Can We Restart The Recovery All Over Again?

By JOHN B. TAYLOR*

* Department of Economics, Stanford University, Landau Economics Building, 579 Serra Mall, Stanford, CA 94305-6072 (JohnBTaylor@Stanford.edu). I thank John Cochrane, Andrew Levin and George Shultz for helpful discussions.

Economics and history tell us that changes in economic policy lead to changes in economic performance. Recently, many have found evidence that the poor performance of the U.S. economy during the past decade — the Great Recession, the Not-So-Great Recovery, the stagnation of real income growth—can be traced to a shift in economic policies, whether you call it a Great Deviation from First Principles, as I have, or an Era of Great Forgetting of what policy works well, as John Cochrane has.[1] Further evidence comes from the prior two decades, when policy moved toward a greater adherence to these principles and economic growth and stability improved. Indeed, during the past 50 years policy and performance appear to have swung back and forth with a frequency somewhat longer than typical business cycles, but much shorter than the perceived long swing of secular stagnation (Taylor (2015)).

In my view economics and history also tell us which policies produce good performance: tax reform to lower tax rates on people and businesses and thus reduce disincentives to work and invest; regulatory reforms to scale back and prevent regulations that fail cost-benefit tests; free trade agreements to open markets, entitlement reforms to prevent a debt explosion and improve incentives, and monetary reform to restore predictability and create output stability along with price stability. The problem has been putting the reform ideas into action.

One barrier to action is skepticism that such reform policies will restart economic growth. It's too late, some say; the economy missed the typical rebound at the start of the recovery, and we can't make it up now. Or there is a new secular stagnation, which can only be addressed by another round of countercyclical stimulus spending (Summers (2014), Stiglitz (2015)). Why bother putting these reform ideas into action if they are not going to make much difference?

But the U.S. economy is currently in a situation where a change in policy can both remove downside vulnerabilities and create a

[1] See Cochrane (2015), Davis (2015), Herkenhoff and Ohanian (2012), McGrattan and Prescott (2012), Mulligan (2015) and Taylor (2008, 2014) for evidence and alternative ways to measure and describe shifts in policies.

sharp acceleration in growth. Because the economy has grown from the start of this recovery at a pace no greater than the pre-recession trend, it has left a vulnerable gap of unrealized potential that can and should be closed with faster economic growth. In several key ways the U.S. economy resembles an economy at the bottom of a recession, ready for a restart, even though the unemployment rate has reached 5%.

I. Labor Productivity

In the current situation, it is best to approach the problem through a growth accounting framework. As a matter of arithmetic, the growth rate of the economy equals the growth of labor productivity plus the growth of employment or hours of work. Productivity growth for the non-farm private business sector is shown in Figure 1 with high-frequency fluctuations smoothed out with a five-year moving average and a Hodrick-Prescott trend.

Note how productivity growth has swung up and down roughly in tandem with the changes in policy mentioned above, giving some evidence of an economic policy cycle and hope for a for a another upturn, though the reasons for the recent slow growth matter.

[Insert Figure 1 Here]

Productivity growth is now unusually low: only 0.6% per year for the past 5 years, which is only ¼ of the 2.3% rate of the previous 20 years. Some of the reasons for this unusual falloff emerge from the Solow growth accounting formula, which points to both a decline in total factor productivity growth and capital services per hour worked where capital includes both physical capital and intellectual property assets. According to the Bureau of Labor Statistics (BLS) (2015), annual labor productivity growth fell from 3.0% during the years 1996-2005 to 0.7% during the years 2011-2014, or by 2.3 percentage points. Over those same two periods, multifactor productivity growth fell from 1.6% to .6% per year, and growth in capital services per hour fell from 3.7% to an amazingly low -.5% per year. Thus a capital share of 1/3 implies a reduction in the contribution of capital from 1.2% to -.2%.

Simply restoring these two contributors to growth to their pre-crisis levels would give a 2.4% per year boost to productivity growth going forward far above the forecasts of economists who have written off the kinds of pro-growth reforms suggested here.

Even assuming the “low hanging fruit have already been picked” story of technological progress and thus a continuation of low multifactor productivity growth, we could get

a 1.4% increase in labor productivity growth to around 2% through more private investment which would raise the capital stock and services of both physical and intellectual capital. Tax and regulatory reforms would be expected to do just that.

II. Labor Force Participation Rate

Next consider employment and the growth of hours per worker. With the unemployment rate around 5%, future increases in the employment to population ratio must come mainly from increases in the labor force participation rate. The recent behavior of the overall labor force participation rate is shown in Figure 2.

[Insert Figure 2 Here]

Note the very sharp drop in this rate in the past few years, especially during the 6 years of slow growth since the end of the recession. Some of the recent decline in the labor force participation rate is due to the baby boom generation retiring, but the decline is very large for teenagers and young adults, for females age 24-54, and it even increased for those of retirement age. More research is needed, but clearly non-demographic factors are playing a role, including the disappointing job prospects due to the low overall growth rate.

As explained by Erceg and Levin (2014), a straightforward way to separate the demographic factors from other factors is to compare projections made by BLS *before* the Great Recession—which take projected demographics into account—with what has actually happened since then. The November 2007 BLS forecast is shown in Figure 2. The economists and statisticians at BLS forecast that the labor force participation rate would decline slightly due to the retirement of the baby boomers to 65.6% in 2015. But this is far in excess of the actual participation rate of 62.6% for 2015. This three percentage point difference is what could reasonably be attributed to non-demographic factors including the slow pace of economic growth. In any case there is no reason to assume that this is a secular development with the participation rate unresponsive to incentives from policy reforms which encourage firms to expand and hire.

A three percentage point rise in the labor force participation rate from 62.6% to 65.6% would mean a 5% increase in the labor force. Over 5 years it would mean a 1 percentage point rise in the growth rate. Over ten years it would mean a .5% per year rise which would double the .5% per year now forecast by BLS. Assuming no change in the unemployment rate, employment growth would also rise from .5% per year to 1% per year. The percentage of the working-age population that is actually

working would grow from the 59.5% December 2015 level (about the same as the 59.4% at trough of recession in June 2009) to 62.1%.

Going forward BLS now forecasts that the labor force participation rate will decline by .3% per year from 2014 to 2024; the supposed change would reverse that decrease to an increase of .2% per year. Adding in .8% population growth, as BLS now projects, gives the 1% per year employment growth. If these effects were front end loaded, then we could have 1.5% for five years and .5% for the next five years.

III. Conclusion

Critics of proposals for tax, regulatory, trade, entitlement or monetary reform often say that they do little to boost growth in the short run. At best, it is said, these reforms work in the long-run taking many years to show real effects. The economist's lag becomes the politician's nightmare, as George Shultz explains the problem.

This long lag pattern is found in simulations of many of the econometric models used to analyze reforms. In contrast many of these same models find that short-run fiscal stimulus packages have larger and more visible immediate effects than the more permanent reforms. This asymmetry tends to tilt policy decisions to so-called "temporary, targeted, and timely" packages and away from more "permanent, pervasive, and predictable" institutional reforms (Taylor (2012)). This is particularly true during times of recession, or anticipated recession, when there are loud calls to do something that shows quick results.

In this paper I have examined evidence that under current economic conditions, more permanent reforms would likely have large short-run effects to go along with their sustained growth effects. They would also help to counteract any short-run depressing effects which may develop in the economy and add a degree of stability.

The unusual recent swing down in labor productivity growth, along with the unusually low contribution from capital services, suggests that it could turn up again if boosted by reform-induced incentives. Similarly, the large drop in labor force participation, along with evidence that it is not all demographics, suggests that it too would revert with reforms.

Thus, policy reforms would not only raise the long-run growth rate of the economy, they would also likely bring an extra boost to growth in the short run, much as in a normal recovery from a recession when growth surges at first before settling into an expansionary mode. Since the economy missed that surge in this recovery, in effect we would be restarting the recovery all over again.

REFERENCES

Bureau of Labor Statistics. 2015. "Preliminary Multifactor Productivity Trends."

Cochrane, John H. 2015. "Institutions and Experience," Remarks at Symposium in Honor of George P. Shultz's 95th Birthday, Hoover Institution, December 11,

Davis, Steven J. 2015. "Regulatory Complexity and Policy Uncertainty: Headwinds of Our Own Making," Hoover Economics Working Paper 15118

Erceg, Christopher J. and Andrew T. Levin. 2014. "Labor Force Participation and Monetary Policy in the Wake of the Great Recession." *Journal of Money, Credit and Banking*, 46 (2), 3-49.

Herkenhoff, Kyle and Lee E. Ohanian. 2012. "Why the U.S. Economy Has Failed to Recover and What Policies Will Promote Growth." In *Government Policies and the Delayed Economic Recovery*, edited by Lee E. Ohanian, John B. Taylor, and Ian J. Wright. 158-187. Stanford, CA: Hoover

McGrattan, Ellen and Edward Prescott. 2012. "The Labor Productivity Puzzle." In Government Policies and the Delayed Economic Recovery," edited by Lee E. Ohanian, John B. Taylor, and Ian J. Wright, 115-155. Stanford: Hoover Institution Press.

Mulligan, Casey B. 2015. "The Effects of Redistribution Policies on Growth and Employment." In *Inequality and Economic Policy: Essays in Memory of Gary Becker*, Edited by T. Church, C. Miller, J.B. Taylor, 91-109, Stanford: Hoover Institution Press

Stiglitz, Joseph E. 2015. *Rewriting the Rules of the American Economy: An Agenda for Growth and Shared Prosperity*, New York: W.W. Norton.

Summers, Lawrence H. 2014. "Low Equilibrium Real Rates, Financial Crisis, and Secular Stagnation." In *Across the Great Divide: New Perspectives on the Financial Crisis*, edited by Martin Neil Baily and John B. Taylor. 37-50. Stanford: Hoover Institution Press.

Taylor, John B. 2008. "The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong." In *A Festschrift in Honour of David Dodge's Contributions to Canadian Public Policy*, 1-18, Bank of Canada

Taylor, John B. 2012. *First Principles: Five Keys to Restoring America's Prosperity*, New York: W.W. Norton.

Taylor, John B. 2014. "The Role of Policy in the Great Recession and the Weak Recovery." *American Economic Review: Papers & Proceedings*, 104(5): 61–66.

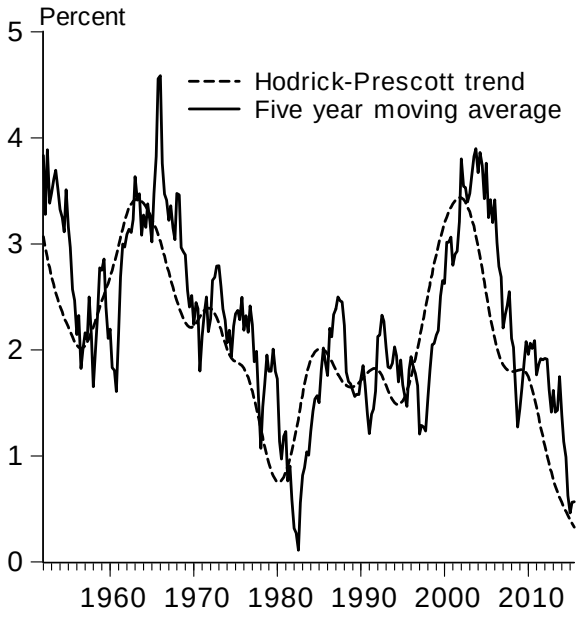

FIGURE 1. LABOR PRODUCTIVITY GROWTH RATE

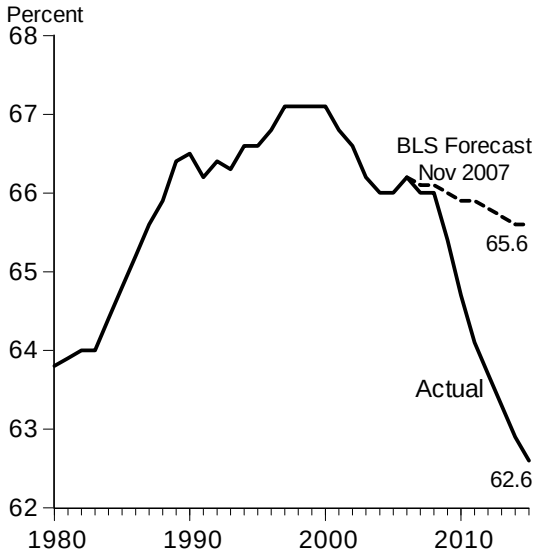

FIGURE 2. LABOR FORCE PARTICIPATION RATE