Time to shift to the supply side

John H. Makin | American Enterprise Institute
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Key points:

• The apparent discrepancy between recent increases in US employment data and the shockingly low first-quarter 2014 growth rate has left many observers of the economy hesitantly optimistic about 2014 growth prospects.
• But these modest monthly increases in employment numbers are only distracting observers from the weak labor market trends underlying the economy’s feeble five-year recovery.
• Policymakers must overcome partisanship to encourage investment through supply-side measures that will enable the economy to grow more vigorously.

Torpid: from Latin torpidus, from torpere (to be numb or sluggish).

--Oxford English Dictionary

The recent drop in US unemployment to 6.1 percent has raised hopes for a stronger economy, even though analysis of the major features of the US economy since 2008—regarding growth, employment, wages, and investment—shows that all are dismal, notwithstanding the recent modest pickup in monthly employment increases. America needs a stronger recovery.

Unfortunately, at a time when imagination and action are required to break out of a persistent pattern of sluggish growth, stagnant wages, and a growing alienation of the majority of the population who have not benefited from either...
the Fed's action to boost asset prices or ad hoc fiscal measures, Congress and the White House have grown torpid.

Neither Republicans nor Democrats can be satisfied with a virtually stagnant economy five years into a recovery. Having now exceeded the average 58-month duration of a post-World War II recovery, the economy obviously needs to be extended and improved. There are well-known ways to boost growth of employment and output, and there are signs that chances for implementation of growth measures after the November 2014 election are rising. There are also faint signs (detailed later) that the White House may be considering a new supply-side growth initiative. And a new policy group, publishing in *National Affairs* and other outlets, is pioneering a more positive, pragmatic approach among Republicans.

It is very easy to dismiss hopes for bipartisan progress on sound supply-side growth measures, but two realities, one political and one economic, are pressing Washington in that direction. Politically, many incumbents cannot survive the substandard performance of the economy. On the economic front, the usual demand-side fiscal and monetary measures are either fully expended or simply ineffective. In short, what has either party got to lose from working together to implement growth measures after November?

**Recovery Remains Weak**

Torpor is insidious. A few months of good labor market reports and an average monthly increase of 257,000 jobs have led many to wonder about the disconnect between “strong” labor market data (figure 1) and weak GDP growth (figure 2), highlighted by the first quarter's shocking -2.9 percent growth rate. Hopes and expectations are unrealistically tilted in the direction of optimism that growth will pick up and continue to hold at about 3 percent over the second half of the year.

These hopes, based on a modest improvement in the labor market, are unlikely to be realized because, among other problems, the growth of employment has been far below average since the official June 2009 start of the current weak recovery. (See the red line in figure 1.) By June 2014, the economy had added 6.5 million fewer jobs since the June 2009 start of the current tepid recovery than would have been the case five years into a normal post-World War II recovery. That's about half the usual job growth during five years of recovery.

**Figure 1. Total Nonfarm Employees (Normalized at 100)**

![Figure 1. Total Nonfarm Employees (Normalized at 100)](source: US Department of Labor, Bureau of Labor Statistics)
In fact, there is no disconnect between weak GDP data and "better" labor market data. Weak GDP data simply reflects the cumulative impact of a very weak labor market that has persisted since 2008. Beyond the persistently subpar employment growth shown in figure 1, the most obvious symptom, repeated in the June labor market report, has been stagnant real wages (figure 3): year-over-year money wages rising at 2 percent while inflation in the 1.5-2.0 percent range is eroding real purchasing power. During the "recovery," Real wages have not risen, meaning wage earners’ demand for goods and services (consumption) has been weak (figure 4).

Slow consumption growth has, along with substantial policy uncertainty enhanced by experiments with monetary policy and other issues, left producers reluctant to add to capacity—that is, to invest. (See figure 5.) It is clear from figures 4 and 5 that both consumption and investment growth have been weak. Together, they make up about 75 percent of GDP, so it is not surprising that weak real wage growth has meant weak GDP growth, even as employment numbers—a large percentage of them for part-time workers—have risen at a modest pace.

Figure 3. Year-over-Year Change in Total Private Average Hourly Earnings of Production and Nonsupervisory Employees
The cyclically adjusted performance of the labor market, even in terms of employment growth (figure 1) and the unemployment rate (figure 6), has been weak. The most recent (288,000-job) June rise in employment translated into a year-over-year growth rate of only 1.8 percent, which is about where the year-over-year rate of employment growth has been stuck since March 2012. Before that, it was lower, dipping into a sharply negative reading from May 2008 to August 2010, then climbing slowly back to the 1.6–1.8 percent range by March 2012, where it has remained.
Consistent with this weak overall employment growth pace, the rate that adjusts for discouraged workers who have given up actively seeking employment (the U6 unemployment rate) is 12.1 percent, about 50 percent higher than it normally would be after five years of recovery.

Figure 6. Civilian Unemployment Rate

Since 2008, growth has averaged about 2 percent, while employment growth has been about 1.0-1.8 percent. Long-run growth is equal to employment growth plus growth of output per worker, or productivity growth. (See figure 7.) GDP growth has continued to be weak, even after the post-March 2012 rise in year-over-year employment growth, because productivity growth has fallen due in part to slower investment growth and a reduction in capital per worker; this, in turn, has reduced output per worker even as the number of workers has grown slightly more rapidly over the past two years.

Figure 7. Nonfarm Business Sector Output per Person (Normalized at 100)
With productivity slipping and a persistent reluctance to invest keeping
growth of productive capital (factory and transport equipment) slow,
employers are adding modestly to hiring to compensate for less output per
worker. But with labor productivity slipping, wage growth remains weak and
much of the hiring is concentrated on part-time workers.

**Boosting Growth with More Investment**

We have seen in past recoveries that the best way to boost hiring and GDP
growth is to encourage more investment in capital. A rising capital stock
means rising labor productivity, more hiring, and faster GDP growth without
inflation, and enhanced capital spending provides a much-needed supply-
side boost. Encouraging investment in capital, however, is obviously long
overdue after five-plus years of demand-side fiscal and monetary stimulus
that has produced no lasting positive effect on growth.

Three specific measures to boost capital spending are: enactment of
accelerated-depreciation provisions and investment-tax credits; a sharp
reduction in the corporate tax rate from 35 to 15 percent to, among other
things, induce corporations to repatriate the $1.95 trillion of accumulated
profits being held abroad to avoid the huge tax bill that would result if those
corporations brought those earnings home; and, finally, a concerted White
House-led effort to set a clear, less-burdensome path for health care and
other regulatory measures as a means to reduce investment-dampening
uncertainty.[1]

The chance for enactment of any or all of these measures seems low, given
the deadly combination of congressional torpor, partisan wrangling, and lack
of leadership coming from the White House. That said, faster employment
and GDP growth are primary concerns among voters of all political stripes.
The November election results will likely underscore this reality.

The belief that real wages, GDP, and investment could all grow faster,
improving the welfare of all income classes of all political persuasions, may
be beginning to produce positive tentative first steps toward enactment of
pro-growth policy measures. President Obama has recently met with both
liberal and conservative economists to discuss ideas to improve the
economy. While priorities still differ, discussion of goals and the primary
means to achieve these goals has started to transcend ideology.

House Majority Leader Eric Cantor’s recent shocking loss in a Virginia
primary to a virtually unknown, underfinanced opponent may carry several
political messages, among which may be that voters are fed up with strictly
partisan politics that in effect have precluded enactment of measures known
to boost the economy.

A group of innovative Republican thinkers have put forward ideas to help
improve the functioning of labor markets and to boost investment and growth.
This group—which includes, prominently, *National Affairs*’ Yuval Levin and
AEI’s Michael Strain, Ramesh Ponnuru, and James Pethokoukis—rejects the
obstructionist Republican policies put forward by the likes of Sarah Palin and
Michele Bachman in favor of more constructive measures aimed at appealing
to both sides of the political spectrum while helping boost growth.[2]

The question is clear: why not adopt a lower tax rate and other investment
incentives? If some revenue is lost—which is not a certain outcome, given that
faster growth of the tax base (nominal GDP) will help pay for a reduction in
the corporate tax rate and other investment incentives—it can be made up by
phasing out other, less productive corporate and household tax expenditures.

By rejecting ideological purity, the new pragmatic Republican group is free to
propose measures that, like reductions in tax rates on capital spending, may
initially lose revenue. Strain, Ponnuru, Pethokoukis, and Levin all bear one
thing in common: they recognize that the need to agree fully among
themselves prevents the initiation of policy proposals and has led to torpor
among policymakers.
Increasing pragmatism on the Republican side, coupled with some sense of urgency at the White House that the economy needs to grow more, may produce positive results. Let's hope so. The alternative is persistent low growth of output and employment, stagnant wages, and a rising risk of recession in a torpid economy that will steadily erode America's sanguine vision for its future.

Notes