to rise or fall along with the male population. The assumed cost of prostitution services will fluctuate along with the prices of lap dances and escort agencies, "the closest activities we have to prostitution" that are already measured.

But the problem, he says, "is you can get very theoretical and there could be some side effects, including the rising skepticism of statistics in the general population."

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