

## Can We Restart the Recovery All Over Again?<sup>†</sup>

By JOHN B. TAYLOR\*

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 US 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.<sup>1</sup> 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 2014).

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.

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

<sup>†</sup>Go to <http://dx.doi.org/10.1257/aer.p20161007> to visit the article page for additional materials and author disclosure statement.

<sup>1</sup>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.

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 US economy is currently in a situation where a change in policy can both remove downside vulnerabilities and create a sharp acceleration in growth. Because the economy has grown from the start of this recovery at a pace no greater than the prerecession 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 US economy resembles an economy at the bottom of a recession, ready for a restart, even though the unemployment rate has reached 5 percent.

### 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 nonfarm 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 another upturn, though the reasons for the recent slow growth matter.

Productivity growth is now unusually low: only 0.6 percent per year for the past five years, which is only 1/4 of the 2.3 percent rate of the previous 20 years. Some of the reasons for this

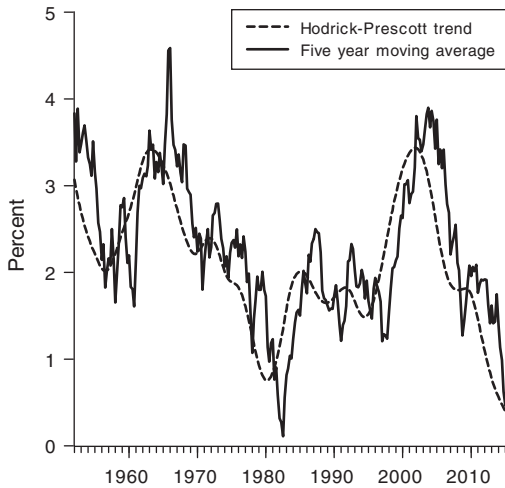


FIGURE 1. LABOR PRODUCTIVITY GROWTH RATE

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 percent during the years 1996–2005 to 0.7 percent during the years 2011–2014, or by 2.3 percentage points. Over those same two periods, multifactor productivity growth fell from 1.6 percent to 0.6 percent per year, and growth in capital services per hour fell from 3.7 percent to an amazingly low  $-0.5$  percent per year. Thus a capital share of  $1/3$  implies a reduction in the contribution of capital from 1.2 percent to  $-0.2$  percent.

Simply restoring these two contributors to growth to their precrisis levels would give a 2.4 percent 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 percent increase in labor productivity growth to around 2 percent 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 percent, 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.

Note the very sharp drop in this rate in the past few years, especially during the six 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—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 percent in 2015. But this is far in excess of the actual participation rate of 62.6 percent 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 percent to 65.6 percent would mean a 5 percent increase in the labor force. Over five years it would mean a 1 percentage point rise in the growth rate. Over ten years it would mean a 0.5 percent per year rise which would double the 0.5 percent per year now forecast by BLS. Assuming no change in the

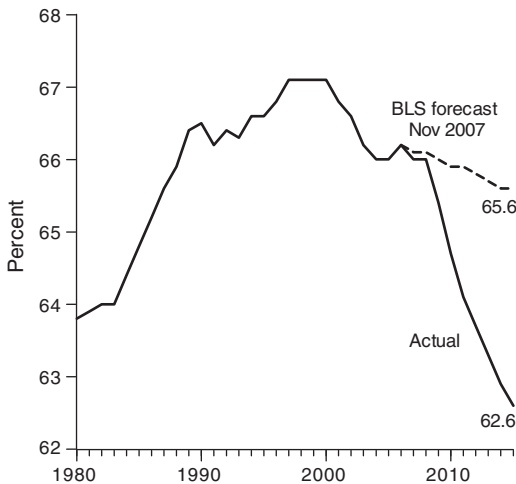


FIGURE 2. LABOR FORCE PARTICIPATION RATE

unemployment rate, employment growth would also rise from 0.5 percent per year to 1 percent per year. The percentage of the working-age population that is actually working would grow from the 59.5 percent December 2015 level (about the same as the 59.4 percent at trough of recession in June 2009) to 62.1 percent.

Going forward, BLS now forecasts that the labor force participation rate will decline by 0.3 percent per year from 2014 to 2024; the supposed change would reverse that decrease to an increase of 0.2 percent per year. Adding in 0.8 percent population growth, as BLS now projects, gives the 1 percent per year employment growth. If these effects were front-end loaded, then we could have 1.5 percent for five years and 0.5 percent 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.

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