

Comments for Policy Session

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Main Themes: Dealing with Slow Growth

- **The historic growth of output per capita in the U. S. between 1891 and 2007 was 2.02 per year**
- **Over the next four or five decades, that growth will slow to roughly 1.0 per year**
- **For the bottom 99% that growth will be only 0.5 percent per year.**
- **There are many implications, including a greater urgency to reform entitlements**
- **The debt/GDP ratio will rise faster because growth of the denominator will be slower.**

What Causes the Great Growth Decline?

- Read my NBER WP 18315, August 2012, or a short version in the *WSJ*, December 22, 2012
- Innovation. While the frenetic pace of innovation continues, it is running out of great ideas. That 2.0 growth rate was built on a transformation of daily life called the Second industrial revolution.
- Electricity, rapid transit, elevator buildings, electric tools, central heat, air conditioning, cars, trucks, airplanes, interstate highways, phone, motion pictures, phonograph, radio, TV. (Also computer 1960-2000)

The Six Headwinds

- **Even if innovators continue to deliver ideas that raise productivity, we still face a dismal future**
- **Headwind #1. Reversal of the demographic dividend**
 - **Baby-boom retirements**
 - **Prime-age adult males dropping out, the “missing fifth”**
 - **More young people in higher education, accumulating debt and dropping out.**

Figure 18: Hours per Capita, 1992:Q1-2012:Q3

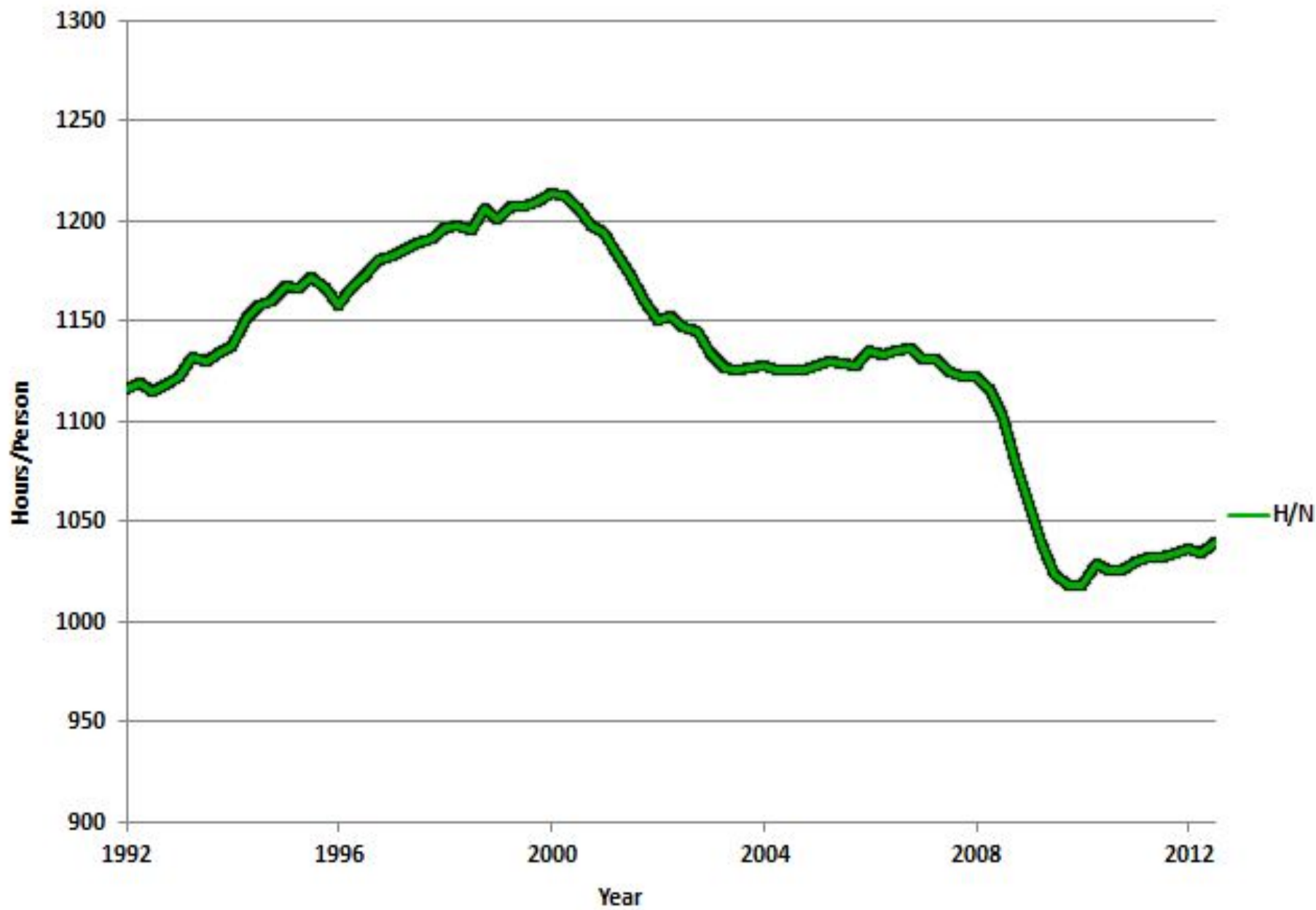
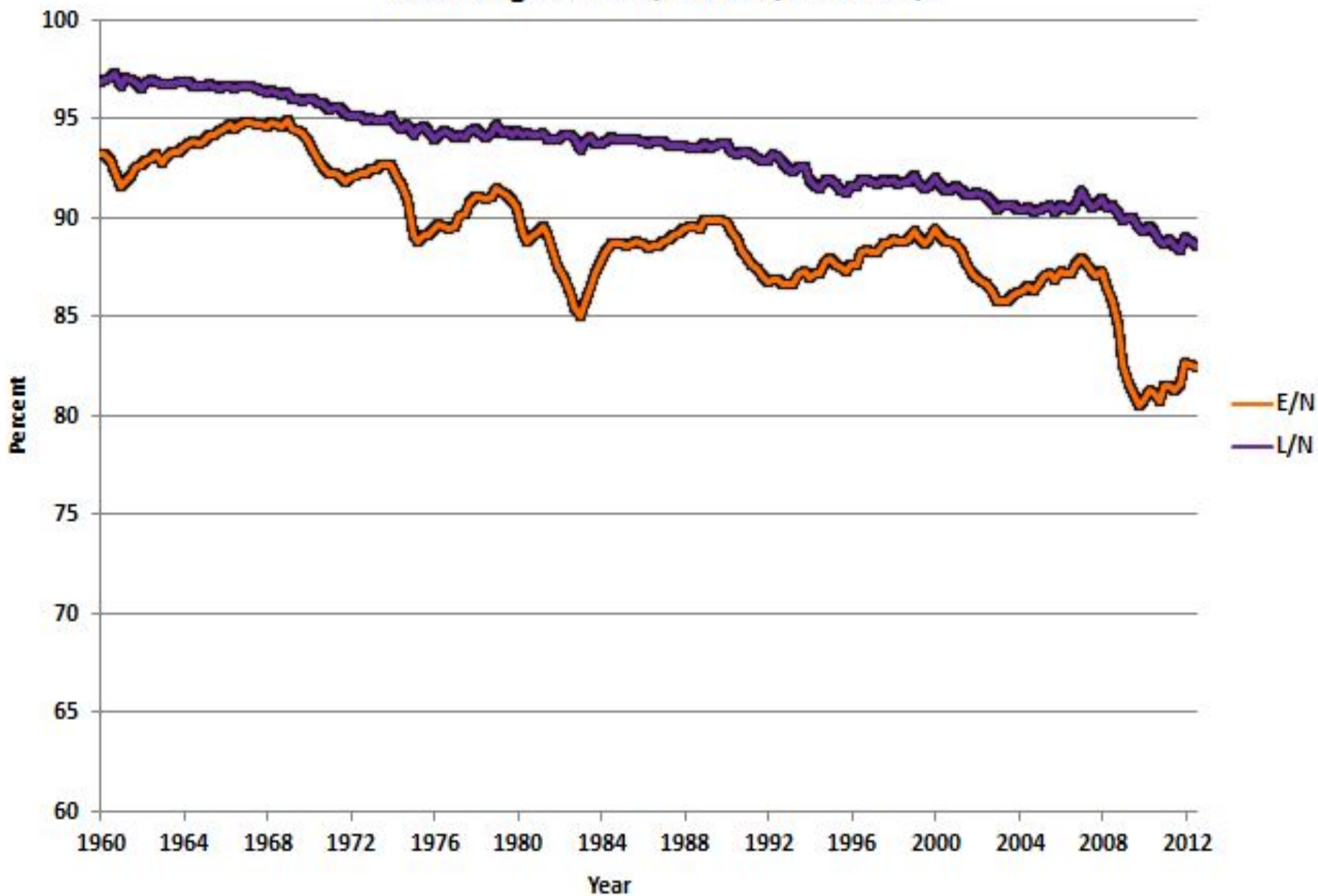


Figure 20: Employment per Capita and Labor Force Participation Rate, Males Ages 25-54, 1960:Q1-2012:Q3



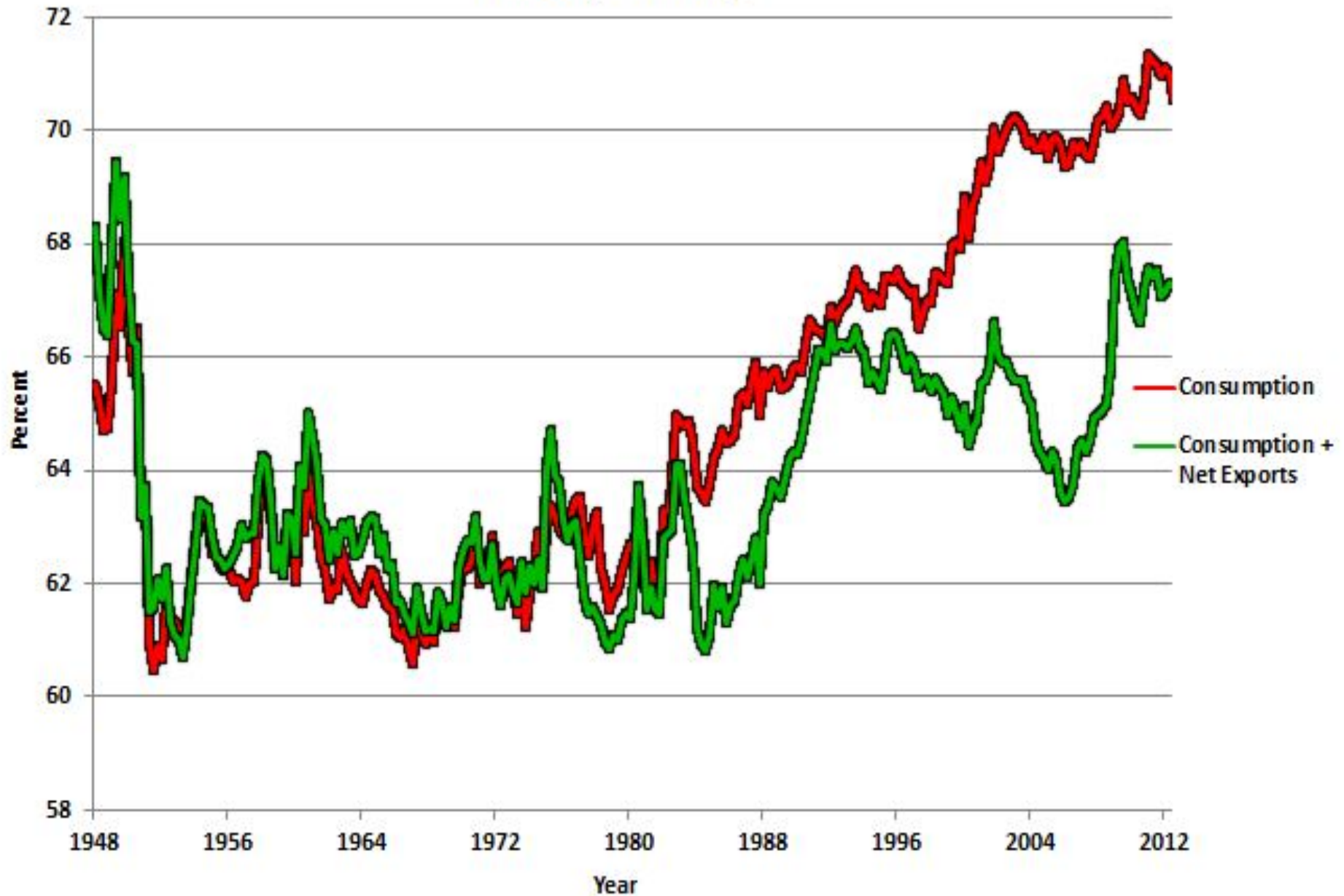
Headwind #2

- **Headwind #2. Education**
- **Tertiary completion rates for 25-34 age group (OECD data): U.S. 41%, Canada 56%**
- **\$1 Trillion in Student Loan Debt**
 - Rampant college cost inflation even worse than medical care cost inflation
- **U.S. high school drop out rate ranks #21 (i.e., bad) out of OECD #26**
 - No improvement of black-white achievement gap since 1960s
 - 20% of Chicago black elementary school students were absent for a month or more in 2011
 - Charles Murray's "Fishtown" (bottom 1/3 of whites) have socio-economic outcomes equal to blacks of the 1965 Moynihan report

Other Headwinds

- **#3. Inequality.**
 - Saez: income increase of **AVERAGE 1993-2008 was 1.3% per year. Bottom 99% was 0.75%.**
- **#4 Globalization**
 - **Contributes to inequality as foreign competition and foreign investment in right-to-work states erodes the last vestiges of the union premium**
- **#5 Energy/Environment**
 - **A carbon tax or any serious attempt to deal with global warming will sap growth on everything else**
- **#6 Consumer and Government Debt Overhang**
 - **Future consumer per capita of bottom 99% will grow slower than future income per capita.**

Figure 9: Consumption and Net Exports as Share of Nominal GDP, 1948:Q1-2012:Q3



Why the Future of Demand Growth is So Abysmal

- **Headwind #6 points out that the ratio of C/Y increased from 62% in 1980 to 71% in 2012**
- **For three decades consumption has been growing faster than GDP. Now this must reverse as consumers repay debts**
- **Part of this rise has taken the form of imported consumer goods. This also cannot go on forever.**
- **Conclusion: Whatever the growth rate of output per capita, consumption per capita will grow slower**

The Implications of Today's Federal Budget Deficit

- Whatever its form, we know that over the next two decades the Federal government deficit must shrink by a lot.
- Whether fast or slow, sequester vs. carefully negotiated plans, *every conceivable method of reducing the Federal debt will reduce the growth rate of disposable income compared to GDP*
- That includes any increase in taxes or reduction in transfers
- Direct cuts in G reduce GDP growth directly
 - When nonmilitary spending is cut, Federal employees are laid off. Fewer air traffic controllers means more airline delays. Fewer TSA and immigration agents mean more airport delays. These budget cuts are not welfare-neutral.

Figure 2: Federal Government Receipts and Expenditures to Actual GDP Ratios, 1955:Q1-2012:Q2

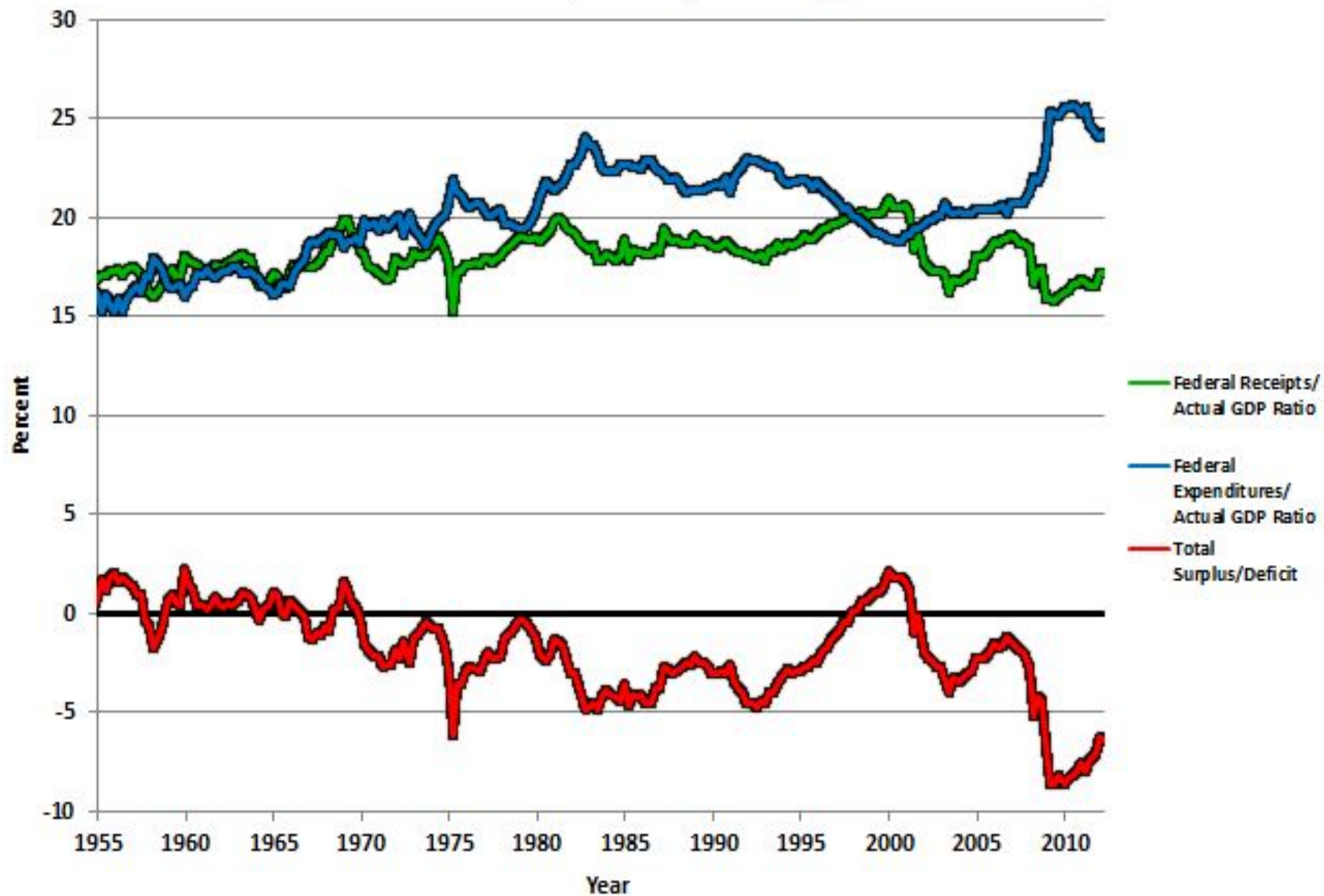


Figure 1: Federal Government Receipts and Expenditures to Potential GDP Ratios, 1955:Q1-2012:Q2

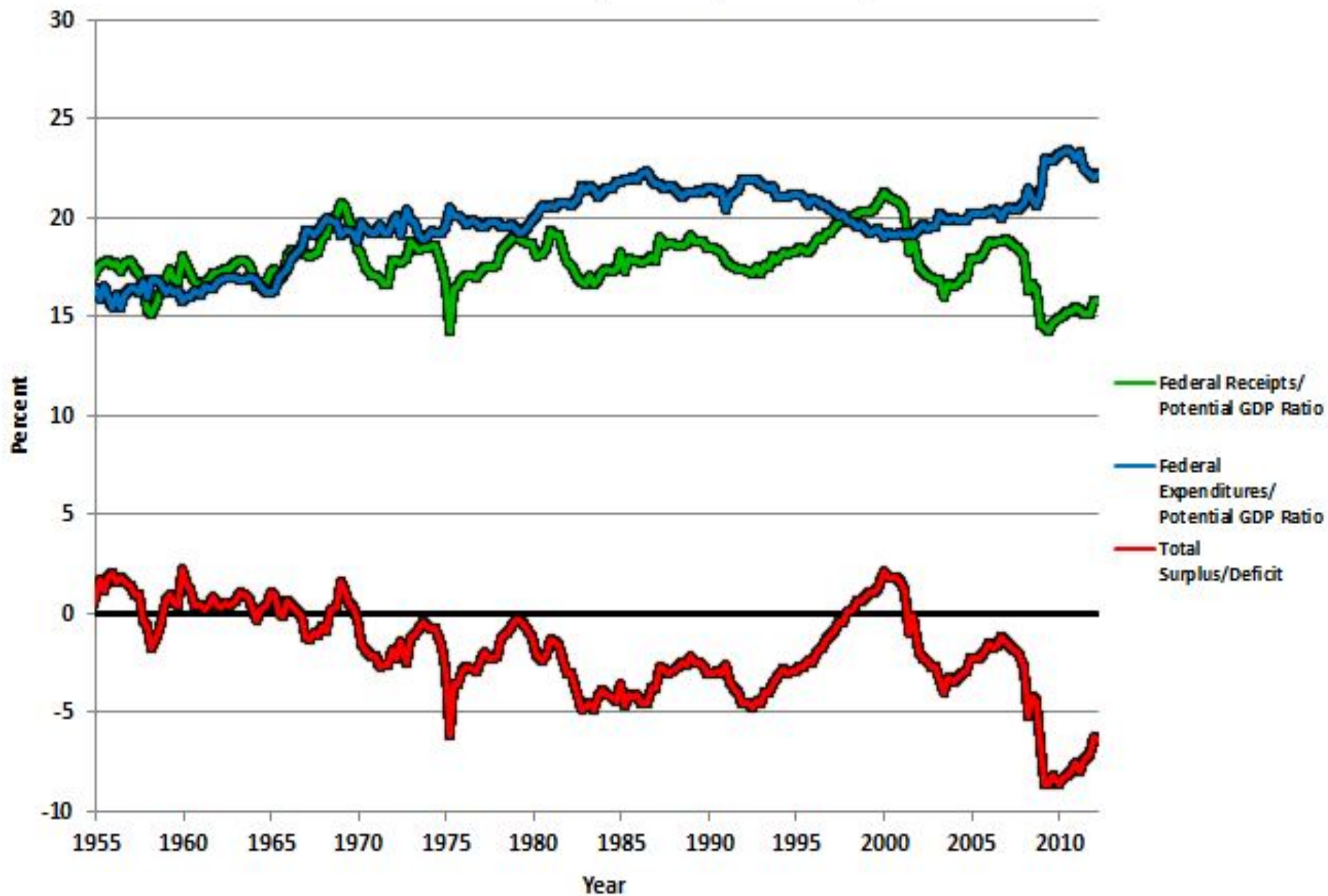
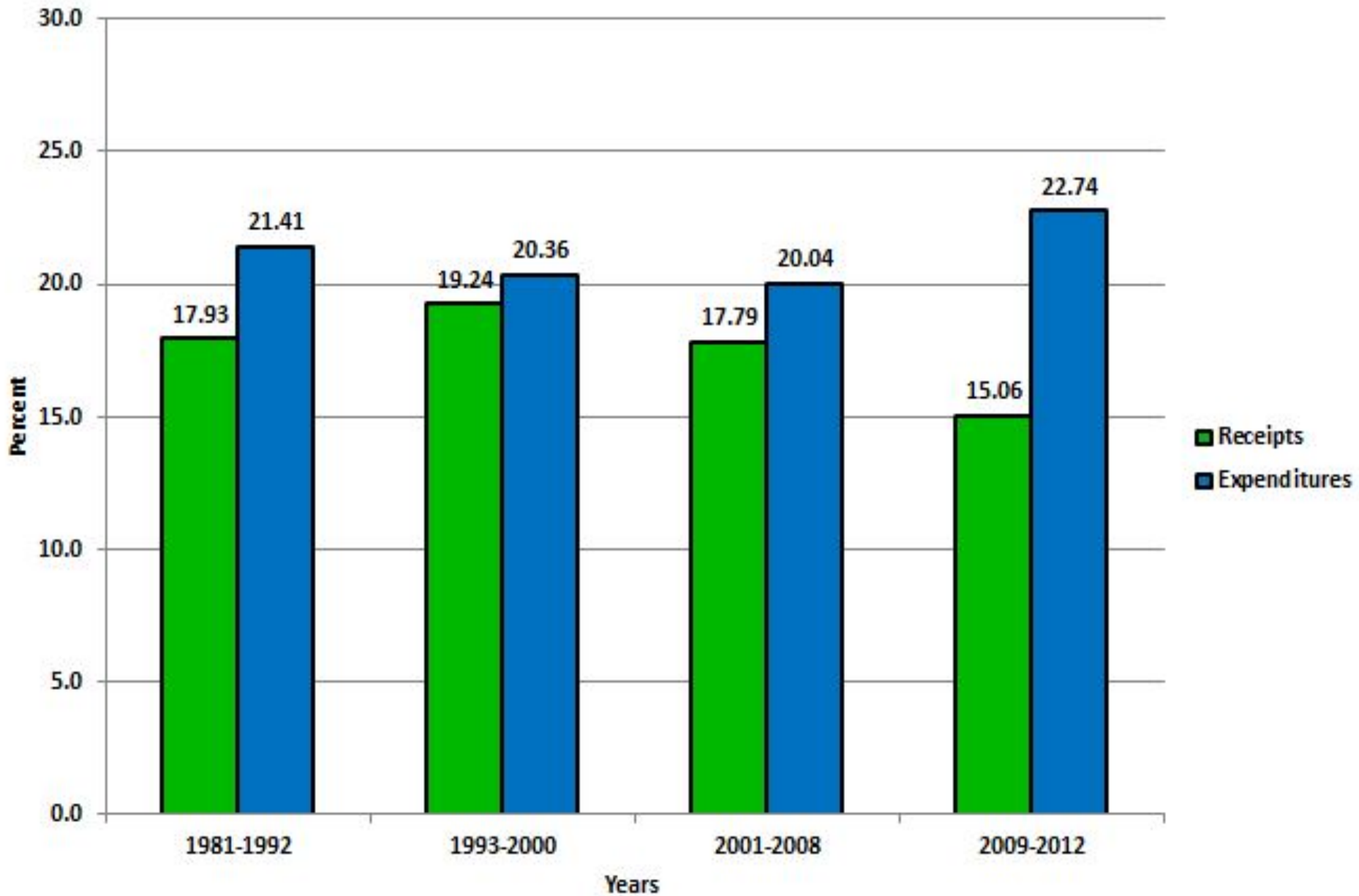


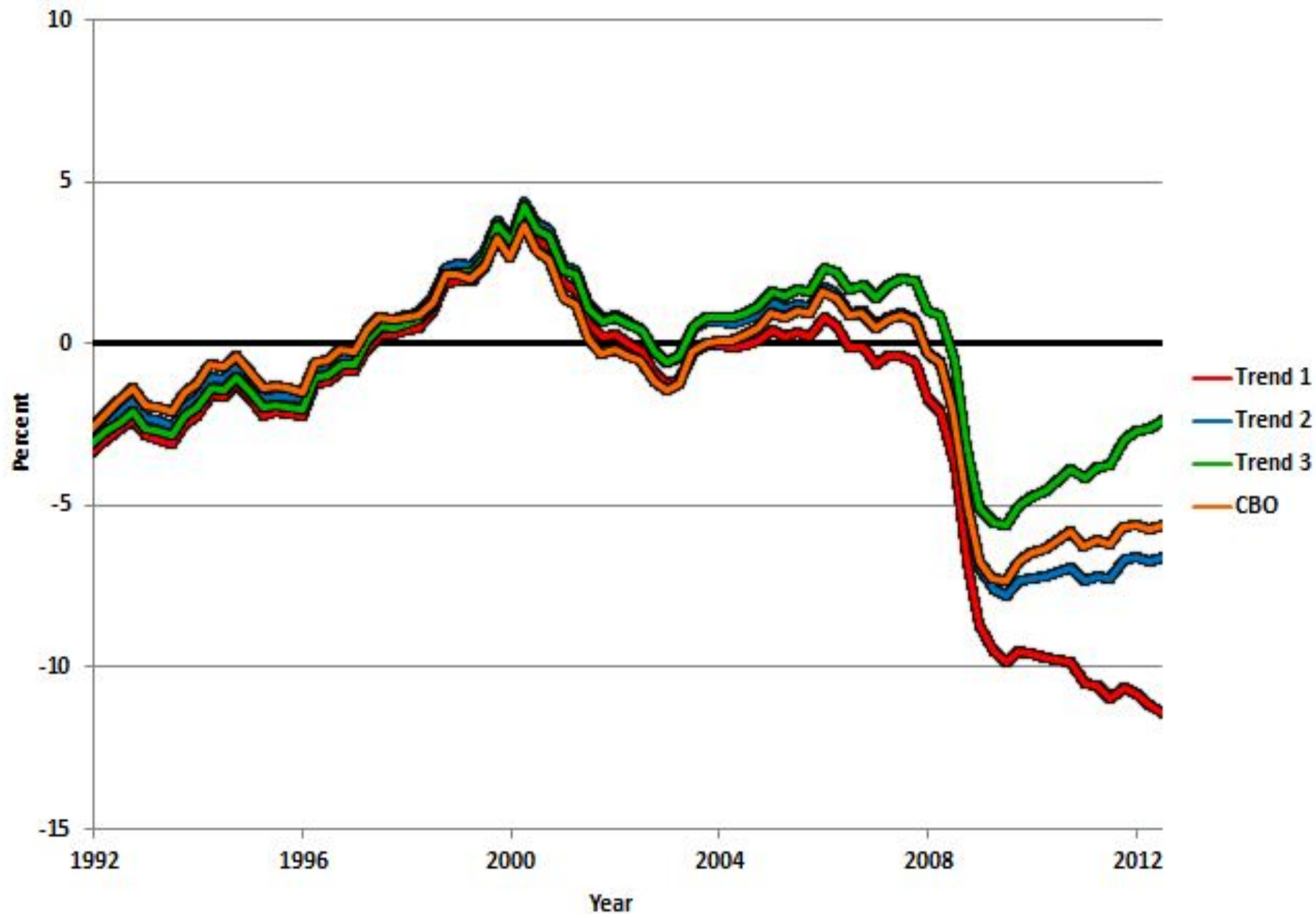
Figure 3: Average Federal Government Receipts and Expenditures to Potential GDP Ratios, Selected Intervals



Is Excessive Spending or Insufficient Tax Revenue the Problem?

- These charts show the ratio using potential GDP as a denominator (we'll get to the potential GDP debate in a minute)
- Comparing Clinton to Obama
 - Revenue share (potential GDP) down by 4.18 points
 - Expenditure share up by 2.38
- This suggests our revenue problem is greater than our expenditure problem.
- But that is short-sighted, because the entitlements will soar in the future, so we have to tackle them seriously
- What is the difference between actual and potential GDP right now??

Figure 8: Implied Output Gaps, 1992:Q1-2012:Q3

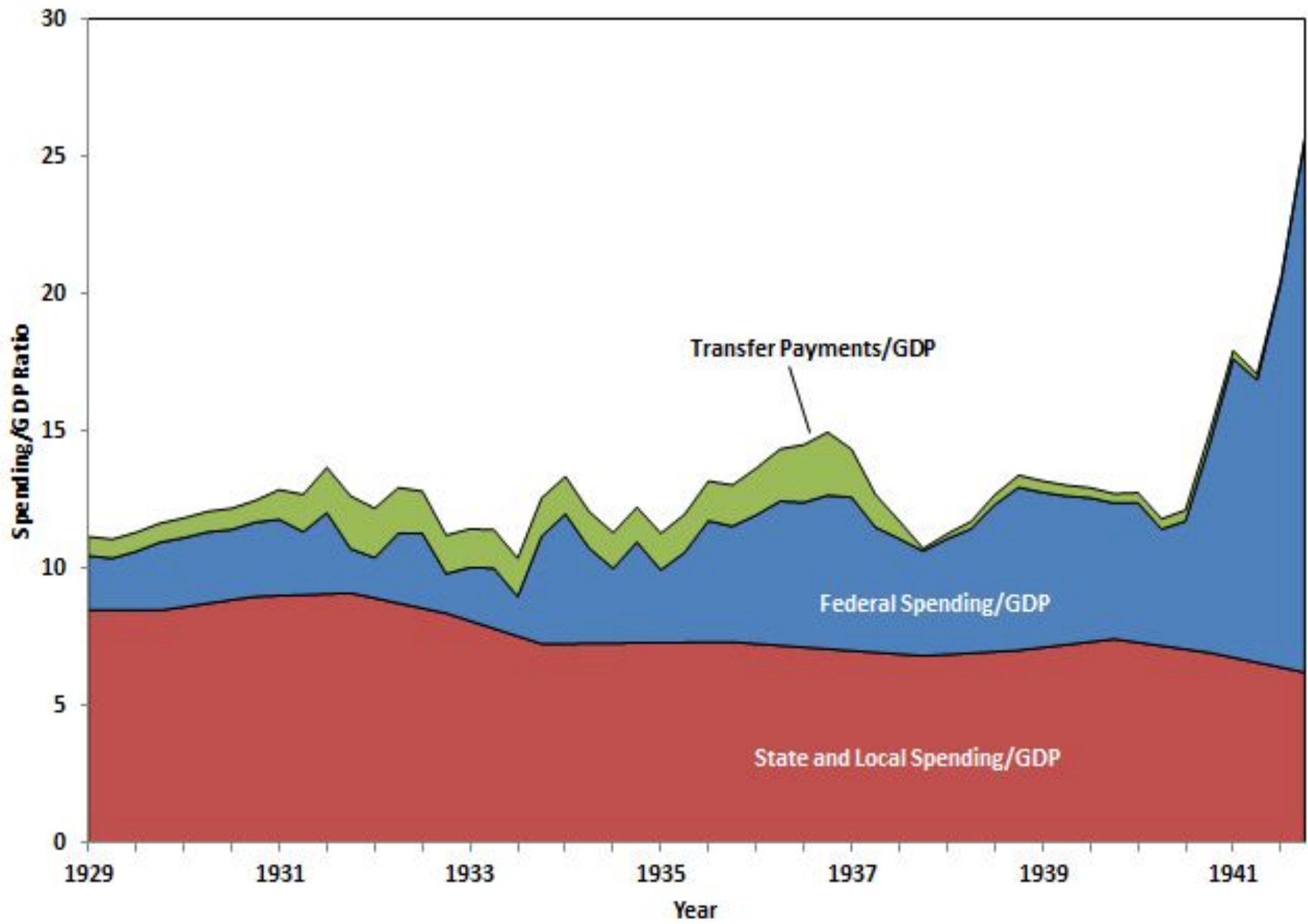


Giving Up on Economic Recovery

- **How can we close that output gap?**
- **Monetary policy is busy monetizing the deficit, which is fine as long as all that monetary base creates only excess reserves**
- **Fiscal policy must by definition be contractionary if any progress is to be made on the Federal deficit.**
- **This means we must give up on any attempt to kick-start the economy by the only fiscal stimulus that we know actually worked.**
- **Qualification: balanced budget multiplier arithmetic of elementary macro**

Why the Great Depression Ended in 1940-41 and This Episode Will Only Get Worse

- **Share of total government spending (state, local, Federal) increased from 12 to 25% between 1940:Q2 and 1941:Q4**
- **The GDP gap went from -20% to zero several weeks before Pearl Harbor**
- **We have a great example of a fiscal stimulus that delivered high multipliers (2.5 to 3) but that example shows why we are in such a bad situation today**



Moving from Side to Side of the Political Aisle

- **While sometimes agree with Paul Krugman, I find myself very sympathetic to Mike Boskin's interpretation of the past and vision of fiscal reform in the future.**
- **I differ from Mike on two key issues, low marginal tax rates for the rich, and his absence of the deep rethinking needed to tackle medical care reform**

Do Lower Tax Rates on the Rich Created Economic Growth?

- **Boskin, Hubbard, Taylor, and many others for many years have been feeding the media the story that low marginal tax rates for the rich create jobs.**
- **Counterexample #1, the economy grew more rapidly with the higher Clinton tax rates 1993-2000 than at almost any time in the postwar era**
- **High incomes are rents, almost by definition. If I raised the rate from 35% to 50% which of the following would quit their jobs for their next best opportunity: Alex Rodriguez? Tom Brady? Tom Cruise? Jamie Dimon? Lloyd Blankfein? Greg Mankiw?**
- **How can you say we need the saving of the rich to fund investment, when we have trillions of cash sitting inside corporate vaults and more than a trillion of excess bank reserves?**

Agreeing with Mike and Glenn

- **Reforming SS is easy**
 - After all, Mike and I were on his CPI commission in 1995-96. We wanted a far more radical fix of “CPI – X” where “X” might be 1.0 per year?
 - Obama should have given ground in the fiscal cliff negotiations on the chained CPI but in the end didn’t need to, at least for now.
 - The chained CPI doesn’t address outlook substitution bias (the “Walmart effect”), new product bias, or quality change bias.
- **Other SS fixes**
 - Indexing the retirement age to life expectancy
 - Adjusting the response of benefits to wage changes
 - If real wages grow slower for people of working ages, then social security benefits should grow slower

What Nobody Is Talking About: This is the Big Deal: Medical Care Costs

- **Latest OECD data for 2010**
 - **US medical care spending as % of GDP: 17.6**
 - **Canada: 11.4**
 - **OECD average: 9.5**
- **The difference between the US and Canada is 6.2 percent of GDP, or \$990 billion of today's US nominal GDP.**
- **What do we receive in return for our excess investment of \$990 billion?**
- **Life expectancy at birth. US 78.7, Canada 80.3, Korea 80.7, Italy 82.0, Japan 83.0**

Sherlock Holmes Wants to Track Down that \$990 Billion

- **Sherlock turns to Cutler and Ly (*JEP* Spring 2011)**
- **The explanation of the extra US spending can be divided into three categories**
 - **Higher incomes of providers, 31%**
 - **Additional procedures for patients, 14%**
 - **Higher administrative costs, 39%**

Examples of Excessive US Administrative Expenses

- U. S. has 2.2 administrative workers per doctor. Canada has 0.5.
- US 1.5 administrators per hospital bed, 1.1 in Canada
- US health insurance administration = 12% of premiums, vs. 5% in Canada
- US Provider groups employ 770 FTEs per \$1 billion collected, compared to an average of 100 employees in other industries.
- Coordination failure in lack of incentive for multiple payers to coordinate credentialing and billing requirements.
- Insurers deliberately introduce needless complexity in order to reduce the ultimate amount they must pay.

High Input Costs

- **There are two other Cutler-Ly categories explaining excess US costs**
 - **Higher input costs, i.e., higher pay for doctors and other medical care professionals**
 - **Higher pay for doctors is notable in international comparisons but comparable to other similarly educated US high-wage workers, reflecting greater US income inequality.**
 - **There are many solutions to this besides wage controls on doctors. Among them are income-contingent loans for medical school scholarships and radical reform of malpractice insurance that deters talented people from entering medicine.**
 - **Every incentive should be used to force people out of fee-per-service with small doctor offices with an excess supply of receptionists and clerks**

The Third Category: Intensiveness

- **The US administers more procedures per patient**
- **Some of this is fruitful: US has a good record in curing cancer for those identified in early stages**
- **But some overtesting is due to ownership of testing facilities by private fee-per-service doctors**
- **There are no constraints on the supply side in US medicine as in most other countries. If you want to set up a MRI imaging center, go ahead, even if your metro area already has 3X the facilities of the typical European country**

Toward a Solution

- **What amazes me is how fiscal policy reform experts like Glenn and Michael never talk about controlling medical care costs**
- **What amazes me is how seldom one ever hears in the discussion of medical care cost inflation a word about cross-country comparisons**
- **This country needs a single-payer system, needs to put every last private insurance company out of business, yet should be open to foreign models including the US VA for operational methods of running group practices and hospitals**
- **Conservatives who think “competition among providers is the answer” condemn us to decades of excessive and unnecessary medical care cost inflation, a quagmire of unnecessary phone calls between doctors and insurance companies:**
- **WILL YOU PAY FOR THIS PROCEDURE?**

In Any Discussion of the Long-run Growth in the Debt/GDP Ratio . . .

- **The share of medical care costs in GDP is the big elephant in the room**
- **Economists and commentators alike are hiding like ostriches in the sand from the big elephant in the room.**
- **Let's have a system like Canada financed deficit-neutral by a VAT**
- **And make sure that top income tax rates on the rich are high enough to offset the non-progressive nature of any VAT.**