THE ECONOMIC SITUATION

A Quarterly Commentary

MERCATUS CENTER
George Mason University

Bruce Yandle

Dean Emeritus
College of Business and Behavioral Science and
Alumni Professor of Economics Emeritus
Clemson University

Distinguished Adjunct Professor of Economics
Mercatus Center at George Mason University

yandle@bellsouth.net

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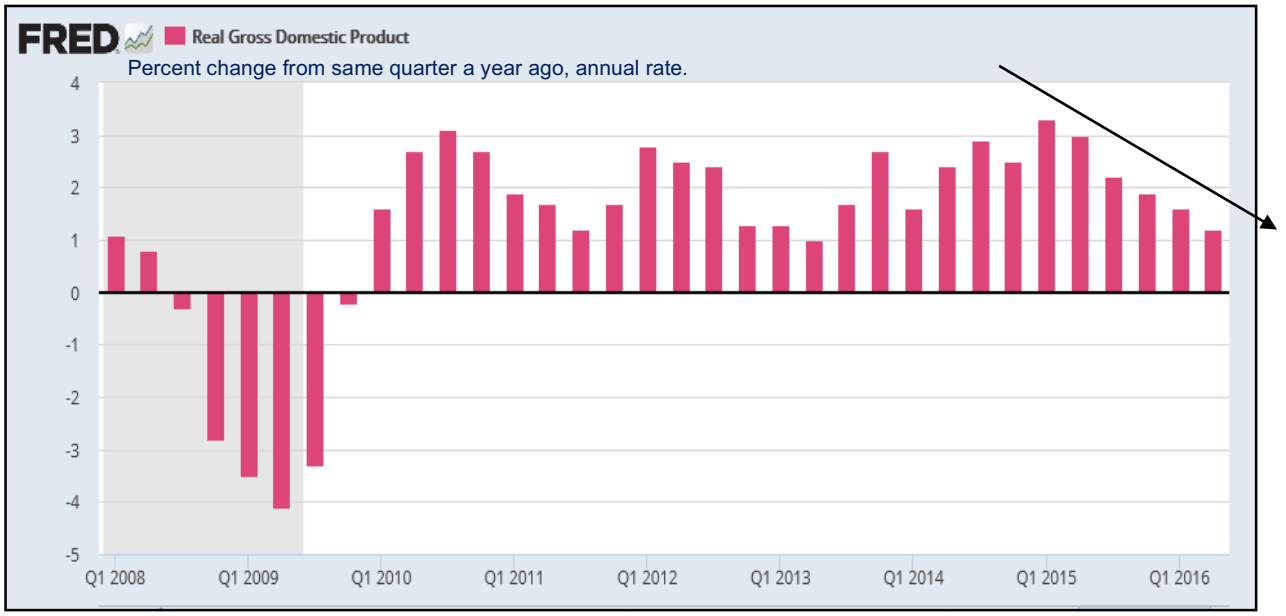
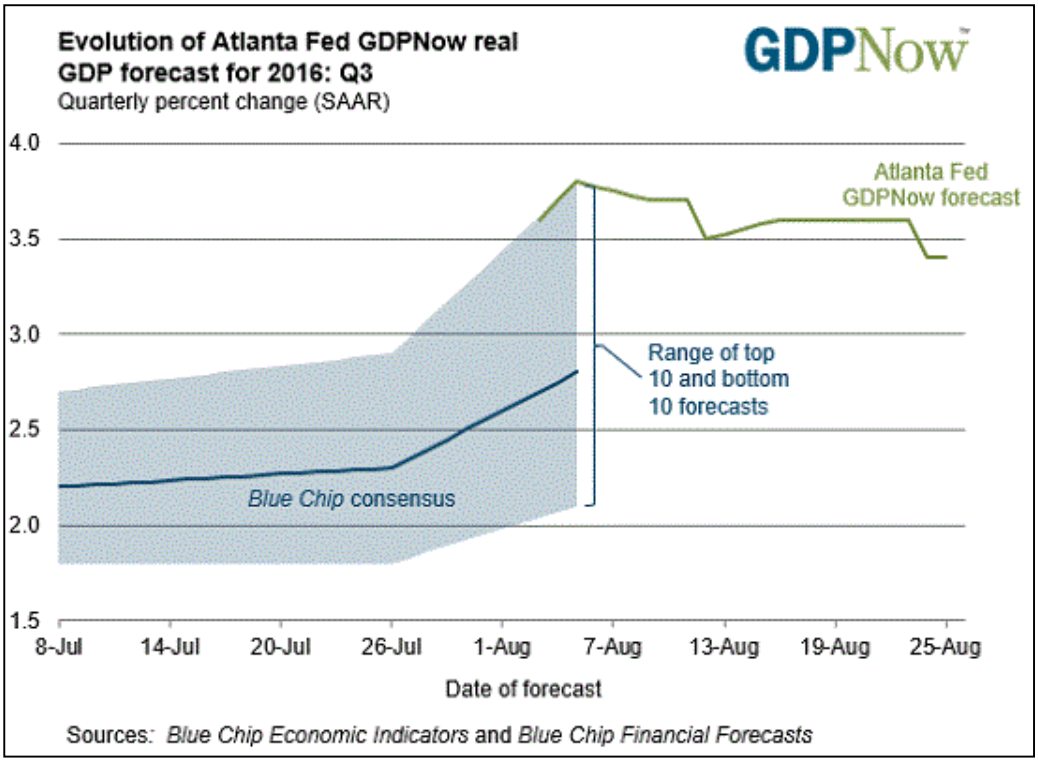
The US Economy: Still in Low Gear

Europe has a bad case of the slows. Mexico's economy has hit the skids. The UK post-Brexit economy is still trying to get up on its legs. And in the United States, the consumer is keeping the merry-go-round spinning. While some politicians claim all is well in the homeland and others say everything is either rigged or falling apart, the truth seems to lie somewhere in between. As September rolls around, the US autumn economy is chugging along, but at a pitifully slow rate.

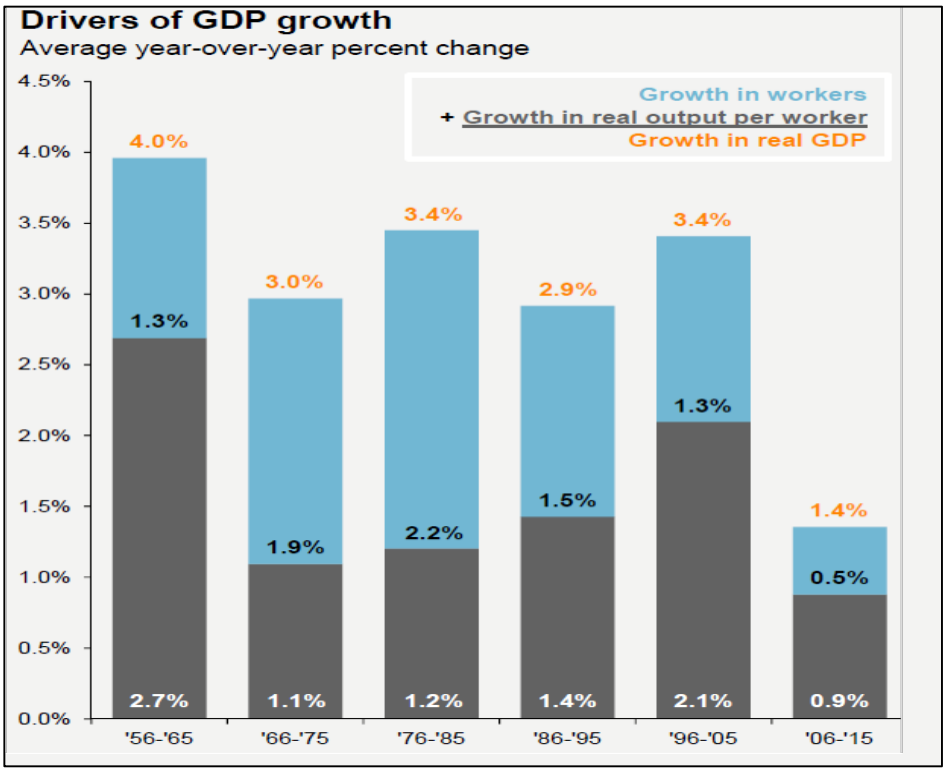
The latest GDP reckoning from the Department of Commerce tells the tale, at least for now. Second quarter growth was 1.1%, which followed the first quarter's 0.8%, giving an average of less than 1.0% for the year's first half. The accompanying chart produced using the St. Louis Fed's Federal Reserve Economic Data (FRED) shows the southbound trend continues. At this pace, we will be lucky to see the year close out with 1.4% growth. In order to hit that target, the

last six months will have to be a lot better. And that is what the Atlanta Fed's GDPNow promises. As of August 26, the 3Q2016 estimate was 3.4%. However, the longer-term prospects are not all that bright.

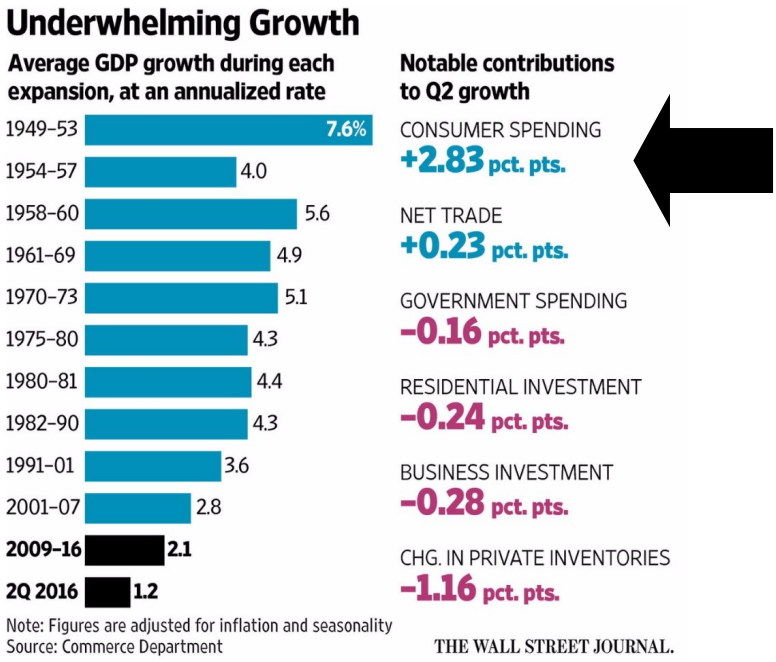




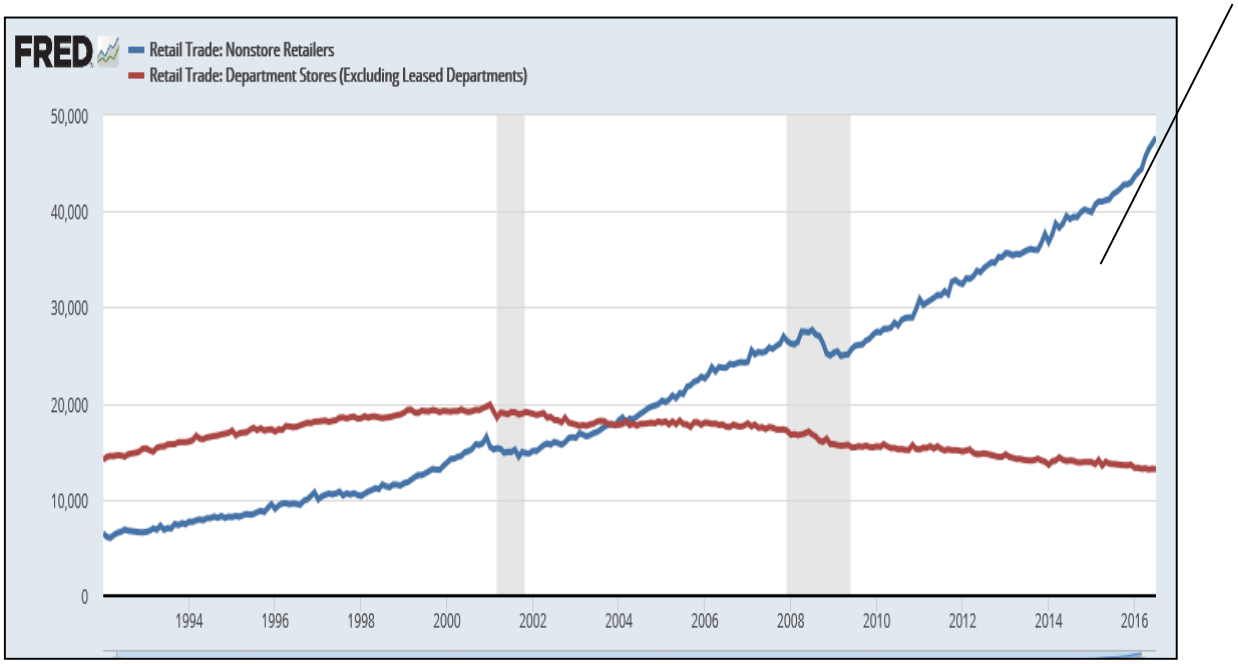
An analysis by Century Wealth Management looks at fundamental GDP growth drivers and explains why we should not expect to see rockets launching in the next year or so.



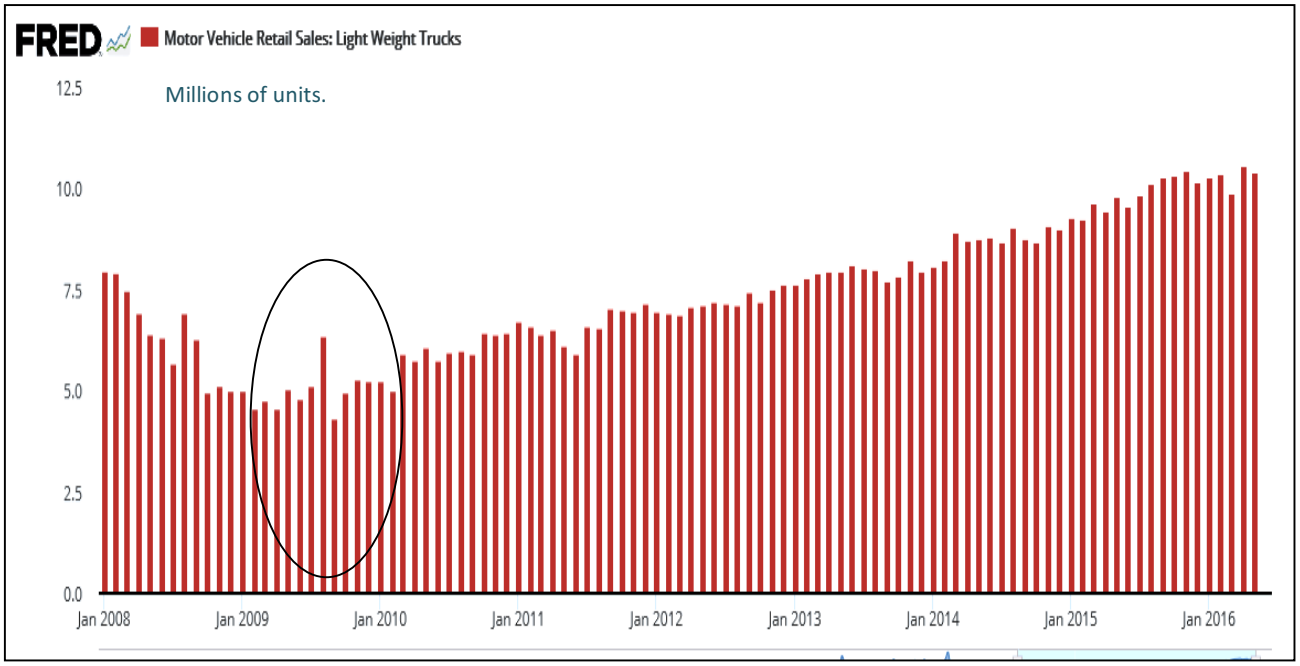
Remember, growth improvements depend on one of two things—more people working smart or the same people working smarter. As indicated here, slow growth in the work-age population coupled with weak gains in labor productivity darken the prospects for hitting the GDP high road. When we look at the post-2008 GDP growth observations, we see one of the palest recession recoveries in modern times. As shown here in the *Wall Street Journal* analysis, in 2Q2016 it was consumer action powering the GDP merry-go-round.



And as the next FRED chart tells us, most of the spending is in online, non-store sales. Notice that online retail sales began to beat out department store sales in 2004. Meanwhile, the trend has accelerated. But get an eyeful of the last four or five observations in the chart. Online activity has lit the afterburner.



While online sales are skyrocketing, sales of light trucks—which include SUVs—shown in the next chart, are finally reaching a plateau, and a high one at that.

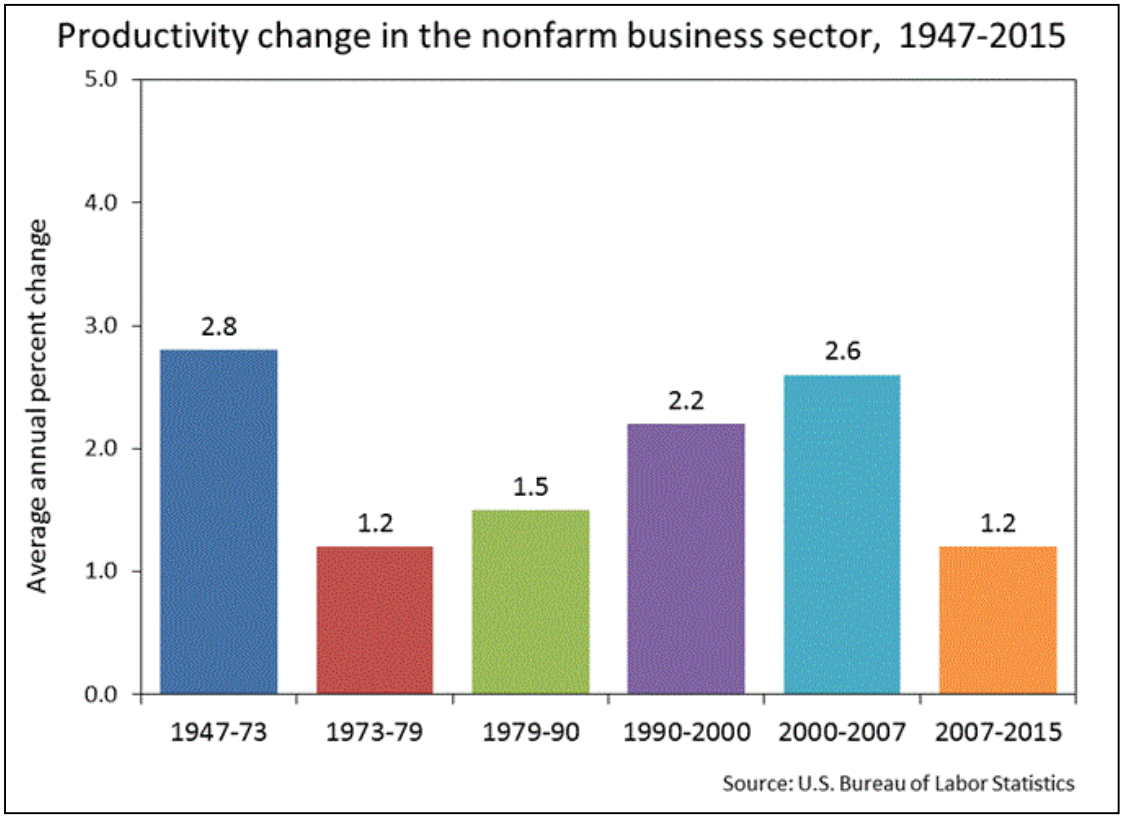


I call attention to the tall 2009 observation that resulted from the federal cash for clunkers program. That program began in July 2009 and ended in December 2009. In an effort to assist the troubled auto industry and encourage the purchase of more fuel-efficient cars, Congress appropriated $1 billion for the program. So many consumers scrambled to get on board that Congress had to find another $2 billion to keep the program going.

If approved, a car buyer could get up to $4,500 from the program to use toward the purchase of listed fuel-efficient cars. It was deemed a roaring success by politicians. It only cost taxpayers $3 billion. In 2014, two Texas A&M University economists produced a study of the program to determine its relative success. They found that instead of stimulating auto industry sales, the program strikingly reduced overall revenues. There was an unnatural surge in the sale of Toyota Corollas, for example, but a later decline in the sale of more expensive cars consumers would have normally purchased. Toyota must have appreciated the stimulus program.

Productivity, Regulation, and America's Prosperity

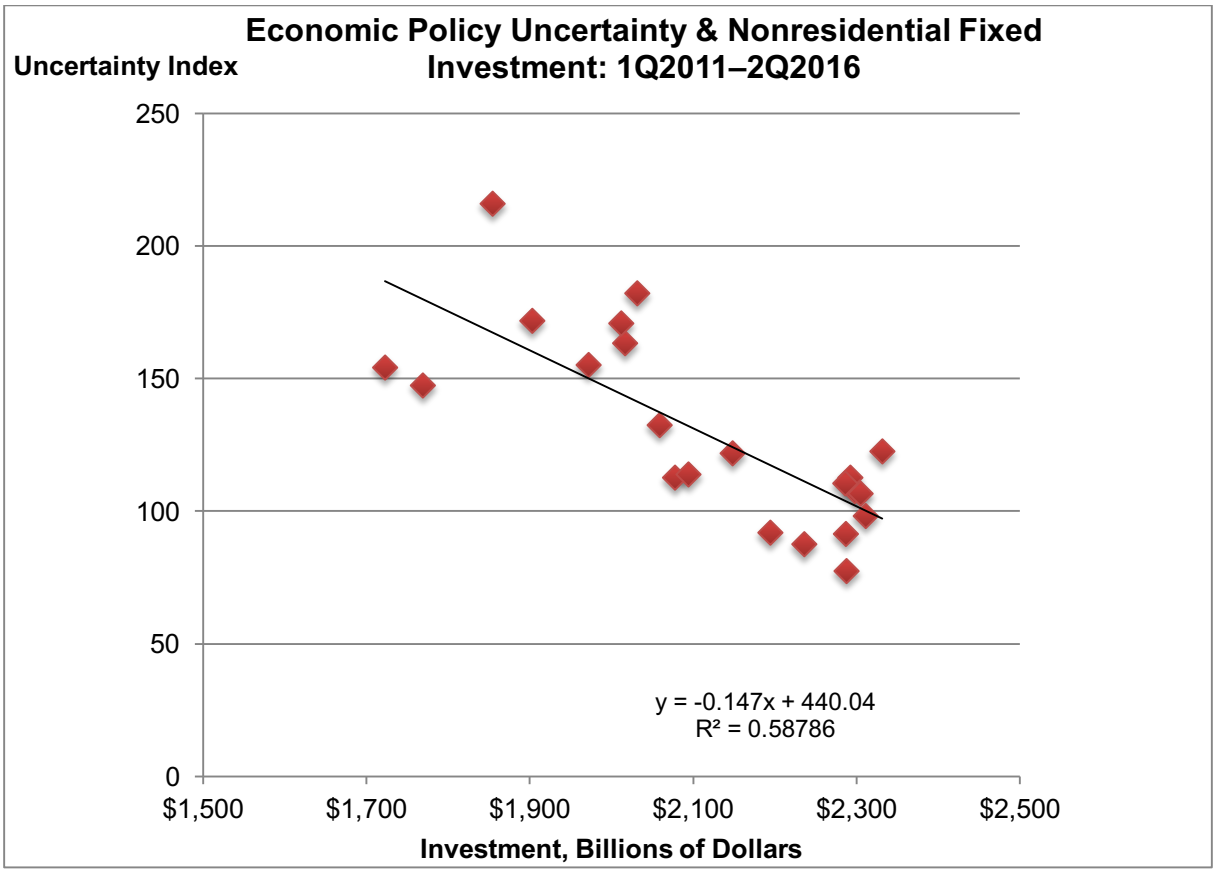
Some argue that America's prosperity can be improved by imposing higher taxes on the more prosperous one percent and shifting the proceeds to the more deserving middle class. Unfortunately, getting long-term improvement through such trickle-over tactics just doesn't work out well. Taxing Peter to pay Paul always gets Paul's vote, but Peter has a way of avoiding the tax haircuts. We know that future GDP growth, wages, salaries, improved healthcare, and even paying college tuition depend on improvements in labor productivity. If all of us hope to get more stuff, we will just have to produce more stuff. Let's face it, someone has to pay for all this stuff. Right now, as shown by the accompanying Bureau of Labor Statistics chart, productivity growth looks pretty sorry.



Lots of moving parts underlie these numbers. For example, there are factors like the average age, experience, and educational attainment of US workers. There are also improvements in the amount and kind of machinery and capital used by workers. Right now, even though interest rates are at rock bottom levels, business investment is lagging. Political uncertainty is one reason why that it so. Here's the logic: Tell me what the king will do, I will tell you if I am ready to place more of my purse in the game.

I show next the relationship between the Economic Policy Uncertainty Index, restated in quarterly terms, and US investment in nonresidential fixed assets since 2011. The relationship does not hold up well for longer periods. No, the mapping is not perfect, but the inverse relationship is strong. High uncertainty, low investment.

Right now? Policy uncertainty is riding high. It's crazy season, and those who want to be king are making a lot more promises than they can ever deliver.



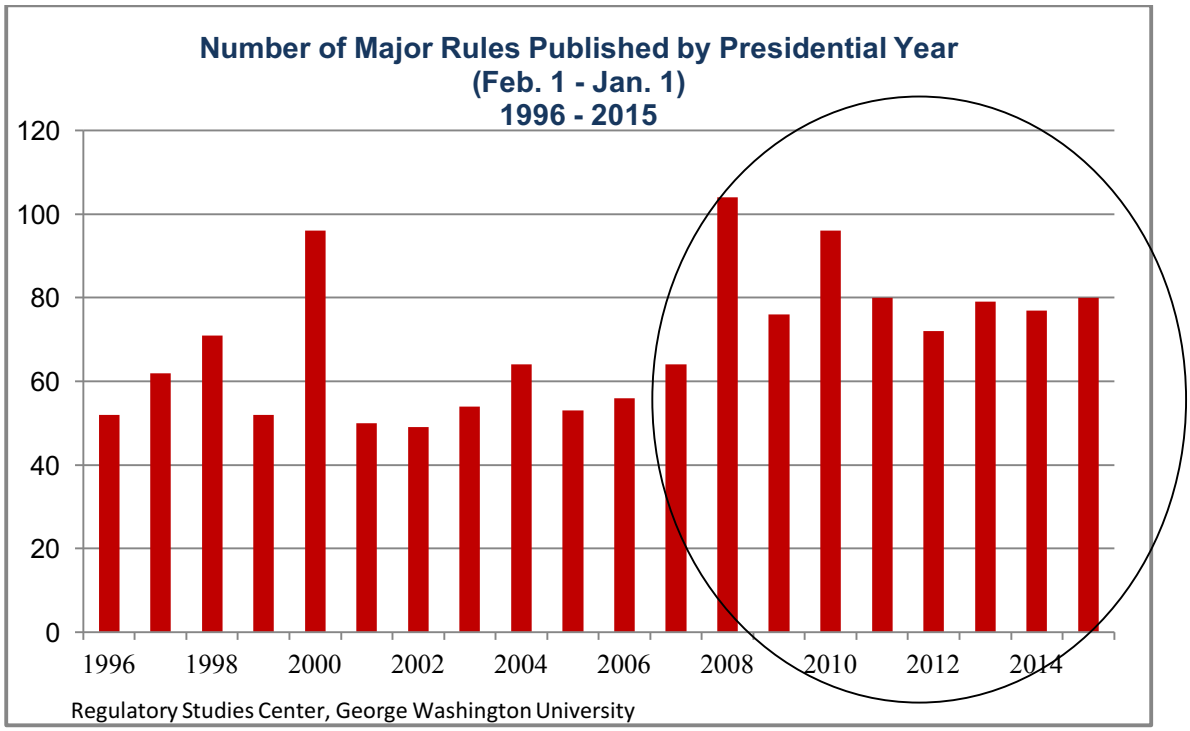
A lot that we produce is not counted

US labor productivity is in the cellar for yet another reason, and a simple one at that. A lot of what is being produced today does not get counted when the Department of Commerce tallies its number. When US workers produce more automobiles, days of healthcare service, and financial transactions, they are also turning out less carbon dioxide, discharging cleaner waste water, working in quieter factories, and making loans with a few million more pages of loan documentation. Put another way, America's regulated capitalism produces a lot of collateral output that does not always get counted.

Some mandated changes do get counted. For example, the EPA's fuel economy standards set on August 16 for large trucks, school buses, and garbage trucks indicated the rules will cut more than 1 billion tons of carbon pollution from the atmosphere and will save $170 billion in fuel costs. When the newly evolved truck engines are developed, the Bureau of Labor Statistics will adjust the quality of truck engines produced to account for mandated changes in fuel economy. Labor productivity may rise with that part of regulatory changes. However, there are no productivity gains associated with reducing a billion tons of carbon emission from the air. The same is true of rules that restrict endangered species habitat and preserve wetlands for water fowl, which in turn reduce the amount of land that can be cultivated by farmers.

Federal regulatory agencies are required to give special attention to rules that impose costs on the economy of more than $100 million annually, which are called major rules. More costly rules,

less productivity. I provide a chart on this for the years 1996 through 2015 produced by George Washington University's Center for Regulatory Studies. Note how the pace has quickened since 2008. In 2008, there were more than 100 major rules placed on the books. That's 100 times at least $100 million in cost each year for as long as those rules are in effect. Yes, each one of those rules produces benefits, perhaps in the form of lower carbon emissions or more efficient irons and washing machines. But those benefits do not get translated into wages, salaries, healthcare benefits, or the ability to pay mortgages and student debts.



Do the benefits offset the costs? Yes, you can bet your boots they do, at least as reported by the agencies that promulgate the rules. But again, that doesn't mean labor productivity goes up. In 2015, the US Office of Management and Budget reported that the *annual* benefits of rules published between 2004 and 2014, for which agencies provided benefit estimates, are in the aggregate between $261 billion and $981 billion in 2010 dollars. OMB notes that the wide range reflects uncertainty in the estimates. I call attention to the high-end estimate—$981 billion in annual benefits from regulations. Let's put this in perspective. Second quarter 2016 GDP was just over $16 trillion. The high-end estimate, $981 billion, is a bit more than 6% of GDP. As they say, that ain't chicken feed. It is not people food either.

Does inflation lie ahead and with it the next recession?

Aside from the gap between labor productivity and regulated production, there is another anomaly seen in current macroeconomic data. We have pale GDP growth, but tightening overall labor markets, at least as measured by the conventional unemployment rate. Lower unemployment rates are of course good news for slow-recovery-weary job seekers. But as labor

markets tighten and the number of individuals entering the labor force for the first time equals the number being hired, the economy reaches a point where, given the huge amount of available credit in the economy, tighter labor markets lead to higher wages and inflation.

The natural rate of unemployment is an estimate of just where that magic number lies. As indicated in the next Federal Reserve Bank of St. Louis chart, the July unemployment rate crossed the natural unemployment rate for the first time in this long post-recession expansion. The chart's observations show two other periods when markets tightened enough to cause the unemployment rate to be smaller than the natural rate. After a lag of almost a year, recessions followed in each of these cases.

Is there cause and effect here? Maybe, in a curious kind of way. The recessions that followed unusually tight labor markets were provided courtesy of the Federal Reserve Board. The Fed raised interest rates in an effort to slow a potentially overheated economy. And recessions resulted.

In a June 2016 report, the Congressional Budget Office (CBO) provided a rather detailed snapshot on how Americans in different income groups are making out when it comes to taxes paid and subsidies received. The next chart, which was developed by American Enterprise Institute, gives the results. Notice first that CBO uses a comprehensive income measure. Their "market income" is an amount that includes wages and salaries, capital gains, property, interest, and other income. They also show federal transfers received for all income groups; this includes Medicare, Medicaid, Social Security, and other federal program benefits. Notice that the average

tax rate is negative across the first three quintiles, which include what some call middle class America. The rate becomes positive and increases across the remaining two quintiles.

Notice also that the average dollars received in transfers for every dollar paid in taxes falls significantly across the five quintile groups. Trickle-over economics doesn't work very well for people in the fourth and fifth quintile.

US Household Data by Income Quintile, 2013	Lowest Quintile	Second Quintile	Middle Quintile	Fourth Quintile	Highest Quintile
1. Average Market Income	$15,800	$31,300	$53,000	$88,700	$253,000
2. Average Government Transfers	$9,600	$16,200	$16,700	$15,000	$12,000
3. Market Income + Government Transfers (Before-Tax Income)	$25,400	$47,500	$69,700	$103,700	$265,000
4. Average Federal Taxes Paid	$800	$4,000	$8,900	$17,600	$69,700
5. Average Federal Tax Rates on Market Income + Transfers	3.1%	8.4%	12.8%	17.0%	26.3%
6. Federal Taxes Paid Minus Government Transfers Received	($8,800)	($12,200)	($7,800)	**$2,600**	**$57,700**
7. Average Net Federal Tax Rates After Government Transfers	-34.6%	-25.7%	-11.2%	2.5%	21.8%
8. Dollars Received in Transfers per Dollar Paid in Federal Taxes	$12.00	$4.05	$1.88	$0.85	$0.17

Source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes," 2013

What lies ahead for 2016?

We have just four more months to go before year-end. GDP growth for the second quarter is hanging at 1.1%. I am expecting 1.4% for the year, which means that growth in the year's second half will be riding higher. Brexit and the related stronger dollar will continue to take some of the edge off export sales and this, at the margin, will slow the pace of growth for manufacturing. The latest readings on the manufacturing and services sectors show both parts of the economy are growing, with a strong pace of growth for new orders.[1] At the same time, inflation at the commodity and consumer levels is still tame. Consumer-led growth should

[1] The Institute for Supply Management reported that "of the 18 manufacturing industries, 11 are reporting growth in July in the following order: Textile Mills; Printing & Related Support Activities; Miscellaneous Manufacturing; Wood Products; Furniture & Related Products; Chemical Products; Food, Beverage & Tobacco Products; Fabricated Metal Products; Nonmetallic Mineral Products; Petroleum & Coal Products; and Computer & Electronic Products. The seven industries reporting contraction in July—listed in order—are: Apparel, Leather & Allied Products; Electrical Equipment, Appliances & Components; Plastics & Rubber Products; Machinery; Primary Metals; Transportation Equipment; and Paper Products," Institute for Supply Management, "July 2016 Manufacturing ISM® *Report On Business*®," August 1, 2016, https://www.instituteforsupplymanagement.org/ismreport/mfgrob.cfm.

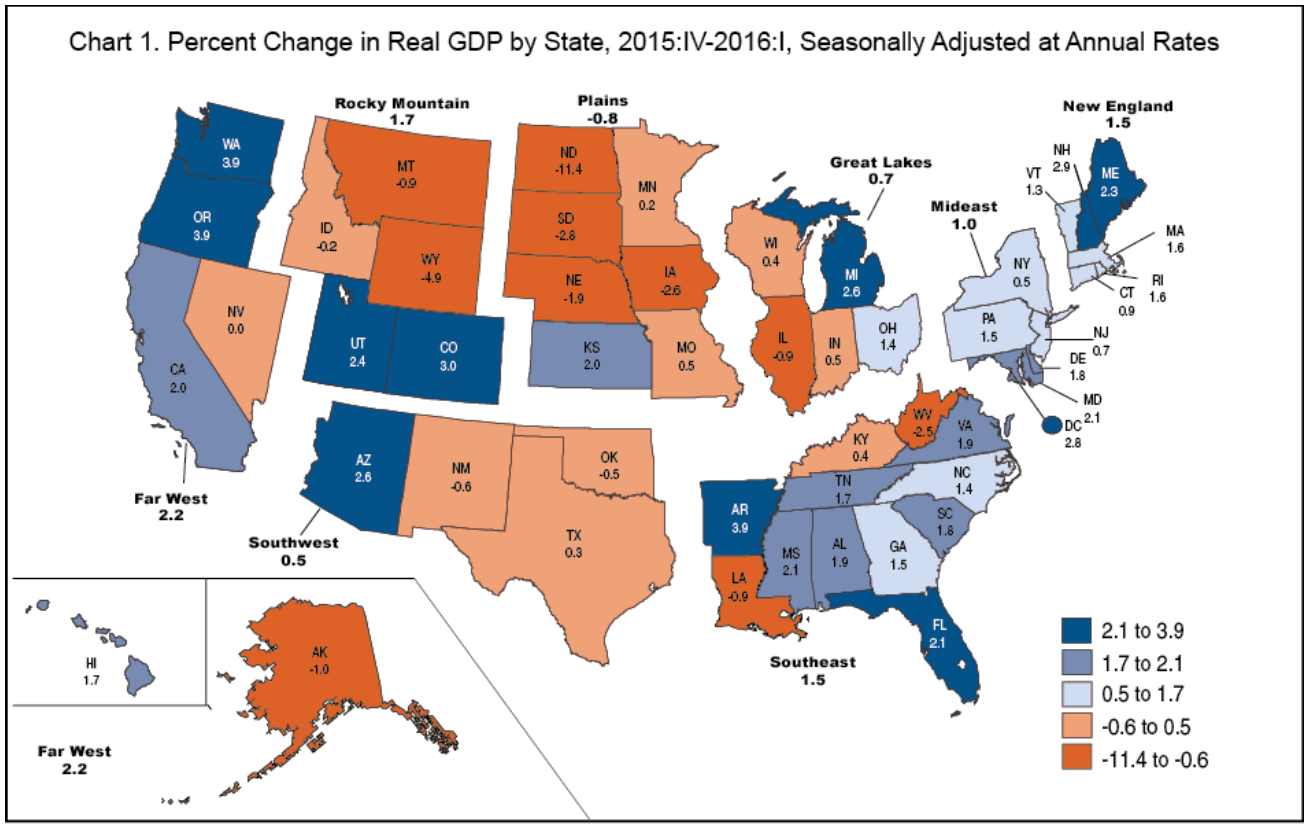
continue apace as we move into the year ahead. As for the rest of the world, it is interesting what a difference a couple of years can make. Not too long ago, newswires were hot with stories about the BRIC economies—Brazil, Russia, India, and China. Well, Brazil and Russia are in recession and China has a heartbeat, but not nearly as strong as two years ago. Of the BRICs only India's economy is flourishing. We can include all of Europe in the economic sick bay, though Germany and Italy still are signaling positive growth.

The US economy is still in the slow lane and will be there for the next 18 months or so.

The Geographic Imprint

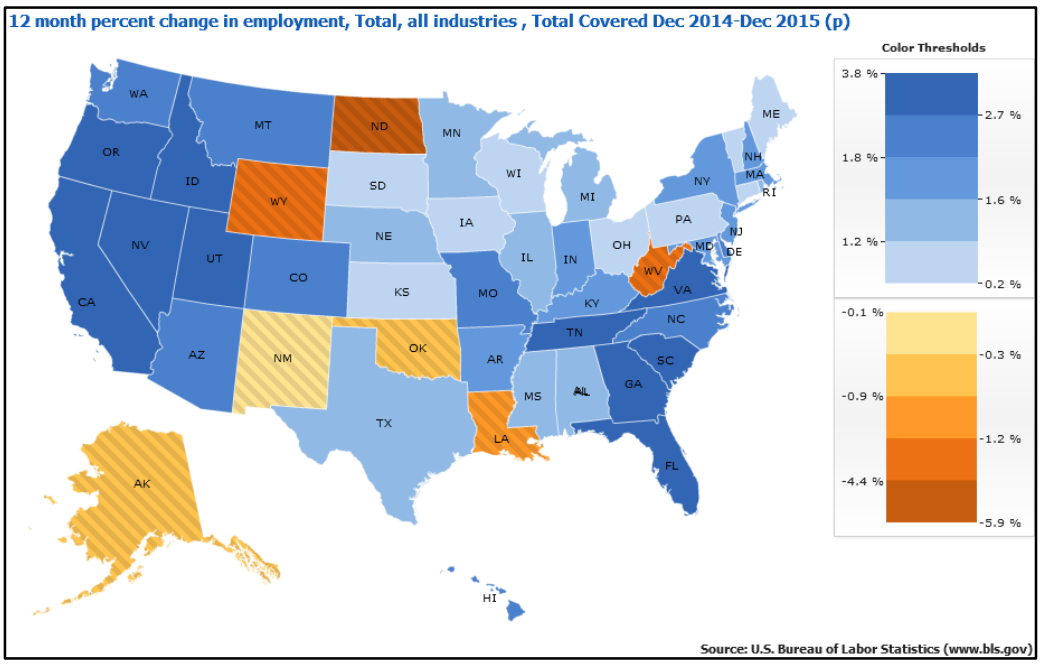
The dynamics of the US economy are seen in the variation in GDP growth across time, the pace of post-recession recoveries, and the distribution of income generated by the churning of the Great American Bread Machine. Just how things happen across the states and regions gives yet another image of the American economy.

Do you ever wonder what someone is thinking when he or she says the US economy is doing just fine? Just what zip code are they thinking about? Which state? Which region? America's is not a monolithic, homogeneous economy. The variation across states is large and deep. One way to see this is to examine short-term changes in real GDP by state. The next chart shows the percentage change from 4Q2015 to 1Q2016. Notice that the Southeast has more blue—the positive color—than any other region, but the Far West has the most dark blue—the strongest growth designation. Note also how the shale-oil-producing region is suffering. The data suggest it's time for states east of the Mississippi to have a good turn.



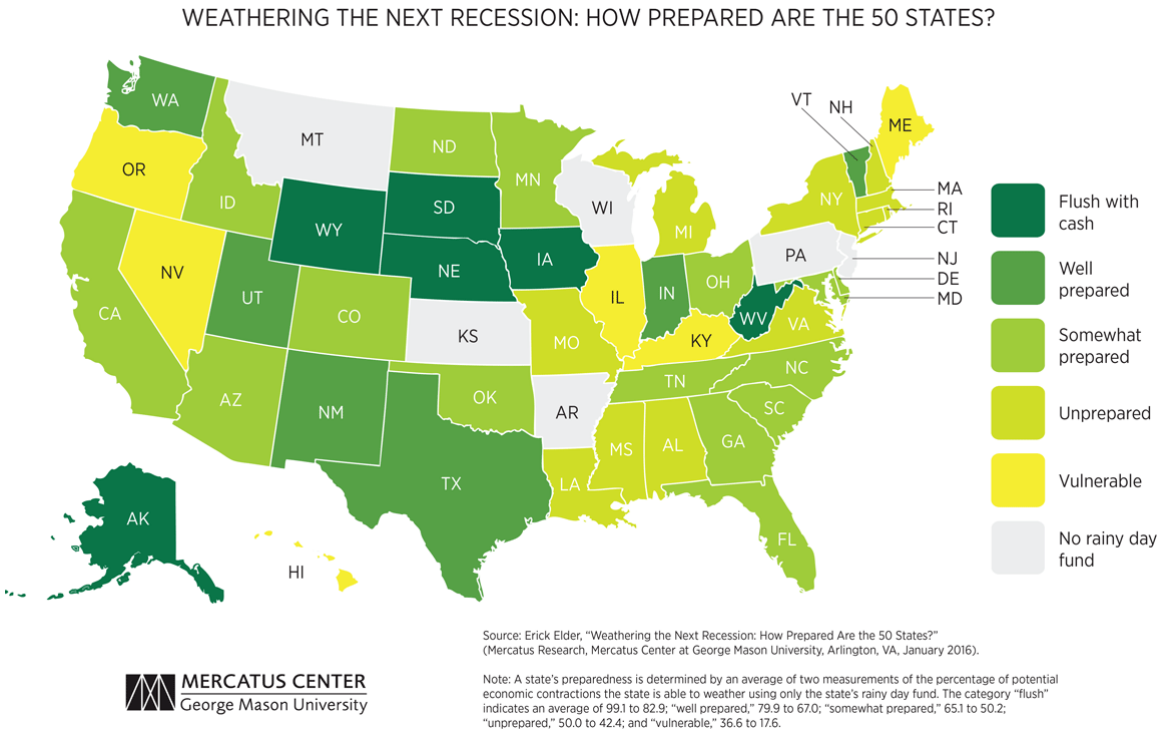
U.S. Bureau of Economic Analysis

When we look at state growth in employment across the last 12 months, we see some similarities to short-term income growth. Notice again the Southeast and Far West are the stronger employment growth areas.



Weathering the next recession

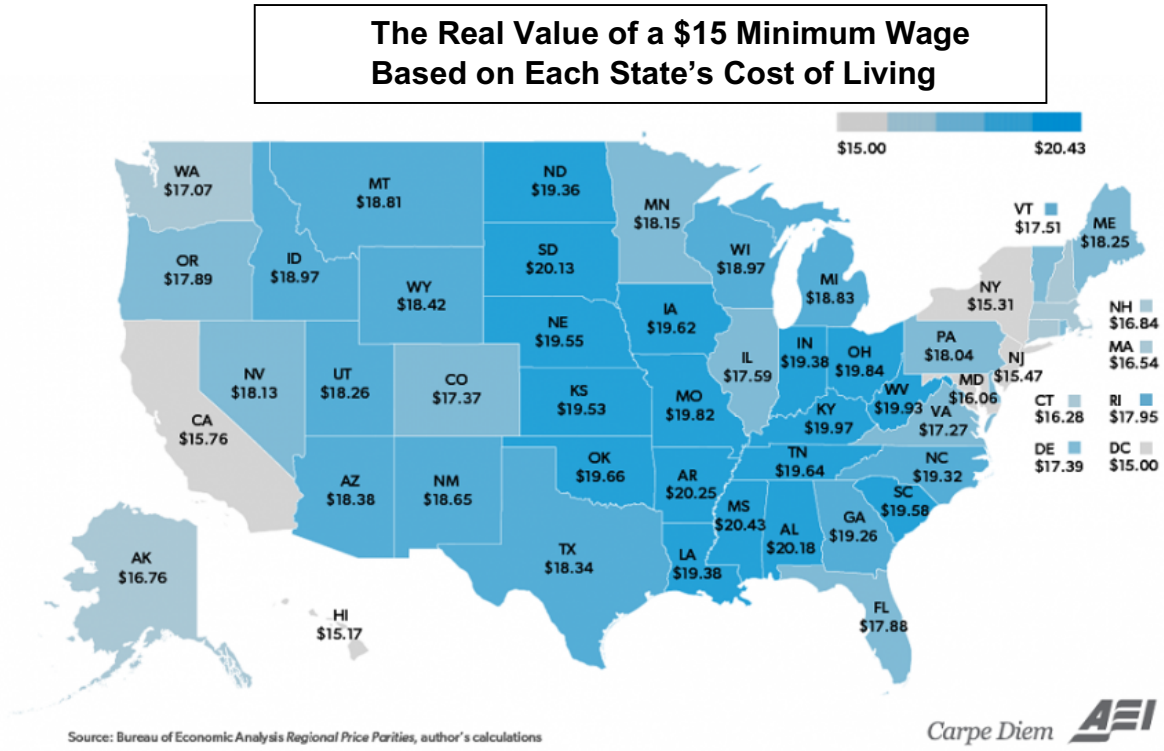
George Mason University's Mercatus Center has published a study by economist Erick Elder that looks closely at state budgets, revenues, and reserves and compared the data with bond rating agency recommendations for rainy day funds. After analyzing the data, Elder ranked the states on their ability to weather the next recession. The next map shows the result.



The geography of minimum wage

Presidential candidate Donald Trump has taken a stand on raising the minimum wage. He said: "I would like to see an increase of some magnitude. But I'd rather leave it to the states. Let the states decide." On the other hand, Hillary Clinton, following Bernie Sanders's lead, has promoted a national $15 minimum wage, a proposal that is naturally popular with workers in states where the number is much lower. Like all normal people, they want to earn more and hope to still be employed if the higher wage becomes reality. This is especially true in states with low cost of living. After all, it's what $15 will buy that determines real income.

A recent map developed by the American Enterprise Institute provides a useful comparison of cross-state effects of a federal $15 per hour minimum wage. The AEI economist adjusted the $15 hourly rate by taking into account what $100 will buy in each state, based on that state's cost of living. On that basis, for example, a $15 minimum wage in South Carolina will buy almost $20 in lower-cost SC goods and services. The adjusted differences are stark. Notice that California, a high-cost-of-living state, has a real wage just a bit higher than $15. In contrast, Mississippi's adjusted rate hits $20.43 per hour. Obviously, organized labor loves the outcome. Low-cost-of-living states lose their advantage when competing for new investment in services and manufacturing industries, and that makes life a bit more comfortable in high-cost states that hope to hold on to their footloose employers.



Shall we close the door to global trade?

For many, wages seem frozen in place. Job openings always seems to be two counties away from where an unemployed worker lives in an upside-down mortgaged house. And the town is still staggering from a recent factory closing blamed on low-cost foreign competition. It's hard for those caught in unemployment's wringer to be raving evangelists for new (or even old) free trade agreements.

Politicians seeking national office understandably respond to those voters who they hope will help put them in office. When asked about free trade recently, Mrs. Clinton responded: "I will stop any trade deal that kills jobs or holds down wages, including the Trans-Pacific Partnership. I oppose it now, I'll oppose it after the election and I'll oppose it as president." On the same topic, candidate Donald Trump had this to say: "I am going to bring our jobs back. I pledge to never sign any trade agreement that hurts our workers." But while all this is understandable when political "crazy season" is running full bore, the overall picture across the states is a bit more complicated. Let's face it, the US is a major global player. The world is integrated into our 50-state fabric. Consider the leading 2014 countries of origin for goods imported by 50 states shown in the next map. China is the top source for 17 states. Do we really want to put tariffs on Chinese goods? Canada is the top source in another 22 states. Do we really want to redo NAFTA?

Now, consider the export side of the ledger, the top-country destinations for goods shipped from the 50 states. As the next map indicates, it's a NAFTA wonderland. In spite of pros and cons, one thing is certain: NAFTA and trade with China are woven into the 50-state economy.

Economic Possibilities for Our Grandchildren

Writing at the outset of the Great Depression, in 1930, John Maynard Keynes took a longer view of the situation. He wrote down his thoughts in "Economic Possibilities for Our Grandchildren." Keynes was convinced that in spite of its problems, a market economy would outperform any other system when it came to producing food, clothing, shelter, transportation, and the other stuff of life that people wanted. But he believed that by the year 2030, people would be satisfied; they would have more than enough stuff to go around. He expressed the hope that his generation's grandchildren would no longer be driven by the desire for personal gain. He hoped a new form of state capitalism would focus attention on the provision of things that markets did not provide so very well. Keynes predicted an expansion of government support of the arts, the humanities, and enhancement of the human condition. He put it this way:

> Thus for the first time since his creation man will be faced with his real, his permanent problem—how to use his freedom from pressing economic cares, how to occupy the leisure, which science and compound interest will have won for him, to live wisely and agreeably and well.

We have 14 years to go to reach 2030. How are we doing? Will we reach Mr. Keynes's promised land?

At the time Keynes wrote, in 1930, US per capita GDP stood at $11,266 expressed in 2015 dollars.[2] It was down 10% from 1929, the roaring year of the November crash. I think we would all agree the 1930 middle class was not doing real well. Do you know anyone today who is getting by cheerfully on $12,000 a year? By comparison, President Hoover was paid $75,000 that year, the equivalent of more than a million in today's money. He was doing great! (This year, President Obama will earn only $400,000, but there are a lot of fringe benefits. Shouldn't he get at least a cost-of-living increase?) By the year 2015, just 85 years after Keynes penned his essay, world per capita GDP stood at $10,000, an amount almost equal to the 1930 US average. Let's face it. A lot of stuff has been stacking up in tents, closets, and storage units.

Keynes thought that US real per GDP would rise four- to eight-fold from 1930 to 2030. In 2015, the number was $51,486, a bit less than a five-fold increase. He made a darn good forecast!

Keynes might have thought that this would surely be enough to provide all the stuff desired for life, that we Americans would have long ago embraced his hope and lifted our eyes to higher ground. But if he were around today, I think he might be disappointed. The conversation is still very much about wages, jobs, income, paying off debt, getting more healthcare, and picking up a larger piece of American pie.

There is always another necessity to yearn for. Or so it seems. Pokémon Go, anyone?

[2] "US Real Per Capita GDP from 1870–2001," Social Democracy for the 21st Century, September 24, 2012, http://socialdemocracy21stcentury.blogspot.com/2012/09/us-real-per-capita-gdp-from-18702001.html. This blog reported 1930 per capita GDP in 1990 dollars at $6,213. When adjusted for the inflation, this converts to $11,266 in 2015.