Introduction

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Economic growth during the recovery from the recession of 2007–09 has been remarkably slow—only 2.4 percent at an annual rate in the first two-and-a-half years. By comparison, economic growth during a comparable period following the deep American recession that ended in 1982 averaged 5.9 percent. Employment growth has also been very weak, with a *smaller* percentage of the working age population now employed than when the recovery began. It is no exaggeration to say that this has been the weakest recovery in American history.

The slow recovery raises a number of important economic and public policy questions. Most important, of course, is what has been the cause of the slow growth? And even if growth eventually picks up, does the long delay signal a new normal of a slow-growth America? Can a slow-growth America lead the world? What can be done to restore robust economic growth in America?

Many economists and policy makers have put forth explanations for the slow growth. For example, Reinhart and Rogoff argue[1] that economic recoveries following financial crises are typically slow, as household debt levels must be reduced and saving rates remain high. While still popular, there are other views. After looking at business cycle experiences throughout American history, Bordo and Haubrich[2] find that recoveries following financial crises are not typically weak. More broadly, a number of countries have recorded very rapid economic growth following severe economic difficulties that significantly impacted their financial systems. This is true of Japan and much of Western Europe following World War II and South Korea following the Korean War. Taken together, data from these countries indicate that understanding the speed of recovery from difficult economic circumstances requires evaluating a broader set of hypotheses.

This book focuses on a completely different explanation for the weak economic growth that the United States is currently experiencing. It explores the possibility that government economic policy itself is the source of the problem. The book centers around six empirical research studies that examine issues from policy uncertainty to increased regulation as the reason for slow growth. The studies are preceded by a "mission statement" from George Shultz which shows how the future of both the American and the world economy is riding on a good diagnosis of the problem and appropriate changes in policy. The papers are followed by a panel with Shultz, Alan Greenspan, and John Cochrane on ways to make the changes. The book concludes with a summary by Ian Wright

1. Reinhart, Carmen M., and Kenneth Rogoff (2009), "The Aftermath of Financial Crises," *American Economic Review* 99(2), 466–472.

2. Bordo, Michael D., and Joseph G. Haubrich (2011), "Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record," Working Paper on Economic Policy, Hoover Institution.

of the comments at a conference where some of the papers were presented. Taken together, the contributors to this volume offer a broad-based assessment of how government policies are slowing economic growth—by creating uncertainty and unpredictability, by engendering short-term planning horizons, and by depressing the incentives for businesses to hire new workers and invest in capital and new technologies. The contributors also provide a framework for understanding how policies should change to restore strong trend economic growth.

Here is a summary.

The Importance of Restoring Strong Growth

George Shultz opens the volume by arguing that diagnosing the situation correctly and thus finding a solution to the economic problem of slow growth is extraordinarily important now. If a slow-growth America becomes the new normal for the 21st century, not only will the future prosperity of the United States be sacrificed but so will American leadership worldwide.

Shultz points out that during the last half of the 20th century the world benefited from American economic leadership. One example is the establishment of a multilateral rules-based trading regime after World War II. Another is the American message—bolstered by its visible success—to developing and emerging market economies that reliance on the market system rather than central planning is the key to economic progress.

He argues that since then we have seen the world move closer to markets with hundreds of millions of people escaping poverty. But a slow-growth America will not be able to provide such leadership in the future. And because there is no natural replacement for this leadership, Shultz argues that a restoration of robust economic growth in America is essential for continued prosperity throughout the world.

Activism and Policy Uncertainty

Following Shultz's opening, Alan Greenspan presents empirical evidence that too much policy activism has been a major factor holding back economic growth in the recent recovery. His analysis focuses on the decline in business investment in long-lived assets—buildings, factories, and large-scale equipment—compared with investment in highly liquid cash and other short-term financial assets. He shows that, after controlling for normal cyclical effects, there is a strong correlation between the decline in such business investment and the recent increase in the deficit. Since these cyclically-adjusted deficits are largely due to more activist fiscal policy, they can thus serve as a metric of activism, providing evidence that the recent increase in activist policy may be the source of the lower business fixed investment and slower growth.

The policy implication of these empirical findings is that a first priority should be to end the short-run temporary stimulus packages and start reducing the deficit immediately. This would reduce the amount of crowding out of investment and start to raise economic growth.

Alan Greenspan also devotes considerable attention to recent economic developments in Europe, arguing that poor economic policy in Greece and other countries that are now in crisis is the likely source of the economic problems currently facing Europe. In particular, he points out that unit labor costs in Greece are well above those in Germany and many other countries in the Eurozone. He shows that wage inflation has been higher in Greece than most of the rest of Europe both before and after Greece joined the Eurozone. But before the euro, currency depreciation (of the old drachma) kept Greece relatively competitive in contrast to what has happened since Greece adopted the euro, which made such depreciation impossible.

Scott Baker, Nick Bloom, and Steve Davis investigate whether policy uncertainty could be a factor causing the recent slow growth. They start by developing a new quantitative index of policy uncertainty, which combines several measures. For example, one of their measures is the number of provisions in the tax code which expire each year. Indeed, this type of temporary tax change is making the entire tax system unpredictable, and thus provides a good measure of policy uncertainty. According to the U.S. Congress's Joint Committee on Taxation, eighty-four tax provisions expired in 2011, about the same number as in 2009 and in 2010. This is ten times greater than the number of provisions that expired in 1999. Other components of the index tell similar though not identical stories. In fact, during the past decade the overall index has increased.

After developing the index and discussing its pros and cons, the authors use time series statistical techniques to test whether changes in the index are correlated with changes in economic growth over time. They find that increases in the index—greater policy uncertainty—tend to be associated with reductions in economic growth. The effect is statistically significant and appears to be timed so that increases in the index lead to reductions in economic growth, suggesting a causal explanation.

Monetary and Fiscal Policy

Bob Hall examines recent problems with monetary policy. He focuses on the "zero bound" constraint on monetary policy as the reason for the weak economic growth and persistently high unemployment in the recovery. In his model, aggregate demand is weak because monetary policy needs to reduce the interest rate to stimulate investment and especially consumption by the household sector. The constraint is the lower bound of zero on the federal funds rate, which prevents the Fed from lowering the interest rate further. As an example he assumes that the Taylor Rule now calls for an interest rate of –5 percent,[3] which is clearly well below zero.

Hall recommends two policies—"magic bullets," he calls them—which would effectively lower the real interest rate. The first would be to enact a consumption tax that would gradually be phased into the tax law in future years. This would effectively lower the price of current consumption compared with future consumption, and thus stimulate households to consume more now. The second proposal is that the Fed should "stop exchanging reserves for currency at par," in order to break the connection between currency and other assets in the economy.

John Taylor and John Cogan focus on the 2009 fiscal stimulus package, showing that it has not been successful in raising government purchases and thus has been largely ineffective in increasing economic growth. Much of the recent economic debate about the impact of stimulus packages has focused on the size of the government purchases multiplier. But equally crucial is the size of the government purchases multiplicand—the change in government purchases of goods and services that the multiplier actually multiplies.

3. The Taylor Rule says that the federal funds rate should equal 1.5 times the inflation rate plus .5 times the GDP gap plus 1. For example, if the inflation rate is 2 percent and the GDP gap is –.5 percent, then the federal funds rate should be 1.5 percent. A federal funds rate reading of –5 percent implies a larger gap, lower inflation, or different coefficients.

Cogan and Taylor find that the American Recovery and Reinvestment Act (ARRA) of 2009 increased federal government purchases as a share of GDP by only .19 percent and infrastructure by only .05 percent at its peak in the third quarter of 2010. While state and local governments received substantial grants under ARRA, they did not use these grants to increase their purchases of goods and services as many had predicted. Instead they reduced borrowing and increased transfer payments. Cogan and Taylor also review research on similar stimulus programs in the 1970s which reveals similar behavior on the part of state and local governments. The paper raises questions about the design and feasibility of such stimulus programs in the federal system of the United States.

Policy Impacts on Productivity

Ellen McGrattan and Edward Prescott examine the role of adverse productivity shocks due to increased government regulation in the recession and the slow recovery. They start by shedding new light on one of the most puzzling features of the U.S. economy in the recession of 2007–09, as well as in the two previous recessions of 2000–01 and 1991–92. In all three of these recessions, labor productivity, measured as real output per worker hour, did not decline. This behavior of productivity stands in sharp contrast to its pattern in all previous recessions when productivity would move nearly in lockstep with real output. Many economists have interpreted this change in the cyclical pattern of productivity to mean that real business cycle models, which emphasize changes in productivity as an explanation for business cycle fluctuations, are no longer important.

McGrattan and Prescott provide new evidence on the cyclical pattern of productivity, and new support for the importance of productivity in driving cyclical changes in economic activity. They do this by developing a model economy that features intangible capital investment and technological change that is specific to the intangibles sector. Their analysis indicates that standard measures of labor productivity are flawed, because they do not include investment in intangible capital in the measure of real output. McGrattan and Prescott then provide evidence that intangible investment declined in the recent recession and has not yet recovered. Thus, actual productivity is likely to have experienced a negative shock. They then provide data on the increased federal government regulations which suggest that these regulations are a source of the adverse productivity shock.

Policy Impacts on Labor Markets

Kyle Herkenhoff and Lee Ohanian also address the question of why the recovery has been so weak. They start by documenting that most macroeconomic variables—including real output, consumption, and investment—remain far below trend nearly three years after the recession trough was reached, and that per capita employment today is below its level during the depths of the recession. This weak recovery is particularly puzzling given that corporate profitability and corporate cash positions improved relative to their pre-crisis levels.

They find that an important reason for why employment has not recovered is that various government interventions have depressed labor markets by negatively impacting the incentives for business to hire workers and for workers to accept offers. These interventions include the very expensive programs designed to boost aggregate demand and to support ailing industries, including the

American Recovery and Reinvestment Act, Cash for Clunkers, the home-buyer tax credit, and home mortgage programs, including mortgage modification programs that reduced the incentives for workers to relocate from poor labor markets to better labor markets. By driving up the public debt, these programs also depressed the economy by creating expectations of higher taxes, and also created uncertainty about future taxes as policymakers vacillated over the future course of the Bush tax cuts and the exact nature of tax changes.

To help restore prosperity, Herkenkoff and Ohanian recommend broad-based tax reform that cuts the corporate income tax, equalizes tax treatment across all types of capital, broadens the tax base, confronts entitlement spending, and more broadly reduces government spending, as well as reforming unemployment benefits to reward job acceptance and accumulating human capital.

In sum, the contributors to this book consider a wide range of topics and policy issues related to the delayed economic recovery. While their opinions are not always the same, together they reveal a common theme: the delayed recovery has been due to the enactment of poor economic policies and the failure to implement good economic policies. The discussion at the conference where some of the papers were presented—summarized by Ian Wright—reveals a similar theme.

The clear implication is that a change in the direction of economic policy is sorely needed. Simply waiting for economic problems to work themselves out, hoping that growth will improve as the Great Recession of 2007–2009 fades into the distant past, will not be enough to restore strong economic growth in America.