Has the American Economy Tanked?
If so, what should the U.S. do?

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Unraveling the Mythology

“It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.” – Mark Twain
Myth 1: *This was a normal recession that government intervention made worse.*

- This was a depression averted, not a recession extended.
- Depressions are serious recessions caused by financial crises. They tend to be associated with price deflation and interest rates near the zero lower bound.
- Government may have failed to do enough, but acts of omission are not the same as acts of commission.

The Great “Balance-Sheet” Recession

- Depressions were common in U.S. before 1945, deeper and longer.
- A recession caused by a financial crisis leads government to become the borrower of last resort (Minsky).
- A “balance sheet” recession causes banks to collect reserves to offset bad debt, rather than lend (Koo).
- Internationally, recessions caused by financial crises tend to be more severe, though fiscal intervention may reduce severity. After seven years, on average, GDP is still down 10% or more.
Myth 2: *The U.S. government tried fiscal policy to stimulate the economy, and it failed.*

- A fiscal policy intervention attempts to make up for decreased private demand by increasing government demand.
- After 2007, the federal government did increase the goods and services it purchased, mostly due to the 2008 Surge in Iraq.
- The increase in federal purchases was canceled out by the decrease in state and local government purchases. Real per-capita government purchases fell from 2007 to 2011.

Putting the Rise and Fall of GDP into Real Per-capita Terms

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</thead>
<tbody>
<tr>
<td>Gross Domestic Product (B)</td>
<td>14,253</td>
<td>13,854</td>
<td>14,997</td>
<td>-2.8%</td>
<td>8.2%</td>
<td>5.2%</td>
</tr>
<tr>
<td>GDP Deflator (2005=100)</td>
<td>107</td>
<td>110</td>
<td>113</td>
<td>2.5%</td>
<td>3.2%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Population (millions)</td>
<td>303</td>
<td>307</td>
<td>312</td>
<td>1.3%</td>
<td>1.7%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Real Per-capita GDP</td>
<td>$43,956</td>
<td>$41,163</td>
<td>$42,469</td>
<td>-6.4%</td>
<td>3.2%</td>
<td>-3.4%</td>
</tr>
</tbody>
</table>

- From 1999-2007, average *annual* growth rates were: nominal GDP = 5.1%, price level = 2.6%, population = 1.0%, and real per-capita GDP = 1.4%.
- From 2007-2011, average *annual* growth rates were: nominal GDP = 1.5%, price level = 1.6%, population = 0.8%, and real per-capita GDP = -1.0%.
Consumption and Investment sank, Trade too. Federal Government purchases rose, but State & Local Government spending fell.

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</thead>
<tbody>
<tr>
<td>Gross Domestic Product</td>
<td>13,326</td>
<td>12,641</td>
<td>13,261</td>
<td>-5.1%</td>
<td>4.9%</td>
<td>-0.5%</td>
</tr>
<tr>
<td>Personal Consumption</td>
<td>9,313</td>
<td>8,999</td>
<td>9,387</td>
<td>-3.4%</td>
<td>4.3%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Residential Investment</td>
<td>523</td>
<td>334</td>
<td>324</td>
<td>-36.1%</td>
<td>-3.1%</td>
<td>-38.1%</td>
</tr>
<tr>
<td>Nonresidential Investment</td>
<td>1,600</td>
<td>1,063</td>
<td>1,454</td>
<td>-33.6%</td>
<td>36.8%</td>
<td>-9.1%</td>
</tr>
<tr>
<td>Exports</td>
<td>1,622</td>
<td>1,449</td>
<td>1,763</td>
<td>-10.6%</td>
<td>21.6%</td>
<td>8.7%</td>
</tr>
<tr>
<td>Imports</td>
<td>2,187</td>
<td>1,781</td>
<td>2,184</td>
<td>-18.5%</td>
<td>22.6%</td>
<td>-0.1%</td>
</tr>
<tr>
<td>National Defense Purchases</td>
<td>622</td>
<td>696</td>
<td>706</td>
<td>11.8%</td>
<td>1.5%</td>
<td>13.4%</td>
</tr>
<tr>
<td>Fed. Nondefense Purchases</td>
<td>300</td>
<td>333</td>
<td>353</td>
<td>11.2%</td>
<td>5.7%</td>
<td>17.6%</td>
</tr>
<tr>
<td>State &amp; Local Govt Purchases</td>
<td>1,533</td>
<td>1,521</td>
<td>1,456</td>
<td>-0.8%</td>
<td>-4.3%</td>
<td>-5.0%</td>
</tr>
</tbody>
</table>

Remember, population grew 3.0% from 2007-2011.
Real Per-Capita Investment and Exports

Exports are growing, Business Investment is recovering

Residential Investment is not likely to recover

Real Per-Capita Government Purchases of Goods and Services

Total Government Purchases, National Defense Purchases, Federal Nondefense Purchases, State and Local Govt Purchases

Quarterly BEA Data

2005 Dollars

$10,000

$5,000

$-

1999 2001 2003 2005 2007 2009 2011

Quarterly BEA Data

2005 Dollars

$10,000

$5,000

$-

1999 2001 2003 2005 2007 2009 2011

Quarterly BEA Data
Total Government Purchases fell, while Transfer Payments jumped.

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</thead>
<tbody>
<tr>
<td>National Defense Purchases</td>
<td>1,577</td>
<td>2,011</td>
<td>2,193</td>
<td>2,196</td>
<td>9.1%</td>
<td>0.1%</td>
<td>9.2%</td>
</tr>
<tr>
<td>Federal Nondefense Purchases</td>
<td>866</td>
<td>949</td>
<td>1,039</td>
<td>1,075</td>
<td>9.6%</td>
<td>3.4%</td>
<td>13.3%</td>
</tr>
<tr>
<td>State and Local Govt Purchases</td>
<td>4,985</td>
<td>5,139</td>
<td>5,058</td>
<td>4,763</td>
<td>-1.6%</td>
<td>-5.8%</td>
<td>-7.3%</td>
</tr>
<tr>
<td>Total Government Purchases</td>
<td>7,427</td>
<td>8,099</td>
<td>8,290</td>
<td>8,033</td>
<td>2.4%</td>
<td>-3.1%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>Transfers (Net)</td>
<td>5,074</td>
<td>5,263</td>
<td>6,039</td>
<td>6,430</td>
<td>14.7%</td>
<td>6.5%</td>
<td>22.2%</td>
</tr>
<tr>
<td>Total Government Expenditures</td>
<td>12,501</td>
<td>13,362</td>
<td>14,329</td>
<td>14,463</td>
<td>7.2%</td>
<td>0.9%</td>
<td>8.2%</td>
</tr>
<tr>
<td>Total Government Revenues</td>
<td>13,351</td>
<td>12,482</td>
<td>10,412</td>
<td>10,991</td>
<td>-16.6%</td>
<td>5.6%</td>
<td>-11.9%</td>
</tr>
<tr>
<td>Net Surplus/Deficit</td>
<td>849</td>
<td>-880</td>
<td>-3,917</td>
<td>-3,472</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Why *did* government spending increase?

- The increase in *net* government spending is entirely due to increased transfer payments. The lion’s share of this was due to increased spending on unemployment benefits.
Change in Federal Budget, 2007-2010

<table>
<thead>
<tr>
<th>Budget Function Area</th>
<th>Change in Millions</th>
<th>Real Growth Per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Security</td>
<td>256,235</td>
<td>+59%</td>
</tr>
<tr>
<td>National Defense</td>
<td>142,315</td>
<td>+18%</td>
</tr>
<tr>
<td>Social Security</td>
<td>120,584</td>
<td>+13%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>102,672</td>
<td>+30%</td>
</tr>
<tr>
<td>Medicare</td>
<td>76,229</td>
<td>+12%</td>
</tr>
<tr>
<td>Everything Else</td>
<td>29,492</td>
<td>-2%</td>
</tr>
<tr>
<td>Change in total outlays</td>
<td>727,527</td>
<td>+18%</td>
</tr>
</tbody>
</table>

Myth 3: The Budget deficit resulted primarily from increased government spending.

• Perhaps if you divide by GDP, but GDP fell: ratios look bigger.
• Whether you measure it in real per-capita terms or divided by the 1999-2007 trend in GDP, the decrease in taxes collected was much larger than the increase in transfer payments.
• Taxes collected fell due to (a) the 2001-2003 tax cuts, (b) the recession, (c) the 2008 ESA, and (d) the 2009 ARRA.
Has The American Economy Tanked?
(A little perspective, please)

• In Jan. 2001, Alan Greenspan testified, “The most recent projections from the OMB indicate that, if current policies remain in place, the total unified surplus will reach $800 billion in fiscal year 2011... despite the budgetary pressures from the aging of the baby-boom generation, especially on the major health programs.” He cautioned against paying off the entire federal debt.

• With good (or bad) policies, things can turn around within a few years.

• The U.S. has had a privileged position for decades, in terms of our disproportionate share of world GDP and the primacy of our financial markets. This is not sustainable even in the best of circumstances.

Myth 4: The growth of the federal debt is unprecedented, at least in peacetime.

• We are not in peacetime.

• As a percentage of GDP, the growth in the federal debt from 2007-2010 is less than the growth from 1981-1993. It is only larger if we include the increase from 2001-2007 and the projections for the next few years.

• The debt includes what we owe to government agencies (mostly the Social Security Administration) and the Federal Reserve System. The debt held by the public is about half as much (half of that is owed to foreigners).
Myth 5: *Borrowing is bad.*

- Borrowing for investment makes sense, if the return on investment exceeds the cost of borrowing.
- Borrowing in bad times, to smooth out consumption, makes sense.
- Borrowing in good times for consumption is dumb.
- Many of the same voices opposed to borrowing now were silent before 2007, while we were funding two wars while cutting taxes and borrowing from abroad. Why?
Myth 6: *We need to recover back to where we were.*

- There is a conflict between the short-run goal of stabilizing the economy and fighting unemployment, and the long-run goal of having a sustainable economy.
- Through 2007, Americans saved too little and consumed too much. We borrowed from abroad, causing trade deficits.
- We don’t want consumption to fall – that makes income fall too – but we don’t want it to be our engine of recovery either.
So What Shall We Do?

• First, get real. Distorting facts may make you politically popular, but it doesn’t help us find answers that work. Hyperpartisanship is ruining our country.

• We need investment (both public and private), in factories, infrastructure and education.

• We need banks to start lending again; exports to catch up with imports; the federal debt to stop growing faster than the economy; and finally, we need confidence.

Is cutting taxes again a good idea?
Possible policies? I am more comfortable with facts than opinions, but here are some possibilities: temporary investment tax credits, incentives to lend for investment purposes, a tax on excess bank reserves, expiration of past tax cuts after two years, ending the wars, public-private investment partnerships, reforms to reduce growth of healthcare costs (esp. for Medicare, Medicaid), higher retirement age, increase cap on social security contributions, restoration of meaningful financial regulation, lower dollar, et cetera.

Appendix

Bank Bailouts

- Emergency Economic Stabilization Act:
  - TARP funds began with plan for purchase of troubled MBS, but changed to an equity purchases approach, with restrictions over executive pay.
  - $270B went to AIG, GM, Wells Fargo, Citigroup, BoA, JPMorgan Chase, Morgan Stanley, and Goldman Sachs.
  - $27B went to over 600 banks ($300K-$968M)
  - Majority has already been paid back, with interest.

Fiscal Intervention

- Economic Stimulus Act of Feb. 2008:
  - Tax rebates for 2008, estimated $150B cost (about 1% of GDP) in 2008.
- American Recovery and Reinvestment Act of 2009:
  - Estimated $800B cost over several years, with less than $200B spent in FY 2009, and $400B in FY 2010 (about 3% of GDP).
  - About 40% in tax credits, 30% in state fiscal support, and 30% in infrastructure investment (education, energy, health care) plus some extended benefit support.
  - Some parts were more effective than others, but there is a big difference between slowing the decline and turning the whole ship around.