

Has the New Millennium Repealed the Old Economic Laws?

Ohio State University
Columbus, Ohio

JOSEPH E. STIGLITZ
OCTOBER 7, 2004

OUTLINE

- Problems--The facts
- Who's to blame?
- Lessons

PROBLEMS

- The gap between actual and potential GDP
- The quadruple deficits
- Sectoral problems

THE GAP BETWEEN ACTUAL AND POTENTIAL GDP

- Cumulative GDP gap is huge:
 - Assuming 3.5% potential GDP growth – the gap is \$ 1.69 trillion in four years (2001-2004)
 - Even at 3.0% potential GDP growth – the gap is \$1.17 trillion in four years

THE DOUBLE EDGE SWORD OF PRODUCTIVITY GROWTH

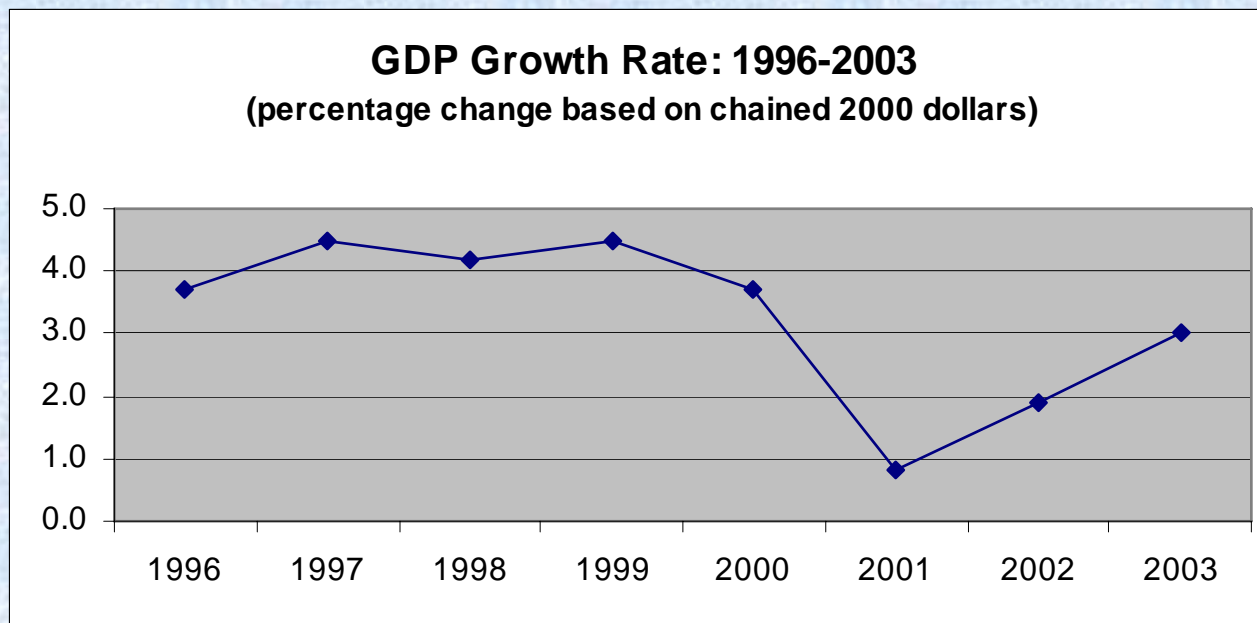
Presents opportunity and challenge

- If the economy is well managed—maintains full employment—then faster increases in living standards
- But economy needs faster growth—must run harder just to stand still
- And if one fails, unemployment will grow and there will be downward pressure on wages

We failed the challenge and lost the opportunity

NOT ENOUGH GROWTH

- Potential growth in the range of 3 to 4 % -- Big improvement over the period 1973-93
- But in 2001 to 2002 we did not live up to that potential
- And in subsequent years we have not closed the gap



NOT ENOUGH GROWTH

- Result is much higher unemployment rate
 - Especially compared to 90s, when unemployment fell to 3.8%
- But unemployment understates problems
 - Discouraged workers
 - Increased numbers on disability
 - Up almost 1 million
 - Lowest participation rates in decade
 - First 8 months 2004 lower by more than 1.1% than in comparable period in 2000

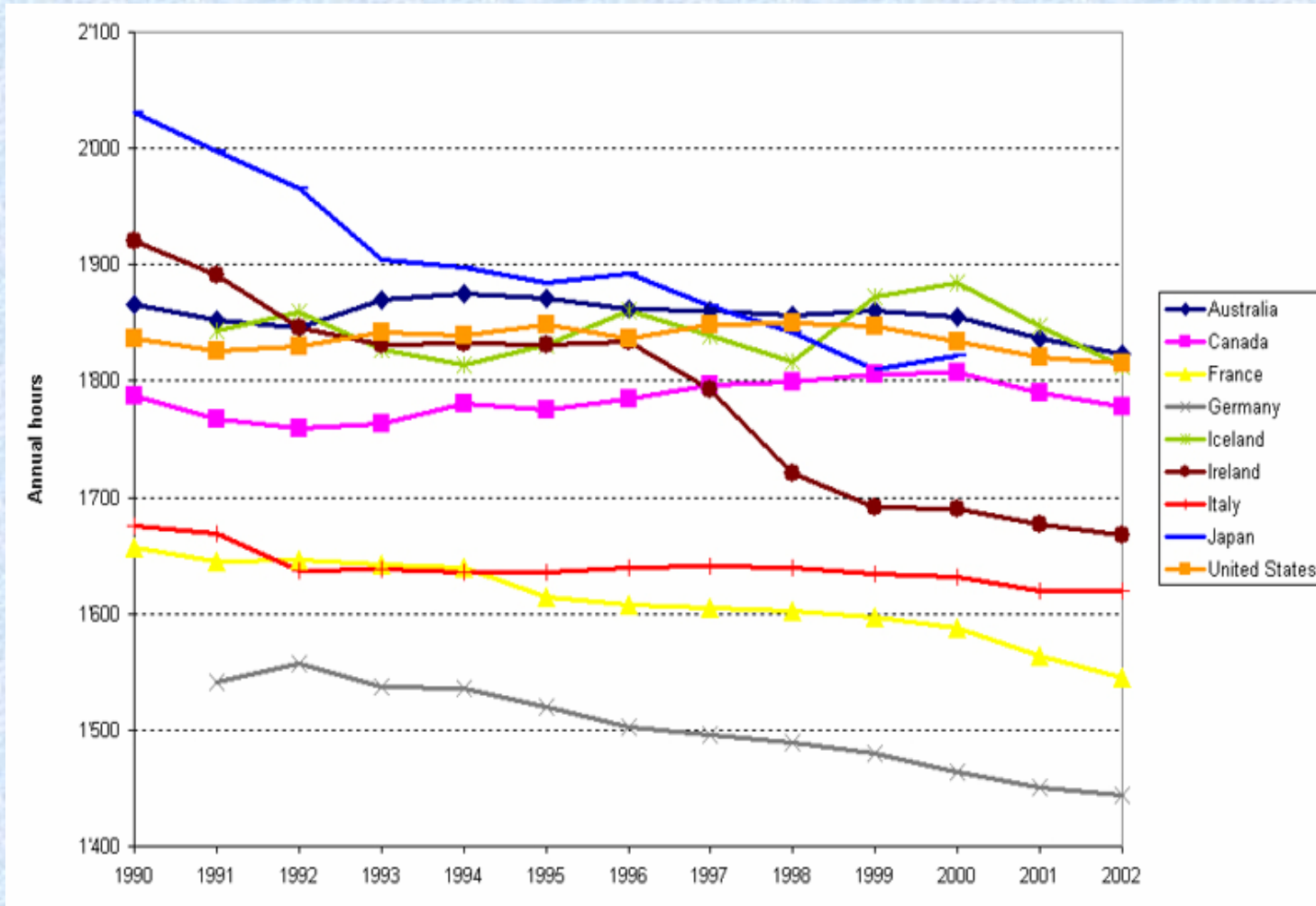
GROWTH IS NOT ENOUGH

Rising tide does not lift all boats

Trickle down economics does not work:

- Average American family worse off today than it was four years ago
 - Median annual real income down approximately \$1500
 - Soaring health, energy, and education costs hit some families particularly hard
- Americans are working longer hours with worsening contracts
 - Nearly one quarter of all workers – more than 28 million in all -- earn less than \$8.78 an hour, the amount needed to lift a family of four above the poverty line with full-time work (about \$18,200 a year).
 - On average, Americans are working longer hours. In 1980, an average employee worked a total 1685 hours during the year. By 2003, it increased to 1792 hours compared to 1446 hours in Germany and 1453 hours in France
 - Fewer workers have health care or pensions

AMERICANS ARE WORKING LONGER HOURS..



GROWING INEQUALITY

- Share of labor (wage share of GDP) lowest in records
- Level of inequality increased enormously—
 - Essentially all of benefits of growth have gone to the top
 - Back to levels of Great Gatsby
 - In the 1920s, the richest five percent of American families received about 30 percent of the nation's personal income. That share had decreased to 15.6 percent by 1969, according to the Census Bureau; now numbers are back to older levels
 - The top 1 percent of households held 38 percent of the wealth.
 - Bill Gates, America's richest individual, alone has more wealth than bottom 40% of the U.S. population combined, or 120 million people
 - Among the industrialized nations, the U.S. has the highest concentration of individual wealth--roughly 3 times that of Germany
 - Levels of poverty also up
 - By 2003, child poverty rose to 17.6% from 16.3 percent in 2001 and 14.4 percent in 1973 – the current rate is highest among 17 OECD countries. The U.S. also has the highest overall poverty rate
 - Trend that had begun in early 70s was arrested in 90s, but then resumed in last four years

SYMPTOMS OF SOCIAL TENSIONS

- On June 30, 2003, 2,078,570 prisoners were held in Federal or State prisons or in local jails
- There are an estimated 480 prison inmates per 100,000 U.S. residents -- up from 411 at year end 1995 (source: Department of Justice)
 - Levels much higher than in Canada, Germany, Japan and the UK –ratio 3.5 to TEN times higher.
 - U.S. is the highest among the industrialized countries

THE QUADRUPLE DEFICITS

- jobs
- fiscal
- trade
- balance sheet—growing household indebtedness

JOBS DEFICIT

Since 2001, the economy needed some 6 million new jobs for new entrants to the labor force

- In fact since 2001, more than 1.7 million jobs lost in the private sector
- Only public sector employment has grown
- The worst job record since the great depression
 - Employment/working age population ratio down 2.2% from peak
 - In comparison to less than .5% in nine other post war recessions
 - In these recessions, employment 3 years into cycle up 3.7%
 - In this case, employment still down
- Also serious questions about quality of new jobs

FISCAL DEFICIT

- Two percent of GDP surplus has turned into 5% of GDP deficit
 - Largest turnaround in such a short span of time
- Do deficits matter?
 - We are borrowing from abroad
 - Meaning that future generations are poorer than they otherwise would be

DO DEFICITS MATTER?

- Full answer—depends on how money is spent
 - If on high productivity investment, then may be good for economy
 - But investment has not increased – in fact, investment down 2.1 percent under George Bush, the first decline of any President in over 70 years.
 - Business fixed investment has declined from \$1,234.4 billion in 2001-Q1 to \$1,207.9 billion in 2004-Q2, a 2.1 percent decline.
 - Money went for tax cut for upper income Americans
 - And money evidently did not find its way into productive investment
 - Worse—fiscal constraints likely to undermine needed investments in infrastructure, technology, education
 - » R&D yields a high return
 - » Was basis for growth in the 90s (internet)
- Deficits will also undermine our ability to meet commitments to future generation
 - Risks abrogating social compact across ‘generations’
 - Gap in social security could have been met with fraction of money spent on tax cut

TRADE DEFICIT

- Richest country in world is borrowing close to 1.5 billion dollars a day
- Growing trade deficit
 - Potential source of global financial instability
 - Already contributed to volatility in exchange rates
 - Makes U.S. more vulnerable to changes in international sentiment
 - U.S. not immune from ‘attack’—early 70s

BALANCE SHEET—GROWING HOUSEHOLD INDEBTEDNESS

- Leading to increased bankruptcy rates
- Natural outcome of ‘low’ interest rates
- But may dampen any recovery
 - Higher interest rates leave less cash available to spend on other things
 - assumes differences in MPC between debtors and creditors
 - As real estate prices come down

SECTORAL PROBLEMS

ENERGY

- High oil prices
- Likely to further dampen recovery

HEALTH

- Family health care premiums up 64 percent from 2000 to 2004
 - fastest increase on record
 - total family premium is now up more than \$3500 since 2000
 - 45 million Americans without health insurance
- More Americans have no coverage
- America spends more than any other country—but gets less for it
 - U.S. ranks 22nd in life expectancy – behind most OECD countries
 - Some health statistics comparable to those of developing country
- Health insurance costs may be contributing to jobs problem

WHO'S TO BLAME?

Problems in assessing blame

- COUNTERFACTUAL HISTORY
 - What would have happened if....
- 'TWENTY-TWENTY' HIND SIGHT
 - Easier to detect mistakes *after the fact*

MACRO-ECONOMIC PERFORMANCE

- The claims:
 - The economy was weak in 2000
 - Bursting of dot com bubble
 - Problems compounded by 9/11
 - And then uncertainty of Iraq war
 - But without tax cuts, the economy would have been even weaker

MACRO-ECONOMIC PERFORMANCE

- The critique:
 - Every president inherits a mixed bag
 - Clinton inherited large deficit, growing inequality, weak economy
 - Economy turned around, poverty reduced
 - tax increase and expenditure cuts turned deficit into surplus
 - Current administration inherited fiscal surplus
 - Could have used money to stimulate the economy
 - Knew the economy was weak—even ‘talked the economy down’ to help get the tax cut through

THE FAILED STIMULUS

Tax cut was not designed to stimulate the economy, and did not provide much stimulus

- Some parts (like elimination of inheritance tax) arguably provided *negative* stimulus
- Much of stimulus provided by Congressional amendments, not in original tax proposal
- provided remarkably little bang for the buck
 - Dividend tax cut particularly ineffective
 - Lower interest rates had already demonstrated lack of sensitivity to cost of capital
 - For most Americans, dividend tax largely irrelevant, since stock holdings in pension funds and IRA's
 - There were ways of eliminating double tax and retaining progressive tax rate (increasing bang for buck)
 - Provisions ensuring that some dividends did not escape taxation totally eliminated at last minute

THE MISSED ALTERNATIVE

- There were alternatives that would have provided more bang for the buck—and were recommended in early 2001
 - Strengthened unemployment insurance
 - Automatic stabilizer
 - America has one of poorest unemployment insurance systems
 - Tax cuts for lower and middle income Americans
 - Targeting corporate tax cuts on those who will stimulate the economy
 - Investment tax credit
 - Aid to states and localities
 - Have balanced budget framework
 - Cutbacks have strong distribution consequences
 - Failure to provide assistance had strong dampening effect

IMPLICATIONS OF BADLY DESIGNED TAX CUT

Forced more of burden on monetary policy

- But monetary policy did not lead to more investment
- Only to increased consumption and indebtedness

THE IMPLICATIONS

- Economy was not stimulated much
- But deficit soared

SOARING DEFICIT

- Not just weak economy
- Not just tax cuts – though they were important
- Not just military expenditure

Fundamental problem - Abandoning pay-go framework --
lack of fiscal discipline

–Irony—many of those supporting budget busting
policies tried to get balanced budget amendment passed

–Many of expenditure increases were for old fashioned
corporate welfare

–federal subsidies to private businesses cost taxpayers \$87 billion per
year

–Farm subsidies increased enormously

Explaining the problems

- Gap between potential and actual GDP and job deficit
 - Poorly designed stimulus
- Fiscal deficit
 - Tax cut that did not provide much stimulus
 - Elimination of fiscal discipline
- Trade deficit
 - Twin deficit problem—when fiscal deficit soars, so often does trade deficit
- Growing household indebtedness
 - Failed fiscal policy pushed burden of stimulation onto monetary policy

FUTURE STRENGTH OF ECONOMY HAS BEEN PUT INTO JEOPARDY, CURRENT RECOVERY IS FRAGILE

HEALTH

Two huge problems

- Soaring costs
- Lack of coverage
- Current policies may contribute to both
 - Forbidding bargaining over drug policies certain recipe for increased prices
 - Problem of asymmetric information (cream skimming, cherry picking) exacerbated by health security accounts (which in any case provide no benefit to less well off, and more benefits to those in high tax rates)
 - Will lead to higher health insurance costs and less coverage for average Americans

HEALTH

- Catastrophic reinsurance focuses on one major problem
 - No significant moral hazard problem
 - Demand elasticity for heart surgery has low elasticity
 - Will reduce problems of asymmetric information
 - Will make health insurance more affordable, reduce problems of lack of coverage

HIGH OIL PRICE

- **Supply:**
 - Predictable and predicted outcome of failed Middle East strategy
 - *though post war Iraq strategy and outcomes worse than even severe critics imagined*
 - Muddled meddling in Venezuela
 - Uncertainty in Nigeria exacerbated by Haliburton corruption
 - Even if 'energy bill' passed ("leave no lobbyist behind") had passed, would have done nothing for today's problems
 - Questionable justification (market failure) for subsidies
- **Demand:**
 - Focus should have been on conservation
 - No use of market mechanism, incentives
- **MOST IMPORTANTLY**
 - "Drain America First" policy makes the U.S. more vulnerable in future

SOME LESSONS FOR FUTURE TEXTBOOKS

- Poorly designed deficits may not provide much stimulus
 - When economy faces worries about deficits, important to maximize ‘bang for the buck’
- Deficits can grow quickly when fiscal discipline –like ‘pay-go’ approach is dropped
 - Balanced budget amendment would have been a mistake
 - But so too is no budget discipline
- Lower interest rates may not lead to more productivity enhancing investments, but rather to more consumption
 - Evidence of importance of credit constraints
- Bubbles can have strong adverse effects after they break—and distort resources before
 - Has reliance on low interest rates led to a real estate bubble?
 - May be too early to tell—but policy has resulted in high level of risk

SOME LESSONS FOR FUTURE TEXTBOOKS

- One has to look at future risks posed by present policies
 - Drain America first makes America more vulnerable in the future
 - Recovery based on increased household indebtedness may weaken strength of future recovery

SOME LESSONS FOR FUTURE TEXTBOOKS

- **Markets may not by themselves solve all problems and poorly designed deregulation may exacerbate problems**
 - Should pay careful attention to market failures
 - Environmental externalities are one of the most important examples
 - In all economies, health care not governed by ordinary market forces
 - Importance of 3rd party payers
 - Importance of adverse selection
 - Theory of second best—increased reliance on *some* market forces does not create a market economy
 - And may make matters worse
- **Strength of American economy based on achieving balanced role between markets and government**
 - Loosing that balance to extremism will weaken economy

SOME LESSONS FOR FUTURE TEXTBOOKS

- The forces that give rise to growing inequality may be outside the control of government, but government needs to deal with the consequences
 - ‘Do no harm’
 - Period of increasing inequality and poverty is not the ideal time for tax cuts centered on very top

SOME LESSONS FOR FUTURE TEXTBOOKS

- Tax cuts for the rich not the solution to every economic problem
- Nor are subsidies for corporations best solution to every ailment
- When a policy fails, re-think why it might be failing, rather than trying more of the same
 - Important to look at theory and evidence
 - Though often inconclusive