The U.S. Economy

The New Normal and an Unsustainable Future

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It is with some trepidation that we contribute to a symposium on the future of the economy. The future is inherently unknowable. Although the laws of economics are universal, the institutional environments within which they operate dictate economic outcomes. Thus, any prediction about the future is ultimately a prediction about institutional evolution. Formal institutions are often shaped by political decisions, and those political decisions are shaped by broader cultural forces. We do not have a comparative advantage in forecasting political or cultural evolution.

Our goal here is more modest. First, we outline where the economy is today and why it is behaving as it is. Next, we project current economic policy into the future and find it unsustainable. Thus, some evolution of policy and institutions is inevitable. Our final section speculates on the forms that evolution might take.

The New Normal

The U.S. recession officially ended in June 2009 (Business Cycle Dating Committee 2010). Yet since the end of the recession, annual growth in gross domestic product (GDP) has averaged only 2.2 percent (U.S. Bureau of Economic Analysis 2015). Meanwhile, unemployment has averaged a little more than 8 percent, and even this

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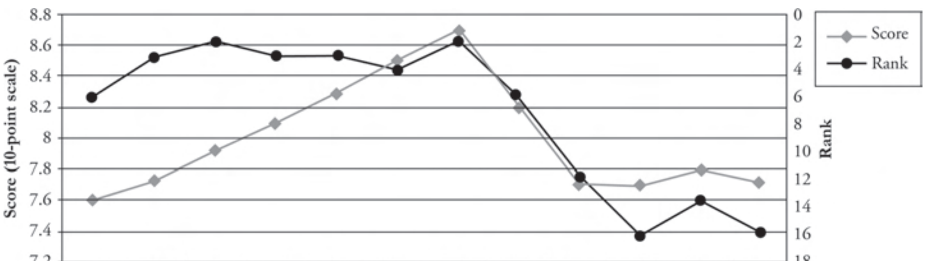
Figure 1
United States, Economic Freedom of the World
Rank and Score, 1970–2013



	1970	1975	1980	1985	1990	1995	2000	2005	2010	2011	2012	2013
Score	7.6	7.73	7.92	8.11	8.35	8.5	8.65	8.22	7.76	7.7	7.81	7.73
Rank	6	3	2	3	3	4	2	6	12	16	13	16

Source: Data compiled from Gwartney, Lawson, and Hall 2015.

percentage understates the problem because many are underemployed or have dropped out of the labor force altogether (U.S. Bureau of Labor Statistics 2015).

The working-age population of the United States has grown by roughly 51 million people since 1994, yet we have added only 21 million jobs. The remaining 30 million people either have left the workforce altogether or are categorized as "underemployed," "discouraged," or "marginally attached to the work force" (U.S. Bureau of Labor Statistics 2015).

This sluggish economy contrasts sharply with the U.S. economic performance in the twenty years prior to the recession. During that time, the economy expanded by 75 percent, growing at a real annualized rate of 3.0 percent (U.S. Bureau of Economic Analysis 2015). Over the same period, roughly 63 percent of the U.S. labor force was employed. Since the end of the recession, that number has dropped to 59 percent.[1]

The U.S. economy's poor performance is no longer related to our most recent business cycle. It instead reflects the type of long-run growth that can be expected due to our decreased economic freedoms. The *Economic Freedom of the World Annual Report* is the best measure of economic freedom available. It measures thirty-one variables across five broad categories: size of government; property rights; sound money; freedom to trade internationally; and regulation of credit, labor, and business (Gwartney, Lawson, and Hall 2014).

The United States ranked in the top four in the world in every year economic freedom was measured between 1970 and 2000 (figure 1). But since the year 2000 U.S. economic freedom has been on the decline. The United States fell from second in 2000 to a low of sixteenth in 2011, thirteenth in 2012, and then

1. The U.S. Bureau of Labor Statistics (2015) defines *labor force* as the civilian noninstitutional population older than sixteen.

sixteenth again in 2013, and its rating (out of ten) fell from 8.65 to 7.73 in 2013. The decline in freedom has been almost across the board.[2] Probably most troubling has been the growth of the size of the U.S. government and the perceived decrease in the security of our property rights. Adjusting for inflation, the U.S. government spends 40 percent more today than it did in 2000 (U.S. Bureau of Economic Analysis 2015). As the next section outlines, this increased spending is expected to accelerate to unsustainable levels in the coming years.

To measure security of property rights, the index relies on a number of surveys in the *International Country Risk Guide*, the *Global Competitiveness Report*, and the World Bank's *Doing Business* project in assessing how secure property rights are here (Gwartney, Lawson, and Hall 2014). The U.S. score for this variable has decreased from 9.2 to 7.0 since 2000. No single "smoking gun" can be pointed to as the reason for the decrease in perceived security of property rights. Possible contributing factors might include the Supreme Court's *Kelo* decision (*Kelo v. City of New London,* 545 U.S. 469 [2005]) that eminent domain can be used for economic development; the increasing seizure by police of personal property of individuals suspected of being involved in the drug trade (without a court verdict or even charges being filed); and the wholesale rewriting of contracts by the government during the bailouts of 2008.[3]

A large literature shows that economic freedom is associated with higher incomes, faster economic growth, longer life expectancies, and most other measures of well-being that people generally care about (Hall and Lawson 2014). Using one estimate (Gwartney, Lawson, and Holcombe 1999) of how economic freedom impacts growth rates, we can estimate that the 0.92 drop in the Economic Freedom Index score for the United States since 2000 should be expected to generate annual growth rates that are 0.736 percentage points lower than they were prior to our decline in economic freedom. This means that a significant portion of our sluggish growth can be attributed to our lower level of economic freedom, but even this correlation understates the impact our decreased freedom can have on growth because changes in economic freedom, regardless of absolute level of freedom, have also been shown to be important for economic growth. So the fact that our decline to a new lower level of freedom is recent is also likely contributing to slower growth. In short, the U.S. economy's sluggish growth is our new normal rather than a product of a business cycle.

Absent a change in the U.S. institutional environment, the future of the U.S. economy looks—based on our deteriorated economic freedom—much like the

2. Ironically, the U.S. score for sound money has not declined significantly (9.7 in 2008 to 9.3 in 2012) despite various Federal Reserve measures, including "quantitative easing," because the index uses a measure of price inflation that does not reflect the magnitude of Fed money creation; much of the increased money supply has merely become excess bank reserves (Gwartney, Lawson, and Hall n.d.).

3. As James Sherk and Todd Zywicki point out, during the bailout of General Motors and Chrysler, the Obama administration effectively subsidized United Auto Workers (UAW) compensation at the taxpayers' expense and offered preferential treatment to the UAW over other bankruptcy creditors. "Legally the UAW's claims had the same status as those of other unsecured creditors, but the UAW recovered a much greater proportion of the debts that General Motors and Chrysler owed the union" (2012).

slow-growth economy we have today. However, due to the impending explosion in entitlement obligations, it is very unlikely that our current environment of economic freedom will be stable.

An Unsustainable Future

Increased government spending played a role in decreasing economic freedom in the United States over the past dozen years. However, that growth in spending pales in comparison to the growth in government spending that would be required for existing government policies to continue in the future.

The U.S. government's official debt of $18.3 trillion amounts today to roughly 103 percent of GDP. Approximately 73 percent of the federal debt is held by the public. According to the U.S. Congressional Budget Office (2014), this publicly held debt is expected to grow to between 92 percent and 135 percent of GDP by 2039. By 2089, it is expected to balloon to 225 percent of GDP. As the European debt crisis has shown, these debt levels are wholly unsustainable.[4]

Forecasted unfunded liabilities in the Social Security and Medicare programs are an even larger problem than official debt forecasts. The "fiscal gap" is an estimate of differences between what these programs have promised to pay out and their forecast revenue. According to Laurence Kotlikoff, who helped to develop generational accounting to measure these unfunded liabilities, "The size of the U.S. fiscal gap—$210 trillion—is massive. It's 16 times larger than official U.S. debt, which indicates precisely how useless official debt is for understanding our nation's true fiscal position" (2015, 5). Other estimates indicate a gap between $54.4 trillion and $91.4 trillion (Gokhale 2014, 67–98). Although these estimates vary widely, the unfunded liabilities even at the bottom of the range dwarf the official government debt by orders of magnitude.

The current fiscal trajectory is unsustainable. Given the U.S. decline in economic freedom, robust economic growth is unlikely to occur and ease these burdens. Programs such as Social Security rely on getting more young workers in to pay the benefits of the old. Current demographic trends indicate that U.S. birthrates will not help, and it seems politically unlikely that the U.S. government will significantly increase immigration quotas (and even if they did, most dynamic and generational estimates of the net fiscal impact of immigrants are clustered around zero [Nowrasteh 2015]). Thus, a change in fiscal policy is necessary.

Kotlikoff estimates that to remain solvent in the future, "[w]e need to either reduce the time path of government expenditures by 10.5 percent of GDP or raise the time path of government revenues by 10.5 percent of GDP. Alternatively, we can enact a combination of spending cuts and tax increases that amount to 10.5 percent

4. Greece, for example, has a debt-to-GDP ratio of 175 percent (Kotlikoff 2015).

of annual GDP. This adjustment needs to begin immediately and continue forever" (2015, 5). Is a policy change of this magnitude likely?

Which Way Forward?

To say that current U.S. fiscal policy is unsustainable is only to say that it must change. Predicting precisely how and when it will change is much less a matter of economic science. Nevertheless, we can speculate on how likely the necessary reforms are to occur and what the consequences will be if they do not.

It is first worth noting the staggering size of the adjustment in fiscal policy that is necessary. Federal tax revenue as a percentage of GDP has been a little lower than and occasionally bumped up against the 20 percent level since the end of World War II, and it peaked briefly at 22 percent during the war (Hummel 2015). Permanently increasing taxes by 10.5 percent of GDP seems highly unlikely. Even splitting the burden and increasing taxes as a percentage of GDP by 5.25 percent would require the political support that was achieved only during World War II for a brief time period. It seems highly unlikely, at least absent a crisis occurring, that the American voters will support a tax increase of anything close to the magnitude necessary to stave off a fiscal collapse.

Budget cuts and cuts to promised entitlements of any magnitude large enough to significantly close the fiscal gap also seem unlikely. The budget sequestration in 2013 cut spending authority by $85 billion for that fiscal year (U.S. Congressional Budget Office 2013) and is estimated to cut spending by a total of $1.2 trillion over an eight-year period (U.S. Congressional Budget Office 2011). This relatively trivial spending cut, which exempted Social Security, was deemed "austerity" in the popular press and vigorously objected to by its political opponents. If such a trivial spending cut generates that reaction, it is a strong indication that the type of cuts necessary to seriously address the fiscal gap are politically impossible, even if coupled with tax increases.

If increased growth and migration are unlikely to save the United States from a fiscal crisis, and the political will doesn't exist to cut spending or increase taxes enough in order to avert a fiscal crisis, then signs point in the direction of a fiscal crisis in the future. Although impossible to predict the timing precisely, the crisis will come before all of the bills are due. Once debt holders begin realizing that there is no way the U.S. government will be able to meet all of its debt and entitlement obligations and start requiring greater risk premiums on government bonds, the crisis will come on quite quickly, as it did in Greece.

It is beyond the scope of this brief essay to predict how such a fiscal crisis might play out. Would radical spending cuts or tax increases become politically possible in the midst of a fiscal meltdown? In that situation, would Medicare or Social Security be significantly cut or even abolished? Would foreign governments intervene to partially bail out the United States? Would the government be forced to default on or even repudiate its debt?[5] Would it choose to go the way of Zimbabwe and hyperinflate?

If such a fiscal crisis comes about, we hope that it will lead to a reassessment of the role government plays in the economy, a reassessment that would make the type of reductions in the size and scope of government that are not politically possible today. As Milton Friedman observed more than fifty years ago, "Only a crisis produces real change. . . . This, I believe, is our basic function: to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes the politically inevitable" ([1962] 2002, xiv). The advocates of laissez-faire need to continue to develop the intellectual alternatives to welfare statism and articulate them to a broad audience. Perhaps, just perhaps, once the folly of the unsustainable welfare state is revealed, people will embrace the market and civil society alternatives.[6]

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5. Jeffrey Hummel (2015; Henderson and Hummel 2014) argues that the U.S. government is headed to a default and repudiation of its debt. In addition, he advocates this outcome as his favored solution to the current fiscal imbalance.

6. Although this scenario would improve the economy in the future, it would not cure the unfunded liabilities and debt that cause the crisis. Some form of default, repudiation, or benefits cuts would still have to occur. See Hummel 2015 for an argument that default and repudiation of debt are morally superior to cutting Social Security or Medicare obligations.

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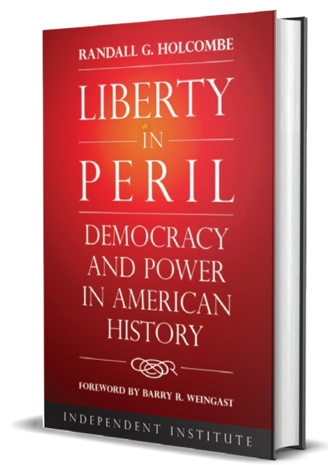

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