

BACKGROUND

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Economic Outlook for 2017

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Abstract

Slow growth, low economic participation, and a high cost of living are the foremost economic trends as the calendar changes to 2017. The economic recovery, such as it was, has been over for a year or more, which means that future economic gains will be harder to achieve. The recovery was less than spectacular: Gross domestic product (GDP) grew less than expected, thanks mainly to low productivity growth. The same trends have kept wage growth low as well. In 2017, policymakers should focus on restoring investment incentives, reengaging those who gave up looking for work, and deregulating the cost of living. If those policies, combined with the efforts of workers, investors, and innovators throughout the economy, can bring income growth back up to the pre-recession trend, the median American household could expect to see its annual income rise by \$4,200. Lowering the cost of living through regulatory reform could lead to a similar rise in the purchasing power of income.

As 2017 begins, the U.S. economy is in its eighth consecutive year of expansion, one of the longest periods of economic expansion in U.S. history, but the recession that took place when *Slumdog Millionaire* was best picture and *Just Dance* topped the charts still casts a shadow over the economy. Economists may debate what made the Great Recession of 2008–2009 so different from previous recessions, but Americans do not need data analysis to understand that something went wrong.

As we enter the new year, the overarching trends are still those that defined the seven-year non-recovery: slow income growth, low labor market participation, and a high cost of living in urban areas.

This paper, in its entirety, can be found at <http://report.heritage.org/bg3183>

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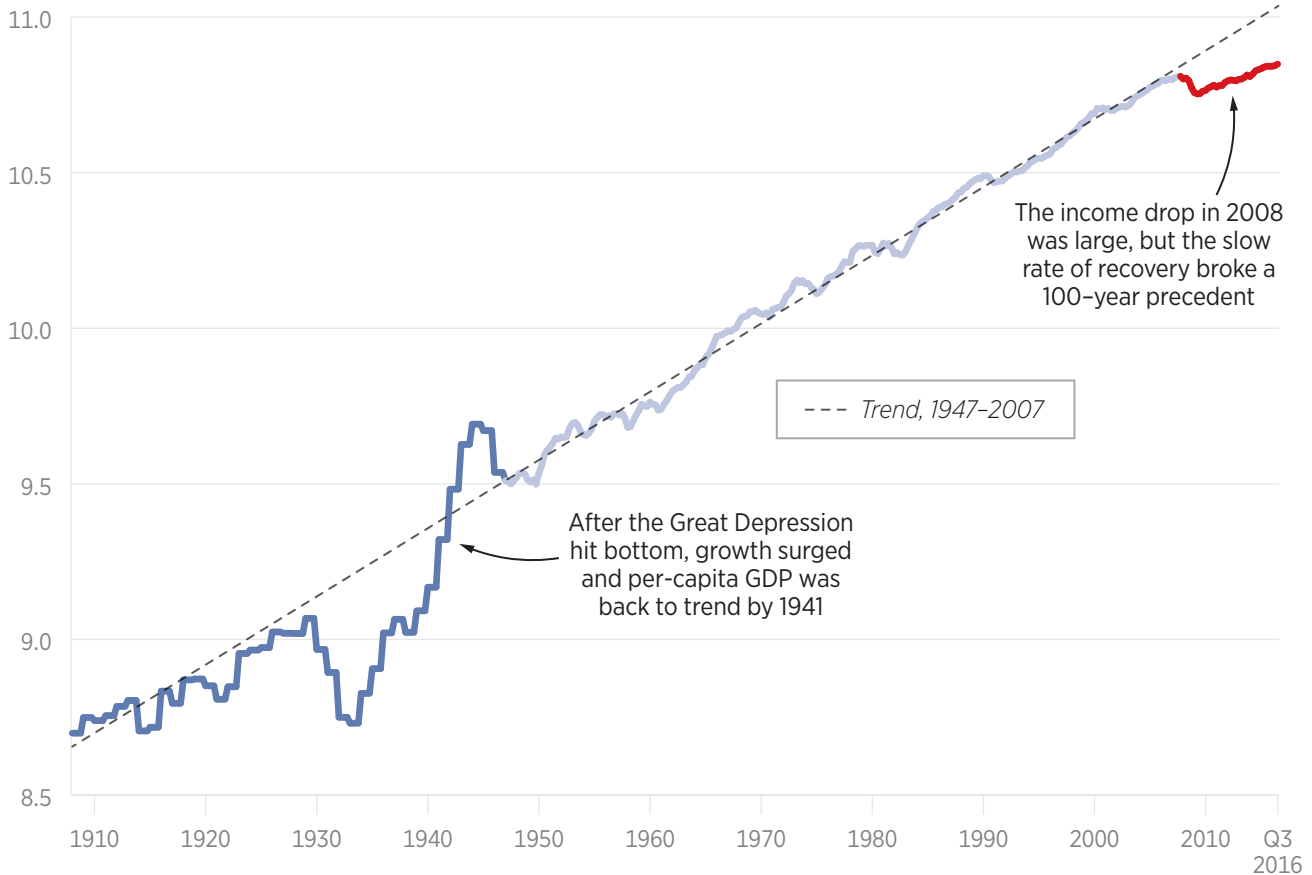
KEY POINTS

- The economic recovery is complete, but the economy continues to underperform expectations. The slow rate of recovery broke a 100-year precedent of rapid rebounds to trend.
- The Congressional Budget Office predicted in January 2009 that the economy would grow at a rate of more than 3.5 percent per year for four years beginning in 2011 and would produce \$20.5 trillion in 2016.
- Instead, 2016 output will come in below \$19 trillion, about 7.5 percent less than expected. This would equal a 7.5 percent cut in income for every worker and investor in the United States.
- Wage growth has been slow and steady, mirroring productivity growth. The exception is a one-time boost in real wages during 2015 and 2016 as a result of low energy costs.
- Cost of living is a major economic problem in U.S. cities and one that state and local policymakers should focus on alleviating.

CHART 1

Economic Recovery Fails to Keep Pace with Historical Trend

REAL GDP PER CAPITA, NATURAL LOG



SOURCES: Louis Johnston and Samuel H. Williamson, "What Was the U.S. GDP Then?" MeasuringWorth, <https://www.measuringworth.com/usgdp/> (accessed December 29, 2016), and Bureau of Economic Analysis, "Real Gross Domestic Product per Capita," <https://fred.stlouisfed.org/series/A939RXOQ048SBEA> (accessed December 15, 2016).

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The biggest factor behind the slow income growth is low productivity growth. Private investments or public policies that restore productivity growth would be welcome signs, but even if those signs prove to be elusive, policymakers can pursue deregulation of housing and other markets to lower the cost of living and allow Americans to stretch their wages further.

A Return to Normalcy

As of the end of 2016, economic growth has been normal for at least a year. With a few exceptions, data indicate an economy operating at or near its "natural" or "potential" level.

The unemployment rate reached a nine-year low of 4.6 percent in November and has not exceeded 5 percent since September 2015. Experience from previous periods of sustained growth indicates that little further improvement can be expected.

Gross domestic product (GDP) is growing at a steady but unimpressive rate. Adjusted for population growth and inflation, GDP grew 0.8 percent from the third quarter of 2015 to the third quarter of 2016.

Private domestic investment grew rapidly from its recession trough but peaked at 17 percent of GDP in early 2015 and has not grown since then. The lack

of further growth is both an indicator and a cause of the end of the recovery: Strong growth in wages and GDP depends on investment. At just 16 percent to 17 percent of GDP, investment is treading water.

Like investment, labor force participation has not reached pre-recession levels. Part of that change is due to the retirement of the baby boomers: People born in 1951 turned 65 in 2016. However, prime-age workers are also less likely to be working or looking for work now than in 2007. Persistently low participation is one of the main challenges facing policy-makers in 2017.

Monetary policy is an exception to the prevailing normalcy. Inflation has remained below the Federal Reserve Board's 2 percent target for years. Consequently, the Fed has left its policy levers in positions that are typical of a recovery and is likely to remain accommodative until inflation reaches 2 percent.

Mediocre Level of Output

Even though the rate of GDP growth is reasonable for a recovered economy, the level of GDP is far below what economists expected before or during the Great Recession. GDP directly measures output, but it tracks national income so closely that the two are often interchanged.¹

Previous experience taught that after a recession or depression, GDP tends to bounce back to its previous trend. After the Great Depression of the 1930s, incomes surged back to their pre-crash trend, and the economy moved along in the 1940s and 1950s as if nothing had ever happened. Now, however, the economy is growing at both a lower level and a slower rate than the longstanding trend. (See Chart 1.)

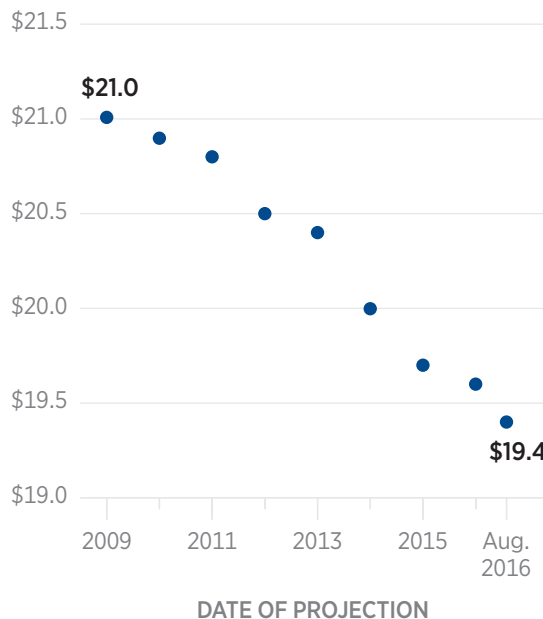
The recovery from the Great Recession was disappointing in two respects: It was much slower than expected, and it did not return the U.S. economy to the previous growth trend.

The Congressional Budget Office (CBO), reflecting the consensus of the time, predicted in January 2009 that the economy would grow at a rate of more than 3.5 percent per year for four years beginning in 2011 and would produce \$20.5 trillion in 2016.²

CHART 2

Declining CBO Forecasts of 2017 GDP

PROJECTED REAL GDP FOR 2017,
IN TRILLIONS OF DOLLARS



NOTE: Figures are in 2015 dollars. All projections except for August 2016 were made in January of the given year.

SOURCES: Congressional Budget Office, *Budget and Economic Outlook*, 2009–2016 and 2016 Update, and Bureau of Economic Analysis, “Real Gross Domestic Product,” <https://fred.stlouisfed.org/series/GDPCI> (accessed December 29, 2016).

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Instead, 2016 output will come in below \$19 trillion, about 7.5 percent less than expected. That would equal a 7.5 percent cut in income for every worker and investor in the U.S.

Looking at income growth trends in another way, the CBO has steadily degraded its expectations for the potential future output of the U.S. economy.³ Its annual forecasts for actual 2017 GDP, plot-

1. The difference between national output and national income is net payments to foreigners.

2. Reported in 2015 dollars.

3. Potential output is the CBO's estimate of the “the economy's maximum sustainable output,” based on the available capital, labor, and technology and the ways those are combined to create output. Congressional Budget Office, “Budget and Economic Data,” <https://www.cbo.gov/about/products/budget-economic-data> (accessed December 18, 2016).

ted in Chart 2, show how the experience of the past eight years has convinced economists that something worse than a mere recession has taken place since 2007.

In January 2009, during the depths of the recession, the CBO projected that potential output in the nonfarm business sector would grow 24 percent between 2009 and 2017.⁴ By the time the most recent CBO report was issued, that estimate had shriveled to 14 percent growth.⁵

The lost growth, according to the CBO's estimate, is due to a trifecta of lower levels of productivity, capital, and labor. Lower productivity growth directly explains about half the loss in output. Indirectly, it explains even more: Lower productivity means lower returns to work and investment, which further reduce output as potential workers and investors stay away.

Moderate Wage Growth

Despite the mediocre growth environment, wage growth has picked up over the past few years.⁶ However, it has been lower than expected, and part of the real wage growth enjoyed in 2015 and 2016 was due to a one-time drop in energy prices.

Although individual compensation often deviates, average compensation for any sizeable group is determined mainly by labor productivity.⁷ For decades, average U.S. compensation growth has closely tracked average labor productivity, although it takes some work to make an apples-to-apples comparison.⁸

Labor productivity is determined by two things: the amount of productive capital per worker and something economists call “total factor productivity.” The latter is an unobservable mix of technology,

management practices, regulatory waste, and market flexibility.

CBO estimates of potential labor force productivity suggest that durable factors have depressed wages: a combination of low productivity growth and low investment. In 2009, the CBO estimated that potential labor productivity would grow by 18 percent through 2017. The most recent CBO estimate dropped that to 10 percent growth.

Policymakers looking to nudge wage growth higher should focus on sustainably increasing labor productivity, which can be done in two ways. The more certain way is to allow investment to increase by simply cutting the marginal tax rate faced by new investment. Regulatory reform can help on a smaller scale by decreasing anti-competition policies, such as certificate-of-need laws⁹ and slow FDA drug approval processes,¹⁰ that discourage investment.

The less certain but more spectacular way to boost wage growth is to figure out how to increase total factor productivity growth, which, if it were easy, would already have been done. Merely getting productivity back to its pre-2009 trend would be a great accomplishment, but there is no single, large-scale lever like taxation that affects productivity across the board.

Much of what constitutes productivity is determined outside the realm of policy. However, where policymakers are concerned, regulatory reform is the most promising approach. The difficulty is that very few regulations are big enough to move the macroeconomic needle significantly on their own. It would take a concerted effort across sectors and at all levels of government to restore the dynamism lost since 2009.

4. Congressional Budget Office, “Budget and Economic Data: Potential GDP and Underlying Inputs,” January 2009, <https://www.cbo.gov/sites/default/files/51137-2009-01-PotentialGDP.xls> (accessed November 10, 2016).

5. Congressional Budget Office, “Budget and Economic Data: Potential GDP and Underlying Inputs,” August 2016, <https://www.cbo.gov/sites/default/files/51137-2016-08-PotentialGDP.xlsx> (accessed November 10, 2016).

6. Salim Furth, “Stagnant Wages: What the Data Show,” Heritage Foundation *Backgrounder* No. 3074, October 26, 2015, <http://www.heritage.org/research/reports/2015/10/stagnant-wages-what-the-data-show>.

7. James Sherk, “Workers’ Compensation: Growing Along with Productivity,” Heritage Foundation *Backgrounder* No. 3088, May 31, 2016, <http://www.heritage.org/research/reports/2016/05/workers-compensation-growing-along-with-productivity>.

8. The Heritage Foundation has done that work. See *ibid*.

9. Salim Furth and Reece Brown, “Finish What Reagan Started—End CON Laws,” *The Daily Signal*, August 12, 2016, <http://dailysignal.com/2016/08/12/finish-what-reagan-started-end-con-laws/>.

10. Alden F. Abbott, “FDA Reform: A Prescription for More and Better Drugs and Medical Devices,” Heritage Foundation *Legal Memorandum* No. 182, June 20, 2016, <http://www.heritage.org/research/reports/2016/06/fda-reform-a-prescription-for-more-and-better-drugs-and-medical-devices>.

Recovering Labor Market

A smaller share of American men and women are working than before the Great Recession, even when those likely to be retired or in school are excluded.¹¹ The good news is that labor force participation among workers aged 25–54 began to recover in late 2015 as real wages grew. The best-case scenario for 2017 is that wage growth will continue and will draw more adults off the sidelines and into the productive economy.

As family structure and public assistance programs have evolved over the past two generations, the U.S. workforce has undergone a quiet transformation. Historically—and as recently as 1980—men were expected to be the breadwinners. The social expectation and the fact that male-dominated professions were substantially better paid meant that the vast majority of mature men had a strong commitment to the labor force. Even if their wages fell, they stuck with jobs because they had to. During a recession, they might lose their jobs, but they would remain in the labor force looking for work.

In the 21st century, the growth in female-headed households has added many women to the ranks of those who are strongly attached to the labor force. A working-class single mother with children to feed is likely to behave much as a stereotypical 1950s father behaved. A growing number of two-earner households fall into this category as well, with lifestyles and mortgages that depend on both spouses working full time.

On the other side of the coin, more adult men appear to have a low attachment to the labor force. They will work for the right price but have options for maintaining their lifestyles without work, such as living with parents or girlfriends. A troubling proportion of both men and women have chosen to rely on disability insurance,¹² which usually means permanent detachment from the labor force.

Policymakers should use the opportunity presented by a reasonably healthy labor market to reform welfare programs in ways that penalize work less. The programs most in need of repair are disability insurance, which is a permanent trap even to temporarily disabled people,¹³ and housing assistance, which often imposes marriage penalties.

High Cost of Living

While workers' wages are determined by their productivity, the value of those wages depends on the prices of the goods and services they purchase. Prices in the U.S. have been pushed higher by regulation and restrictions on trade. If continued, those policies will mute the benefits of economic growth in 2017.

Federal regulation is a well-known problem, especially with regard to energy. Increasing tariffs, as some have proposed, would also raise consumer costs and make it harder for Americans to enjoy the benefits of growth.

Although it is less widely acknowledged, new regulations at the state and local levels continue to raise prices. In 2016, both New York City and Austin, Texas, placed severe limits on short-term home rentals.¹⁴ Aside from lowering incomes, the regulations will increase the cost and decrease the flexibility of the market for accommodation.

Even more costly are the limits placed on residential construction, especially on the West Coast and in the Northeast. The surging technology sector, centered in Silicon Valley, is having less of an impact on economic growth than it might have if the surrounding region allowed for construction and growth. Historically, cities have grown up around thriving industries, allowing for shared prosperity. Today, local laws against density and development are preventing population growth in high-productivity cities. Instead of benefiting from growth, working-class renters are often priced out of the market.

11. For a detailed treatment of labor force participation trends, see James Sherk, "Not Looking for Work: Why Labor Force Participation Has Fallen During the Recovery," Heritage Foundation *Background* No. 2722, September 4, 2014, <http://www.heritage.org/research/reports/2014/09/not-looking-for-work-why-labor-force-participation-has-fallen-during-the-recovery>.

12. *Ibid.*, Table 5.

13. Romina Boccia, "What Is Social Security Disability Insurance? An SSDI Primer," Heritage Foundation *Background* No. 2994, February 19, 2015, <http://www.heritage.org/research/reports/2015/02/what-is-social-security-disability-insurance-an-ssdi-primer>.

14. Michael Nunez, "New York Law Bans Airbnb Short-Term Rentals," Gizmodo, October 21, 2016, <http://gizmodo.com/new-york-law-bans-airbnb-short-term-rentals-1788086399> (accessed December 14, 2016); Melissa Quinn, "He Rented Out His Condo After Losing His Job. Now Austin Wants to Ban That,," The Daily Signal, July 12, 2016, <http://dailysignal.com/2016/07/12/he-rented-out-his-condo-after-losing-his-job-now-austin-wants-to-ban-that/> (accessed December 14, 2016).

To be sure, regulations can have benefits as well. And some of those benefits are widely shared. Too often, however, the benefits are narrowly concentrated and create powerful constituencies that oppose reform.

The high cost of regulation is a major drag on living standards. A Heritage Foundation report in 2015 estimated that just 12 specific regulations set the average household back \$4,440 a year.¹⁵ Little has improved since then, although the list is down to 11 since Congress repealed the ban on crude oil exports.¹⁶ If policymakers at all levels prioritize deregulation in major consumer markets—housing, transportation, and energy are the biggest—the prospects for improvements in standards of living in 2017 and beyond will be brighter.

Conclusion

The U.S. economy has recovered from the Great Recession, but the recovery has been disappointing. Incomes are lower, jobs and workers are fewer, and prices are higher than history had led us to expect. In the “new normal,” investment is low, and more people are content to stay on the sidelines.

All of the top-down fixes tried since 2008 have failed. The major economic policies of the past business cycle have been bailouts, stimulus spending, financial market regulation, expanded health care entitlements, and large deficits. These have not increased investment, have not restored economic participation to a high level, and have not addressed the cost of living for most Americans.

In 2017, policymakers should resolve to restore investment incentives, reengage those who gave up looking for work, and deregulate the cost of living. If those policies—combined with the efforts of workers, investors, and innovators throughout the economy—can bring income growth back up to the pre-recession trend, the median American household could expect to see its annual income rise by \$4,200,¹⁷ with even larger gains for those who are currently unemployed. Lowering the cost of living through regulatory reform could lead to a similar rise in the purchasing power of income.

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15. Salim Furth, “Costly Mistakes: How Bad Policies Raise the Cost of Living,” Heritage Foundation *Backgrounders* No. 3081, November 23, 2015, <http://www.heritage.org/research/reports/2015/11/costly-mistakes-how-bad-policies-raise-the-cost-of-living>.

16. Nicolas Loris and Elayne Allen, “The Lifting of This Oil Ban Could Add 800,000 New Jobs,” *The Daily Signal*, July 6, 2016, <http://dailysignal.com/2016/07/06/how-free-market-reforms-can-transform-the-american-energy-sector/> (accessed December 14, 2016).

17. Median household income in 2015 was \$55,775, and the 2016q3 gap between GDP per capita and the pre-2008 trend was 7.5 percent. Their product—about \$4,200—approximates what one could reasonably hope that the median household would gain from a return to trend output growth.