Challenges and Barriers to the Recovery

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This Talk Will Be a Splash of Cold Water in the Face

• This is a left-leaning audience, and I’ll pledge allegiance by providing more reasons than you need about why we should deal with inequality by taxing the rich.

• But I’m also here to tell you why some of your assumptions about the future are wrong or infeasible or both

• First, a word about where we are in slogging through the crisis and extended slow recovery

• Then some reasons for pessimism about the long run

• Then some specific policy discussion about energy/environment, taxes, entitlements, and especially medical care
Pessimism About the Future, the Condensed Version

• For the full version, see NBER WP # 18315.
  – A short and very readable version is in WSJ, Saturday Review section, 12/22/12

• There are two INDEPENDENT reasons to be pessimistic about future U. S. growth

• First, we all got used to 2.0 annual growth in real GDP per capita, the actual historical number 1891-2007. In the future that will be 1.0 percent
  – And for the bottom 99% of the income distribution, it will be 0.5%

• The reduction from 2.0 to 1.0 reflects the influence both of less fruitful innovation, and of the six headwinds
The History: Economic Growth Was a Three-Century Phenomenon

GDP per capita Growth, 1300 - 2100
2.0 Growth Anchors Our Thinking

- Real GDP per capita grew at 2.02 percent between 1891 and 2007.
  - 2.20 for Y/H, -0.18 for H/N.
- In my interpretation the 2.0 was propelled by the 2\textsuperscript{nd} industrial revolution and all its spinoffs, 1891-1972.
- Then the early decades of the computer revolution (IR #3), replaced many dreary clerical tasks by computer-related machines.
- My prediction is that over the next few decades that 2.0 number falls to 1.0, and to 0.5 for the bottom 99%.
Figure 16: Annualized Growth Rates of Output per Hour, Output per Capita, and Hours per Capita, 1891-2012
There are Many Reasons to be Pessimistic About Future Y/N Growth

- There are at least 7, let me start here with only three
- Demography, Education, and Inequality
- Why have hours per capita grown so slowly?
  - Decline of 7% 2000-2004, no recovery 2004-07, further decline of 8% 2004-2012
  - Baby-boom retirement
  - “The Missing Fifth”, related to Charles Murray’s “Fishtown”
  - Youth entering higher education but then dropping out, especially at community colleges
Figure 18: Hours per Capita, 1992:Q1-2012:Q3

- The graph shows the hours per capita from 1992:Q1 to 2012:Q3.
- It indicates a general increase in hours per capita from 1992 to around 2004, followed by a decline until 2012.

[Graph with data points and trend line indicated]
Figure 20: Employment per Capita and Labor Force Participation Rate, Males Ages 25-54, 1960:Q1-2012:Q3
The Dismal State of American Education

• Tertiary education completion among 25-34 year olds: U.S. 41%, Canada 56%
• $1 trillion in student debt
• U.S. ranked #21 of #26 OECD countries in high school graduation rates
• 85% of foreign exchange students say that their American high school classes are much easier than in their native countries
• The black-white gap has not narrowed since the 1960s and the social negatives of the bottom 30% of the white income distribution (Murray’s Fishtown) are at levels chronicled in the 1965 Moynihan report.
The Stark Saez Statistics on Inequality

• 1993-2008: *AVERAGE* real income growth = 1.3 percent per year.
• Same period: same concept for the bottom 99% grew at 0.75 percent a year.
• There is no reason why this increase in inequality will not continue for the same reasons as before
• This is why I mark down my forecast of 1.0 percent future Y/N growth to 0.5 percent for the bottom 99%
The Interaction Between Inequality (#3) and Globalization (#4)

- Globalization = free trade, who could be against that?
- But in the US environment, there are low wage states and high wage states
- Japanese and German and Korean auto transplant factories have established in TN, AL, GA, SC
- These are great jobs for people in those states
- But they erode the remaining vestiges of “union rents” in the high-wage UAW states
American Manufacturing Is Sliding Down the Labor Demand Curve

• We hear many stories about employment expansion in manufacturing, even in unionized states
• The entire industry has been made over thanks to the two-tier wage structure and rising Chinese wages
• But the overall level of wages in manufacturing is going down, and this contributes to the ongoing growth of inequality.
Global Warming? Forget It

• Probably my most anti-left position relates to the need for carbon taxes to deal with global warming.

• Any action by the US government to raise taxes to control carbon emissions would help to derail the recovery.

• The basic undeniable fact is that the pollutants coming from China and India are now far greater than coming from the US.

• And why should China or India strangle their growth now when we were not required to in 1900-1950?
  – The US polluted the air and water like crazy in 1910 and 1920. India and China say, why not us?
As If This Weren’t Bad Enough

• Economy was artificially pumped up beyond any underlying demand in 1990-2007 by stock market and cash-out refinancing.

• How can consumption growth in the future at any significant rate after this history.

• The next slide shows C/Y and also (C+NX)/Y
Figure 9: Consumption and Net Exports as Share of Nominal GDP, 1948:Q1-2012:Q3
The Implications of Today’s Federal Budget Deficit

• Whatever its form, we know that over the next two decades the Federal government deficit must shrink by a lot.

• Whether fast or slow, sequester vs. carefully negotiated plans, every conceivable method of reducing the Federal debt will reduce the growth rate of disposable income compared to GDP

• That includes any increase in taxes or reduction in transfers

• Direct cuts in G reduce GDP growth directly

• There is room for using the balanced budget multiplier concept of elementary economics
Figure 2: Federal Government Receipts and Expenditures to Actual GDP Ratios, 1955:Q1-2012:Q2

- Green line: Federal Receipts/Actual GDP Ratio
- Blue line: Federal Expenditures/Actual GDP Ratio
- Red line: Total Surplus/Deficit
Figure 1: Federal Government Receipts and Expenditures to Potential GDP Ratios, 1955:Q1-2012:Q2
Figure 3: Average Federal Government Receipts and Expenditures to Potential GDP Ratios, Selected Intervals

- 1981-1992: Receipts (17.93%), Expenditures (21.41%)
- 1993-2000: Receipts (19.24%), Expenditures (20.36%)
- 2001-2008: Receipts (17.79%), Expenditures (20.04%)
- 2009-2012: Receipts (15.06%), Expenditures (22.74%)

Legend:
- Green: Receipts
- Blue: Expenditures
Is Excessive Spending or Insufficient Tax Revenue the Problem?

• These charts show the ratio using potential GDP as a denominator (we’ll get to the potential GDP debate in a minute)

• Comparing Clinton to Obama
  – Revenue share (potential GDP) down by 4.18 points
  – Expenditure share up by 2.38

• This suggests our revenue problem is greater than our expenditure problem.

• But that is short-sighted, because the entitlements will soar in the future, so we have to tackle them seriously

• What is the difference between actual and potential GDP right now??
Figure 8: Implied Output Gaps, 1992:Q1-2012:Q3
Giving Up on Economic Recovery

• How can we close that output gap?
• Monetary policy is busy monetizing the deficit, which is fine as long as all that monetary base creates only excess reserves
• Fiscal policy must by definition be contractionary if any progress is to be made on the Federal deficit.
• This means we must give up on any attempt to kick-start the economy by the only fiscal stimulus that we know actually worked.
Why the Great Depression Ended in 1940-41 and This Episode Will Only Get Worse

- Share of total government spending (state, local, Federal) increased from 12 to 25% between 1940:Q2 and 1941:Q4
- The GDP gap went from -20% to zero several weeks before Pearl Harbor
- We have a great example of a fiscal stimulus that delivered high multipliers (2.5 to 3) but that example shows why we are in such a bad situation today
My Left-Wing Comment

• Boskin, Hubbard, Taylor, and many others for many years have been feeding the media the story that low marginal tax rates for the rich create jobs.

• Counterexample #1, the economy grew more rapidly with the higher Clinton tax rates 1993-2000 than at almost any time in the postwar era.

• High incomes are rents, almost by definition. If I raised the rate from 35% to 50% which of the following would quit their jobs for their next best opportunity: Alex Rodriguez? Tom Brady? Tom Cruise? Jamie Dimon? Lloyd Blankfein?

• How can you say we need the saving of the rich to fund investment, when we have trillions of cash sitting inside corporate vaults and more than a trillion of excess bank reserves?
What the Left Must Defend

• Much Higher Tax Rates on the *RENTS* earned in the top 1%

• Any consumption tax or VAT must be accompanied by a high-rate income tax system for the top 1 or 2%

• Must impose the “Buffett Rule,” that Buffett must pay as high a tax rate as his secretary

• This means bringing tax rates on dividends and capital gains into equality with income tax rates
What the Left Must Abandon

• The current attempt to try to fix the long-term Federal deficit only with revenue increases
• Entitlement declines must happen
• Social security fixes are easy, and the left must come on board in realization that the future growth of SS benefits should be just as slow as the dismal outlook for US economic growth
• Join with Feldstein and the conservatives in an all-out attack on tax expenditures, e.g., loopholes, subsidies, and deductions.
Other Aspects of the 20th Century That Must Be Abandoned

• **Labor Unions.** The right-to-work states will create all the jobs, leaving the unionized states in stagnation. Even Michigan is now a right-to-work state.

• **Immigration Resistance.** The birth rate is falling, the control on immigration is a disaster. We need more young people relative to old people.
  – Unlimited quotas for high skilled degree holders
  – Go back to a no-passport, unlimited immigration regime as in 1865-1913
Immigration Self-regulates Itself to the Business Cycle

Actual vs. Predicted by Output Gap Regression - Gross Annual Immigration as a Percentage of Total US Population, 1860-1913
Education: Sole Focus on Teachers as Villains

• In the Chicago Public Schools in 2011, 20 percent of African-American elementary school students were absent for more than one month from school.

• This is how poverty is transmitted from generation to generation

• Stop blaming the teachers, start blaming the incompetent parents

• And listen to Jim Heckman, the only educational remedy that has a high benefit-cost ratio is early childhood intervention in poor families
Reforming Social Security

• Reforming SS is easy
  – Remember the Boskin Commission of 1995-96? We wanted a far more radical fix of “CPI – X” where “X” might be 1.0 per year?
  – Obama should have given ground in the fiscal cliff negotiations on the chained CPI but in the end didn’t need to, at least for now.

• Other SS fixes
  – Indexing the retirement age to life expectancy
  – Adjusting the response of benefits to wage changes
What Nobody Is Talking About:  
This is the Big Deal: Medical Care Costs

• Latest OECD data for 2010
  – US medical care spending as % of GDP: 17.6
  – Canada: 11.4
  – OECD average: 9.5

• The difference between the US and Canada is 6.2 percent of GDP, or $990 billion of today’s US nominal GDP.

• What do we receive in return for our excess investment of $990 billion?

• Life expectancy at birth. US 78.7, Canada 80.3, Korea 80.7, Italy 82.0, Japan 83.0
Sherlock Holmes Wants to Track Down that $990 Billion

• Sherlock turns to Cutler and Ly (JEP Spring 2011)
• The explanation of the extra US spending can be divided into three categories
  – Higher incomes of providers, 31%
  – Additional procedures for patients, 14%
  – Higher administrative costs, 39%
• We’ll never cope with US medical care inflation until we adopt a single-payer system and drive every private insurance company out of business
IS THAT ENOUGH PROVOCATIVE IDEAS FOR ONE MORNING?