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Redefining the Economical Power of Nations

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11 August 2013

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MPRA Paper No. 49890, posted 18 Sep 2013 06:42 UTC

Redefining the Economical Power of Nations

Economics/ Macroeconomics/ Econometrics/ Statistics

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For a new horizon and a clearer picture



Picture from: <http://therealityinstitute.net/wp-content/uploads/2012/02/greetings-from-reality.jpg>

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This paper is (over the formulas) self explaining¹. The measurement of economies no longer by GDP alone, but by an Index that includes other important factors as well, a *Social factors relativized GDP*. This *index cuts out the part of the GDP that is long term frozen up by social transfers (using the highly aggregated GINI coefficient)*.

Social factors relativized GDP: $GDP - GDP \times GINI = K_Index$
 Written differently: $(1 - GINI) \times GDP = K_Index$
Inflation indexed Version: $(1 - GINI - Inflation) \times GDP = K_Index_Infl.$

Productivity Index: $K_Index / Labor\ Force = K_PROD$
Inflation indexed Productivity Index: $K_Index_Infl. / Labor\ Force = K_PROD_Infl.$

Debt-to-K_Index: $National\ debt / K_Index = K_Debt$
Debt-to-K_Index_Infl: $National\ debt / K_Index_Infl. = K_Debt_Infl.$

JEL Classification: O11, C02, C01, E01, F02, C10, C50
 (Extended E00, E1, E10, E160, E170, E230, F020, I320, F60, F620, O110, O400, O410, O470, A10, C10, C100, C5, C6, E01).

Keywords: Economic Indicator, GDP, GNP, GINI, Productivity, Inequality, Income Distribution, Poverty Growth, Poverty Measurement, Macro Models, International Economic Order, International Industrial Order, Econometrics, Econometric Methods, Econometric Modeling, Macroeconometrics, Mathematical Methods, Mathematical Models, Numerical Methods, National Income and Product Account, Economic Growth, Wage, Economic Growth, Multisector Growth, Saving Growth, Aggregate Productivity, Gross National Product, Gross Domestic Product, Macroeconomic Model, Macroeconomic Time Series, Micro to Macro, National Income Accounting, National Wealth, Econometric Modeling.

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¹ The “dry nature” of the matter requires a certain level of rhetorical guidance of the reader.

1 The Problem

Economists all around the world, from Stiglitz to less well-known people, were looking for a way to deal with the weaknesses of the GDP. These efforts went so far, that many considered replacing it with alternatives² like the Gross National Happiness³. In my Bachelor study of Economics, I thought about this problem and invented the K_Index. This Index relativizes the GDP with the famed GINI coefficient. In later studies, I refined it further with the factor of Inflation and diversified it with productivity and debt-ratio variants.

How did the nations develop, when you include two simple and widely acknowledged factors (GINI and inflation) in the GDP, and use this new index as a basis for some further clarifying measurements?

The scientific gain is a clearer picture and more adequate ranking of the economies. This works also ex-post recalculating the recent years, or decades, and therefore showing the rise and fall of economies resetting some rankings without too many statistical problems.

2 The Index and its Versions

2.1 GDP - GDP x GINI

$$(1 - \text{GINI}) \times \text{GDP} = \text{K_Index}^4$$

This was the original invention from my early days in my Bachelor course. The GINI-coefficient is a highly aggregated statistical measure for income inequality. In short, the incomes of a Nation are put in relation with an absolutely even distribution of all incomes. Figure underneath.

Why would you want to mix this coefficient into the “holy” GDP?

² Countless indicators try in principle the same. Food affordability Index by Big-Mac or Engel, the fairly sociologic and complex HDI, the World Economic Forum giant statistical attempts, (and no one uses Theil anyway, why even mention it ;D), **but no one simply cuts out the financially frozen up part of the GDP, which is reserved for social matters.** Income inequality (equals often poverty) is a big reason for transfer payments, and right this inequality is measured by the GINI coefficient.

³ Especially in the recent economical crisis

⁴ Its K because of the beginning of my last name, call me arrogant ;D but it seemed reasonable in the working process, later I simply kept it

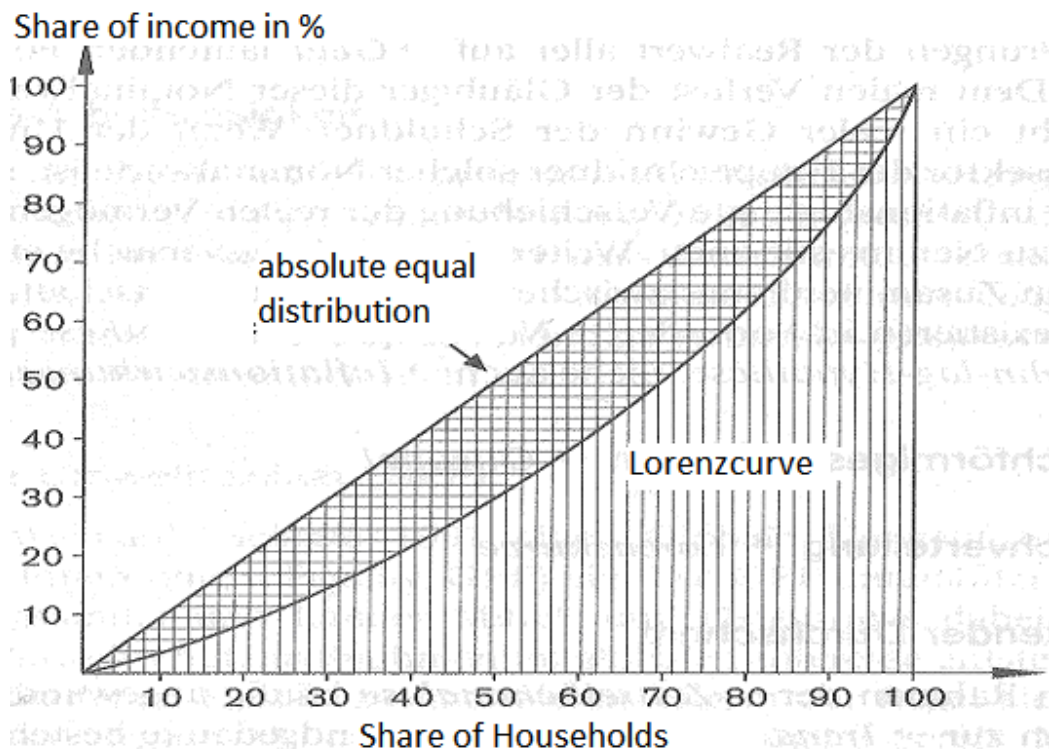


Figure 1 The GINI⁵

Economists tend to view those Economies as healthier, which have a population and workforce that actually can afford things (goods and services). In its extremes, it is also known as domestic demand driven economy. Of course, import and export plays also a big role in this, the balance of these two factors is important for long-term stability.

Economies that are simply exporting raw materials have also a high GDP very often, but their people are poor, cannot afford goods or services, while an often corrupt elite finds ways to cut its share off the exports. The country gets looted, very few get very rich, but the people generally are chanceless and miserable.

When it comes to GDP, both nations are equal.

The simple introduction of this additional factor GINI coefficient ranks the less developed nation a lot lower, and the developed nation only a little bit lower, depends on how well the income is distributed.

⁵ Hohlstein, Michael (2003): Lexikon der Volkswirtschaft, p.317

2.2 Arbitrary pick of GINI?

The GINI coefficient measures indirectly the pressures on the economy which require transfer payments. Since economical policy⁶ is often short term and not truly comparable, the GINI is. Most countries spend⁷ about third of their income to deal with social questions in their societies, which are very often based on income inequality⁸. Using therefore an *inequality index* (like the GINI coefficient) for a reality adjustment of the GDP is logical. *The governments have to pay away about a third of their GDPs on these social questions, i.e. the GDP is de facto relativized already by this fixed-spending-factuality on the ground.*

Necessary social transfer payments freeze up a part of the GDP. Why not make this visible in the GDP?

In other words: What oil price does for instance Russia⁹ need, to finance its social programs? And why not ask this question from the “tail of the horse” over the inequality Index? Under the precondition¹⁰ that income inequality decides (more or less directly *and long term*¹¹) about the amount of necessary transfers, it makes sense to deduct these payments from the GDP over the GINI.

Period. End of story? Not quite yet.

2.3 GDP – [(GDP x GINI) + (GDP x Inflation)]

$(1 - \text{GINI} - \text{Inflation nominal}) \times \text{GDP} = \text{K_Index_Infl.}$

It seemed a good approach to relativize less healthy economies¹² with the income distribution. But there are further pressures on the economy that could also help rate economies clearer. One of these pressures is Inflation.

⁶ If for instance (when designing a new indicator) simply choosing the percentage of GDP paid for social matters, those countries which pay less to social transfers would keep a higher GDP. You would need an inverse ranking logic when you want to measure economic strenght. This and the **short term timeframes for economical policy** makes a social expenses based index problematic.

⁷ In general

⁸ Multiplier effects with well paying jobs, negative multiplier effects with unemployment (i.e. not just opportunity costs but external effects as well)

⁹ as a raw materials exporter

¹⁰ Hypothesis

¹¹ More long term than median economic policy timescale changes at least

¹² If the complete economy relies on exporting oil or ore, the whole nation becomes *very* dependant on pricing and vulnerable to external shocks. Reagan pressured the Soviet Union with lowering the oil price, and while the oil price was high in the 70s, the Soviets invaded Afghanistan, while- what a surprise?- once the oil price was down in the 80s, they had to retreat. The complete raw materials exports of the whole empire

It's viewed by the "tiny homo Oeconomicus" (the individual) as "everything got so expensive" or as "why is so much month left over at the end of the paycheck, it was enough earlier..." or "...what? Grandpa? Cinema for 50 cents in 1950?". For the "large homo Oeconomicus" (the Investors, Companies) it means the investment made doesn't pay off anymore, the profit is eaten up by inflation, or the savings need an investment method *at least* above this inflation level. For the "supersized homo Oeconomicus" (the States) it means on one hand cheaper exports, and on the other hand more expensive imports. So it depends if you have a balanced trade budget¹³, or if you are an export driven nation¹⁴, or if you are an importer (for instance of energy), the effects mean something good or bad to you¹⁵. Generally, inflation is *not* good for the most.

Including the factor of inflation in the relativization of the GDP is meant to downgrade nations that undermine the spending power/buying power of its people or gambles with its fiscal stability, while ranking those that act responsibly above the irresponsible. In any case it *is too important (on too many levels) to be simply ignored if the GDP should be more realistic. The more broken the economy, the more relevant this factor becomes*, since Inflation that's out of control is typically not a simple external shock, but is often caused by longstanding structural problems¹⁶. Those hit hardest are not so much investors that can flee, but the weaker social layers like elderly which cannot flee¹⁷. These persons get a share of the GDP over income re-distribution for social matters.

High inflation relativizes the social transfer payments¹⁸ (to the receiving persons) downwards, but amplifies countless negative external effects that are caused by misery in an economy (and society), while causing the necessity for even more substantive transfer payments.

The GINI coefficient and Inflation are interdependent if the relativization of the GDP towards realism is the goal.

basically barely topped the years earning of just one of many American multi nationals (like GE) at the time.

¹³ Italy for instance

¹⁴ Japans famed Abenomics devalued the Japanese currency Yen to make the exports cheaper and to leave a decade long stagnation over export surpluses.

¹⁵ The mechanism of artificially downgrading the currency to make the nation and its products cheaper is important for "staying in the game" of export, attract investments etc. There are furthermore anticipation games, when all expect things to get cheaper tomorrow you don't spend today, but when you know its more expensive tomorrow and the savings are less valuable then you're likely to invest today.

¹⁶ It can prevent a recovery as well

¹⁷ Example Euro crisis: Wealthy Greeks bought the UK and German housing market empty (causing a real estate bubble "by the book"), while in Greece old people died on lack of affordability of medical care.

¹⁸ Typically a third of GDP

Usually the relativization is a lot less grave than the relativization over the GINI. It can only serve as a pinnacle in tight rankings when the countries are well governed. Now we have a beautiful way to measure the nations with a more realistic view of the economy. I admit it, I just single handedly destroyed the beauty of GDP – GDP x GINI with the technical and quirky additional inflation relativization. However there are variants doable, and as a German proverb goes: nothing is as good that it cant be enhanced a little bit further, so lets not stop here¹⁹, and check some variants.

2.4 GDP_per_capita, and GNP variants

$(1 - \text{GINI}) \times \text{GDP_per_capita}$

$(1 - \text{GINI} - \text{Inflation nominal}) \times \text{GDP_per_capita}$

$(1 - \text{GINI} - \text{Inflation nominal} - \text{Unemployment rate nominal}) \times \text{GDP} = \text{K_Index_Infl._Un.}$

$(1 - \text{GINI}) \times \text{GNP}$

$(1 - \text{GINI}) \times \text{GNP_per_capita}$

The advantage of this formula construction is it works with anything. GDP_per_capita, and as my old Professor²⁰ (from the Bachelor Thesis long ago) suggested, Gross National Product GNP²¹ (or better GNP_per_capita). The advantage of the GNP would be that it removes the inflation already, but I simply do not like the balance sheet adjustments of the import/export calculations. (All nationals abroad are counted in, but all people within the state borders that are foreign nationals are counted out etc.). This would transform the K_Index to an *income distribution index*, away from a *reality adjusted national economic power index*. I did gently reject it, but it sure deserves a mentioning here. Variants with the unemployment rate further downgrades the irresponsible nations but the downgrading might go too far. Let's enhance it all further and have a look at productivity when we apply this K_Index.

2.5 Productivity Index (K_Index_Infl. / Labor Force)

$\text{K_Index} / \text{Labor Force} = \text{K_PROD}$

$\text{K_Index_Infl.} / \text{Labor Force} = \text{K_PROD_Infl.}$

Each economy is in a different state of development. The less developed an economy is, the less value the working force creates per work hour or per worker. A lower developed economy that has half of its labor force in agriculture, and barely earns a proper

¹⁹ The German proverb goes: the better is the enemy of the good

²⁰ Prof. Dr. Enke (retired) from University of applied Sciences Nuertingen and University Marburg, who I would love to thank for the support and encouraging me to pursue this Index further

²¹ In German it's the BNE = Bruttonationaleinkommen

GDP, is not equal to an economy where the same workers create turbines in the same work time.

When the K_Index is applied as the basis of this input-output question, the productivity is also more realistically adjusted than the classical GDP based productivity index, since less developed economies tend to have a higher GINI coefficient. A nation that exports oil or ore, has almost no workers in that industry, but gets over the high GDP a good productivity Index. This does not reflect realistically the situation of the country. Poor people watching a pipeline aside their village until they become terrorists or sabotage it to get some fuel, *is not valid productivity* (in economical sense).

2.6 Debt ratios K_Debt or $K_Debt_Infl.$

National Debt / K_Index = K_Debt

National Debt / $K_Index_Infl.$ = $K_Debt_Infl.$

The Debt-to-GDP ratios are very common in economics. Using these K_Index and $K_Index_Infl.$ values as basis for a debt-ratio makes sense only to a certain point, namely when there is an interest in a *broader scope about the economy*, and therefore in more than the *strict financial ability* of a nation to pay its debts. Early warning systems that analyze the development path of nations might get sooner warning signs with the $K_Index_Infl.$ than with debt-to-GDP ratios alone. All values are of course higher percentages than classical debt-to-GDP numbers, since K_Index and $K_Index_Infl.$ generally lowers the GDP values.

2.7 Useful digression: Four- or Five-Sector-Model

X-raying the *sectoral structure* of economies helps further to clarify the picture. Usually the economy is segmented in three sectors with the “three sector hypothesis”. Primary, Secondary and Tertiary Sector. Economies tend to grow towards the third sector, the higher developed the economy is.

Table 1 Three sector hypothesis

Sector I	Extraction of raw materials + fishing (developed Nation 1-5%/ undeveloped 50% or more)
Sector II	Industry, manufacturing, construction (developed Nation 20 to 30%/ undeveloped 20%)
Sector III	Services (developed Nation 50% or more/ undeveloped 10%)

Table 2 Modified three sector hypothesis with two additional sectors and readjusted third sector

Sector I	Extraction of raw materials + fishing
Sector II	Industry, manufacturing, construction

Sector III	Services + I.T. (with communications industry)
Sector IV	State sector and Nonprofit (Govt. Jobs, churches, red cross etc.)
Sector V (option)	Shadow economy (problem to get correct numbers, usually 15-20%)

The modified sector model removes the distortions from Government overheads or non-profit economy sizes. If the numbers about the shadow economies are credible or available at all, helps also to judge countries more adequately (especially those that have a problem with good-governance). Aging population in mind shows also a possible usefulness of this model²².

3 Examples

3.1 Example *K_Index* and *K_Index_Infl.*

Country A and Country B have a GDP of 2.5 Trillion Euro each.

Country A (Less developed):

Gini	0.40
Inflation	7% = 0.07 nominal
Relativization	0.47
GDP	2,500,000,000,000 Euro
Labor Force	42,000,000

$$K_Index \text{ (without Inflation): } (1 - 0.4) \times 2,500,000,000,000 = 1,500,000,000,000$$

$$K_Index_Infl. : (1 - 0.4 - 0.07) \times 2,500,000,000,000 = \mathbf{1,325,000,000,000}$$

Country B: (Higher developed)

Gini	0.28
Inflation	2% = 0.02 nominal
Relativization	0.3
BIP	2,500,000,000,000 Euro
Labor Force	42,000,000

$$K_Index \text{ (without Inflation): } (1 - 0.28) \times 2,500,000,000,000 = 1,800,000,000,000$$

$$K_Index_Infl. : (1 - 0.28 - 0.02) \times 2,500,000,000,000 = \mathbf{1,725,000,000,000}$$

²² Analyzing the Greek economy or the German economy over this model could be interesting.

Comparison of the results:

Even if both nations have a similar GDP, the picture looks very different when only two further factors are included (Gini and Inflation). The difference between K_Index and K_Index_Infl. is small, but will be important in tight rankings.

Country A (less developed) relativized GDP	:	1,325,000,000,000
Country B (higher developed) relativized GDP	:	1,725,000,000,000

3.2 Example Productivity K_PROD or K_PROD_Infl.

$K_Index / Labor\ Force = K_PROD$

$K_Index_Infl. / Labor\ Force = K_PROD_Infl.$

Productivity county A (with inflation)

$K_PROD_Infl. = 1,325,000,000,000\ Euro / 42,000,000 = 31,547$ Euro per capita

Productivity country B (with inflation)

$K_PROD_Infl. = 1,725,000,000,000\ Euro / 42,000,000 = 41,071$ Euro per capita

Productivity country USA level (with inflation)

$(1 - 0.49 - 0.032) \times 11.363\ Trillion\ Euro = K_Index_Infl. = 5.431\ Trillion\ Euro$

$5.431\ Trillion\ Euro / 142m\ Labor\ Force = K_PROD_Infl. = 38,250$ Euro per capita

Productivity country China level (with inflation)

$(1 - 0.47 - 0.054) \times 6.23\ Trillion\ Euro = K_Index_Infl. = 2.965\ Trillion\ Euro$

$2.965\ Trillion\ Euro / 802m\ Labor\ Force = K_PROD_Infl. = 3,697$ Euro per capita

The new numbers of productivity are generally lower, but the productivity of the less developed economies with a high inequality is now more realistic.

4 Criticism

Does it matter how realistically you relativize the GDP downwards, and how adequate the new picture is, when all that matters is the de-facto nominal GDP (and therefore spending power) that's been generated?

Does it matter when you downgrade a raw materials exporting economy, when all that counts is the nominal cash the economy generates, i.e. *the ability to pay off its debts*? A debt-to-K_Index_Infl. ratio will always be worse (higher) than the classical debt-to-GDP ratio. How relevant can the Index therefore be, when used to measure *debt* ratios? A sinking K_Index_Infl. (maybe due to worsening GINI or Inflation) just warns the economists sooner about internal problems in the economy/ society (that might or might not be addressed/quelled).

As for the GINI coefficient, a lower GINI coefficient means only a more equal income distribution, but it says nothing about the *level* of income. When all are equally poor, the GINI is low. This however would only be likely in a low GDP nation, a high GDP with a good income distribution is a very good sign in contrary.

As for the productivity Index K_PROD or K_PROD_Infl., a lowered GINI coefficient (inequality gets better) is *technically not a productivity increase*, the same with a lowered Inflation rate. On the other hand, the classical productivity index is also "just a theoretical value", which includes distortions from the famed upper 10% of income and GDP.

A professor²³ mentioned once that not all nations might see inequality as a bad thing. I agree that for instance Calvinistic societies²⁴ might tolerate inequality more than European economies, but the general acceptance of the GINI coefficient makes this worry irrelevant in my opinion. The formula uses the GINI and a high GINI value is commonly acknowledged as a not overly positive thing. A very abstract professor²⁵ argued that the pick of the factors could be seen as arbitrary, even if mixing indicators is not uncommon in economical sciences. The indicator sets a very clear goal, namely increased realism or reality based adjustment of the GDP with an indicator that is used already. However this question forced me to write more clearly (chapter 2.2 and 2.3) *why picking right these indicators is not so arbitrary* as it might seem.

Is a relativization for instance of 1 Trillion in a 2.5 Trillion economy with high GINI, and a relativization of 700 Billion in a similar sized economy with a good GINI overkill-

²³ Prof. Dr. Hayo from University Marburg

²⁴ USA/ UK and Anglo-American influenced

²⁵ Prof. Dr. Koerber-Weik (retired) from University of applied Sciences Nuertingen

downgrading? (That's a relativization of 28-40% depends on whether the GINI is 0.28 or 0.40). I think it's perfectly elegant with the right aggregated value, due to the countless problems inequality creates²⁶. Almost every developed country spends about 30-35% on social matters (which often tries to deal with inequality problems).

5 Conclusion

A social factors relativized GDP is the basis for a variety of *more realistic economical indicators*²⁷, including productivity and debt-ratios. *Cutting out the financially long term frozen up part of the GDP which is needed for social matters, is the basis of this relativization.* For this purpose the GINI coefficient is most suitable, since it tries to measure the basis of the transfer payments, the income inequality.

The GINI coefficient and the factor Inflation are interdependent if seeing it through the lens of a reality adjusted GDP.

Countries with a bad income distribution and a high inflation rate are downgraded strongly, while countries with a good GINI coefficient and a low inflation are relativized downward only by a small margin. The now more realistic picture to differentiate nations with a similar GDP can help to identify problems and instabilities sooner.

The K_Index or K_Index_infl. repairs some of the weaknesses of the classical GDP, while relying on established and commonly acknowledged factors and methods of measurement. The K_Index or K_Index_Infl. cannot be questioned by its coherent logical construction²⁸, only by its relevance when used in debt-ratios (where only the *nominal* financial credit generated counts).

²⁶ From long-term economic development, to social stability to spending power and its effects on trade

²⁷ Scientific gain

²⁸ Its mathematical beauty in simplicity neither

6 References

Well it's a working paper about my invention, which is almost self-explaining. So not much here this time.

Hohlstein M. (2003): Lexikon der Volkswirtschaft, 2. Auflage, DTV Verlag München, 2003, ISBN 3-423-05898-6

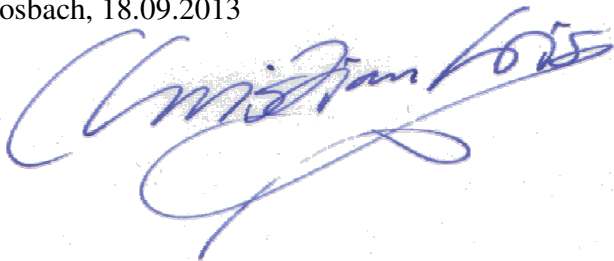
7 Ehrenwörtliche Erklärung (German declaration)

Ich erkläre hiermit ehrenwörtlich:

- dass ich dieses working paper selbstständig und ohne fremde Hilfe angefertigt habe
- dass ich die Übernahme wörtlicher Zitate aus der Literatur sowie die Verwendung der Gedanken anderer Autoren an den entsprechenden Stellen innerhalb der Arbeit gekennzeichnet habe.

Ich bin mir im Weiteren darüber im Klaren, daß die Unrichtigkeit dieser Erklärung zur Folge haben kann, dass ich von der Ableistung weiterer Prüfungsleistungen ausgeschlossen werden und dadurch die eventuelle Zulassung zu einem weiteren Studiengang verlieren kann.

Mosbach, 18.09.2013

A handwritten signature in blue ink, appearing to read 'Christian Kiss', with a stylized flourish underneath.