Grading the 1993-97 Economy

By Alan Reynolds

The sixth or seventh year of any economic expansion is always greeted by wildly enthusiastic news reports. That was certainly true in 1997, just as it had been true in 1968 or 1989. It is remarkable how slow many economic journalists were to notice that the economy was improving at all. A couple of years ago, *The New York Times* ran a long series of articles fretting about all the jobs supposedly lost to "downsizing." Now, after only one good year in 1997, everyone has suddenly gone overboard in the opposite direction. News reports are constantly telling us the economy is booming, the best ever. The press release accompanying the new *Economic Report of the President* boasts of "The Strongest Economy in A Generation."

Such political interpretations of statistics often lack perspective. Of course, the economy has generally improved since the 1990-91 slump, and even since 1993 or 1994. If it had gotten worse, we would be in a recession. The more interesting question is whether output, income, or employment improved more rapidly than we would normally expect.

"The one thing that's most striking about the current economy is very low inflation, particularly in 1997. The fact that last year's low inflation was combined with better economic growth mystifies many mainstream economists, who have long argued that low unemployment pushes up wages and thus pushes up prices. In reality, periods of high inflation have always been associated with terrible economic and financial performance (e.g., 1974-75, 1979-81), so it should be no surprise that low inflation has been good for investment, economic growth and employment."

To answer that question, we will grade the 1993-97 economy as one would grade a college term paper, where an "A" is excellent, a "C" is average, and nobody ever gets an "F." The economy *has* been better than usual in a few important respects—such as a strong dollar and the related low inflation, or strong investment in information technology. Whether such events have anything to do with some Presidential "three-part strategy" is a separate matter. Whenever I claim some 1993-97 figures below a "C" grade, that is not meant to be rude. It means the statistics have been worse than normal for periods between recessions. That is a question of fact, not opinion.

Inflation: A

The one thing that is unique about the current economy is very low inflation, particularly in 1997. The fact that last year's low inflation was combined with better economic growth mystifies many mainstream economists, who have long argued that low unemployment pushes up wages and thus pushes up prices. No "new classical" or "supply side" economist ever agreed with that "Phillips Curve," so they have no explaining to do. (In reality, periods of high inflation have *always* been associated with terrible economic and financial performance (e.g., 1974-75, 1979-81), so it should be no surprise that low inflation has been good for investment, economic growth and employment.)

Should we give credit for low inflation to the shrinking budget deficit? Not likely. Inflation in 1995-97 was lower in Germany than it was in the US, and close to zero in Japan, but Germany and Japan had very large budget deficits. The fact that inflation was *higher* in the US also makes it hard to give *all* the credit to the Federal Reserve. World central banks pushed inflation down almost everywhere, with the Fed being the dominant source of monetary integrity, but not the only one. If prices had been rising fast in Europe and Japan, the dollar would have had to rise much more than it did to avoid importing such inflation.

Treasury Secretary Robert Rubin deserves a lot of credit for sticking to his "a strong dollar is good for America" policy. Most of his predecessors had eventually tried kicking the dollar downstairs (in 1972, 1979 and 1987) in an effort to gain trade advantages. A year or two later, inflation heated up. The Treasury has not yet threatened to sink the dollar during this cycle, except during a trade scuffle with Japan in 1994.

Budget Deficit: A-

Government borrowing is not inherently worse than corporate borrowing or home mortgages, but it does tend to be more wasteful. So, it is a good thing that deficits are virtually gone, for the time being. Interest on the national debt can be a slightly smaller portion of future government spending. The effect on the economy, however, is surprisingly uncertain.

In traditional Keynesian economics, a smaller trade deficit is supposed to be *bad* for economic growth. Issuing more government bonds is somehow supposed to "stimulate" spending, and spending is said to be the source of employment and production (rather than the other way around).

The President, by contrast, suggests that enacting higher tax rates in the fall of 1993 "reassured financial markets" and pushed interest rates down. Yet the interest rate on 30-year bonds *rose* from 6% at the time of the tax hike to more than 8% by November 1994. Besides, sharply higher tax rates on families earning more than $140,000 (called a "millionaire's surtax" in the 1992 campaign) had virtually nothing to do with the deficit. Even the White House never claimed these taxes would bring in more than about $25 billion a year, and half of that was devoted to raising the earned income tax credit rather than cutting the deficit.

If interest rates really depended on budget deficits, why did interest rates fall from 13% in 1981 (when the deficit was small) to 6.6% in 1993 (when the deficit was large)? And why are interest rates so low today in Japan and Germany, where budget deficits are large? This is simply a hoary myth. If smaller deficits really lowered interest rates on US bonds, then investors would switch to foreign bonds until US rates came back up.

The fact that officials are so surprised by the recent deficit reduction shows that it was *not* a matter of deliberate policy. In his State of the Union address, the President referred to an old CBO estimate that deficits would be $385 billion by now. But that was an utterly ridiculous estimate, as I pointed out at the time. Deficits always fall as the economy pulls out of recession. This time, there were the added advantages of slashing defense by about $150 billion a year, ending payments of more than $60 billion a year to S&L depositors, and benefitting from lower inflation in medical costs and interest expense. Because inflation came down so sharply in 1996-97, interest rates also came down—raising profits and stock prices, and therefore generating a lot of federal revenue *from taxes on corporate profits and capital gains.*

In 1997, the top tax rate on capital gains was also slashed from 28% to 20%. Proponents of a lower capital gains tax (myself included) had always insisted that it would give a big boost to the economy, the stock market, *and especially to tax receipts.* It is astounding that Congressional Republicans now *complain* about this ephemeral revenue windfall when it was one of the reasons they pushed for a lower capital gains tax in the first place.

Business Investment: B+

A major force behind business investment has been information technology—computers, modems, fax machines, and all the hardware and software needed to make the Internet work. All other varieties of business investment were actually rather weak—amounting to 7.4 % of GDP from 1993 to 1996, down from 8.3% in 1983-89. But perhaps cheap technology can substitute for more costly old investments. The Internet can substitute for library buildings, for example. Investments in information technology are quite promising, but this has nothing to do with Presidential strategies regarding trade deals, budget deficits, or education.

One widely unappreciated benefit of low inflation is that it is good for business investment. One reason is obvious: Low inflation holds down the cost of plant and equipment, and related materials, and it makes it easier to raise funds by selling stock or bonds. But low inflation also means lower taxes on corporate profits and capital gains. Depreciation allowances are based on what equipment cost in the past, so they can be quite inadequate when it comes time to replace that equipment at inflated prices. Unless depreciation allowance are indexed, inflation raises the actual corporate tax. Capital gains are also not adjusted for inflation, so inflation can make the actual tax much higher than the apparent rate. Again, low inflation avoids that problem, raising the after-tax returns to stockholders.

An alternative story is that shrinking deficits increased investment by increasing national savings. That isn't true either.

Savings: D+

In 1997, the economy set one new record: Consumers saved only 3.8% of their after-tax income—the lowest since 1936. We should not make too much of that. Corporations do most of the nation's saving, through retained profits and depreciation. And higher prices on stocks and bonds made people more wealthy, at least on paper.

What is far more telling is that the reduction in the budget deficit was offset by an even larger reduction in private saving (including corporate saving). Overall national savings dropped to 15.5% of GDP in 1993-96, down from 17.2% in 1983-89. That is why investment had to be financed by tapping foreign savers, a capital inflow that has been matched by a growing current account deficit. Remember the theory of "twin deficits"? A smaller budget deficit was supposed to result in a smaller current account deficit. Yet the opposite happened.

Employment Growth: C-

The Administration appears most proud of having "created" 15 million jobs over a five year period. That is almost true, but it is a mediocre rate of gain. There is a technical glitch in 1994, when new survey methods added an extra 1.1 million to measured employment (and to the labor force). We have to pull that statistical increase out to make 1994 comparable to 1993. When we do that, it turns out that employment grew by 1.5% a year in 1993-97. That compares poorly with average job gains of 2.4% a year from 1983 to 1989. In an October 1996 *Wall Street Journal* article, Treasury Secretary Robert Rubin boasted about "an exceptionally high level of job creation." Actually, job creation has been exceptionally *slow.*

Unemployment is *not* low because of unusually rapid growth of jobs. Unemployment is low because of unusually *slow* growth in the number of job seekers. The labor force grew by nearly 1.6% a year in the Eighties. At the start of the current decade, demographers expected the labor force to grow by 1.3% a year, but it has slowed even further, to 1.1%. My own prediction, in 1993, was that many skilled women who would be thrust into the new 36-40% tax brackets because of their husbands' income would drop out of the job market. I also suggested that many men would retire a few years earlier than otherwise. I believe this partly explains why the economy is facing such severe labor scarcity after only five years of relatively meager economic growth.

The irony is that low unemployment, which the President now treats as a major achievement, is precisely what makes it almost impossible for the economy to grow by more than 2% in the future. Employment can no longer grow by even the mediocre 1.5% rate of the past five years, but must slow to about 1%—given the slow pace of labor force growth. If real

GDP per worker could grow by 1%, that might give us a couple more years of 2% growth, as the Administration hopes. Unfortunately, productivity growth since 1993 has been even slower than that.

Productivity: D+

Although job growth has been slower than normal, it was relatively fast when compared with the unusually slow growth of real GDP. But to say that employment grew nearly as fast as production is nothing to brag about it. It is just another way of saying that labor productivity barely improved at all. From 1993 to 1996, productivity increased by just 0.6% a year—far below the 1.5% average of the previous expansion (1983-89). Even if the productivity figures understate productivity gains, as some claim, that would have been true in the eighties too. The slowdown is still a slowdown.

In 1997, however, productivity rose by 2.2% over the last four quarters. That brief glimmer of good news led some "new economy" theorists to claim that high tech investment was finally boosting productivity. Yet even these optimists are not expecting economic growth higher than 2-2.5% for 1998-99, which suggests that 1997 was probably a temporary aberration for productivity—as it was for GDP.

Economic Growth: D

The preliminary estimate is that the economy (real GDP) grew by 3.8% in 1997, or 3.2% if we ignore the unsustainable accumulation of inventories. If one year was all that mattered, that is not bad. Unfortunately, economic growth from 1993 to 1996 averaged less than 2.7%. And for 1998-99, even the Clinton Administration estimates that the economy will grow no faster than 2% a year. Why? Because we are running short of willing and able workers, and our trade deficit is getting so large that foreigners may tire of lending us the money to finance it. *If the Administration's estimate is right, economic growth will average 2.6% from 1993 to 1999—far below the 4% rate of growth for 1983-89.* It is also well below the previous postwar average—which was 2.9%, even with recessions included. This has been a fairly long expansion, so far, but not a strong one.

Income Growth: D-

Slow growth of real output per worker (productivity) should be reflected in slow growth of real income per family. Yet the new *Economic Report of the President* says, "typical family income is up $2,169 since 1993, when adjusted for inflation." That figure, for median family income in 1996, is correct—as far as it goes. But measured in 1996 dollars, median family income ($42,300 in 1996) was *down substantially from $43,290 in 1989*. Indeed, "typical family income" in 1996 was even lower than it had been back in 1988 ($42,695) or 1987 ($42,775).

In fact, median family income over the last five years is still lower than it was during the last three years of Ronald Reagan's presidency. To make matters worse, the *Economic Report* compares 1996 incomes with *1993*—which happens to be the year of Mr. Clinton's tax increase. Why do they compare one Clinton year with another? Because median income was *lower* in 1993 than in 1992. It was even lower than during the recession years of 1990 and 1991. You have to go all the way back to 1985 to find a median figure income lower than it was in 1993, even *before* taxes.

When it comes to the distribution of these stagnant incomes, the *Economic Report* again turns to Clinton's first year as the benchmark: "Since 1993, every income group . . . experienced a real increase in their income, with the poorest 20% of American households experiencing the biggest percentage increase (6.8%)." That sounds as though the poorest 20% are gaining on the rich, or at least doing better than median family income (which has gone nowhere). Not so. In 1996, the poorest 20% received only 4.2% of income, while the top 5% got 20.3%. From 1983 to 1989, by contrast, the poorest 20% received a larger 4.7% share of total money income, while the top 5% received much less—16.5%.

Actually, increased inequality of *family* income is not explained by difference in pay per hour, which is a common mistake, but rather by differences in hours. At the top, there have been more hours worked by spouses in high-income families (mainly before the 1993 tax law shoved second earners into high tax brackets). At the bottom, there have been fewer hours worked, largely because the poorest 20% is increasingly over represented by single mothers (at least until recent "workfare" requirements take effect).

Policies and Performance

There is an unfortunate tendency to blame any bad economic news (such as "downsizing" on business), while crediting all good news to the Administration. If the US had a centrally planned economy, and the economy was also closed to the rest of the world, and the President was a dictator, then it would be perfectly reasonable to put credit and blame at the President's feet. But Presidents have very little control over many things that matter economically. Congress and the Federal Reserve usually have more. And the rest of the world can throw us some surprises. With rare exceptions (such as Herbert Hoover's tariffs and taxes and Richard Nixon's price controls), the state of the economy normally is little shaped by the White House.

Now in the 1990s, minor changes in the federal government's modest education and training efforts could not possibly have had *any* economic impact in such a short period of time. Opening foreign markets to American goods could only have "worked" by making exports grow faster than imports—but the trade deficit is in fact getting larger. The reduction of the budget deficit is welcome, but it is hard to say that something so unexpected was part of a grand strategic plan. And it requires a huge leap of faith to believe that a smaller deficit has "caused" (rather than been a consequence of) such good news as low inflation and low interest rates.

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