

The Economy, Productivity and the Budget

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Mr. Chairman and Members of the Committee, I am pleased to be here today to discuss issues surrounding the economic slowdown, its impact on productivity and the federal budget. I would like to emphasize that I speak for myself and not my employer, Griffin, Kubik, Stephens & Thompson, Inc.

After many years of stellar performance, the economy has clearly entered a period of dramatic slowdown. During the four years ending in the second quarter of 2000, real gross domestic product in the United States grew at an average annual rate of 4.5%. This growth boosted civilian employment by an average of 2.2 million jobs per year. And, at the same time, inflation-adjusted average weekly earnings climbed 1.6% per year, the fastest four-year period of growth in this measure of real incomes ever measured.

Since then, things have gone badly. Real GDP has expanded at an annualized rate of just 1.5% during the nine months ending in March. Moreover, in May 2001 civilian employment was 78,000 less than the average during the second quarter of 2000 while real weekly earnings have risen just 0.3% in the past year.

Today's economic problems are most evident in the manufacturing sector. Industrial production has contracted for eight consecutive months and new orders for durable goods are down 10.9% from year-ago levels. The high-tech sector – the engine of U.S. growth in the past four years – has been particularly hard hit with new orders for computer and electronic products down 40.8% at an annual rate in the past six months.

While clearly showing signs of weakness, consumer spending has shown surprising resilience. Adjusted for inflation, consumer spending is rising at a 2.4% annualized rate this year versus a 7.6% growth rate in the first quarter of 2000.

Weakness in the job market, when combined with high debt levels, will make it difficult for spending to accelerate in the months ahead. As a result, it is my view that the economy will remain weak for the remainder of this year.

Already, weak economic growth is reducing the growth rate of federal receipts below projections, which will cause the budget surplus to be smaller than expected this year. The important questions before us today are: How did this happen? When will it end? And, most importantly, is the U.S. now in for an extended period of economic growth that will fall below expectations?

In short, my answers are that the U.S. economy is going through a typical cyclical slowdown caused by tight monetary policy, high tax burdens and an energy crunch. Each of these problems is now in the process of being corrected. The Federal Reserve has cut interest rates enough to bring the economy back by early 2002 and taxes have been cut which will provide a boost to economic activity. In addition, high energy prices provided the incentive for a sharp boost in energy production which is already bringing prices down.

The forces that brought us strong growth in the late 1990s are still in place. High-tech investment has boosted productivity and will continue to do so at a very rapid pace in the years ahead. In addition, the tax cut – as it is phased in – will slowly increase the underlying potential growth of the economy. This suggests that CBO and OMB surplus estimates are still on track in the long-run.

Two Views

There are two views of the current economic slowdown. One of those views is that a “bubble” in investment and the stock market has caused the problems associated with the economy. According to this view, the economic growth we experienced in the late 1990s was unsustainable and a period of sub-par economic growth is now in store.

I do not subscribe to this view. While there may have been excesses during the boom and clearly some ill-advised investments were made, most of the investment in the late 1990s increased the economy’s productivity and its growth potential. The esteemed Yale professor, William D. Nordhaus, in a recently published paper², wrote that, “there has clearly been a rebound in labor-productivity growth in recent years.”

He finds that “well-measured” productivity (a measure which excludes services and other problematic sectors of the economy) accelerated to a pace of 4.65% between 1996 and 1998.

In responding to critics of the New Economy who say that productivity gains in the production of computers and semi-conductors are responsible for the surge, Nordhaus subtracts those sectors from his measurement and proves them wrong. He found that “non-high-tech” output per hour virtually doubled to a 3.0% growth rate between 1996 and 1998, from 1.6% between 1990 and 1995.

It is important to understand that Nordhaus was using data from the 1996 to 1998 period. Productivity growth actually accelerated further in 1999 and 2000. These gains in productivity boosted real incomes and corporate profits. They also boosted government revenue, creating massive surpluses in recent years.

In January, Alan Greenspan told this committee, “the key factor driving the cumulative upward revisions in the budget picture in recent years has been the extraordinary pickup in the growth of labor productivity....”³ He went on to say that because productivity had held up well during a slowdown in aggregate demand, “the apparent increases in the growth of output per hour are more than transitory.”⁴

The Fall in Productivity

This debate reached a crescendo in economic circles during recent months after a report that showed non-farm productivity fell by 1.2% at an annual rate in the first quarter. Pessimists argue that this decline in productivity is a sign that the trends in the economy are worsening.

In my opinion, however, this decline is not indicative of a drop in longer run productivity trends. In fact, it is normal to see a drop in productivity when an economy slows as rapidly as the U.S. has in the past year. Because production is falling faster than employment, output per hour of work declines. This is especially true when the economy is near full employment.

In 1999 and 2000, employers found it necessary to offer flexible working hours, hiring bonuses, and higher pay to attract workers. Employers are reluctant to let go of these high cost employees, especially if the slowdown proves temporary. But by holding on to these employees while output slumps, productivity suffers.

There are other important factors at work as well. Higher oil prices have almost always been associated with falling productivity. In the fourth quarter of 1990, in 1987, in 1979-1980, and in 1974, productivity turned negative when oil prices shot higher.

As the economy heads into the latter half of 2001, near-term developments are creating a better outlook for productivity. Energy prices are coming down rapidly, and the job market has weakened significantly. While it is never good to see layoffs, these developments bode well for productivity going forward.

More importantly, Federal Reserve interest rate cuts and the tax cut just signed into law will help boost growth in 2002. The end result will be that productivity will get back on track in the years ahead and budget revenue projections will prove to be correct.

Some Thoughts on Productivity

One of the major problems associated with any debate on the strength of productivity is our ability to accurately measure its growth rate. As we now know, service sector productivity is virtually impossible to measure. For years, financial services productivity, as measured by the Bureau of Labor Statistics, was stagnant.

With the advent of automatic teller machines and Internet banking, the statistics were clearly wrong. The same is true in the medical services field. Alan Greenspan recently said that statistics, which show a decline in medical services productivity between 1990 and 1999, are “implausible.”⁵

While service sector productivity is hard to measure, new technology is creating havoc with manufacturing productivity statistics as well. For example, new technologies in the lumber industry use lasers and CT scanners to measure the exact dimensions of logs entering the mill. This information, in real-time, is then plugged into a computer that is updated to include current market prices of lumber products. The log is then cut to maximize profits.

The lumber mill may cut the same number of logs after implementing this new technology and sell the same amount of lumber, but profits margins will be higher because the process is more efficient. This improvement in profitability is not captured by standard statistical measurements and as a result, productivity is underestimated.

These types of technological advancements are proliferating in every industry. Moreover, the use of the Internet is still in its infancy and the benefits of using it are just now being discovered. As new and more important networks are developed, the underlying rate of productivity growth should accelerate further, not decelerate.

Federal Reserve Board Governor, Laurence Meyer, recently presented research that shows how productivity moves in waves, averaging 24 years in length.⁶ His research suggests that, “the recent [productivity] data should be interpreted as part of another high-growth wave....”⁷ Once again, this suggests that CBO and OMB forecasts are supported by the data.

Surpluses

In July 1999, I completed research that was published in the Wall Street Journal, forecasting much higher budget surpluses in the future than those forecast by the CBO or OMB.⁸ The reason for my optimism was a higher productivity growth forecast than that of White House or Congressional forecasters. Fortunately, my forecast proved correct and both the OMB and the CBO have raised their productivity estimates.

The CBO now estimates that non-farm productivity will increase by 2.7% per year through 2011. Despite this revised outlook, the CBO estimates of revenue growth are very conservative. Between 2001 and 2011, the CBO estimates an average annual growth rate for federal revenues of 4.9%, but an annual growth rate for nominal GDP of 5.1%.

This would contradict history. For the past 20 years, federal revenues have grown at a 7.1% rate while nominal GDP has grown at a 6.6% rate. Even though tax brackets are now adjusted for inflation, rising real incomes push taxpayers into higher tax brackets. As a result, the CBO estimates seem well within realistic assumptions.

Conclusion

The U.S. economy has hit a rough patch caused by excessively tight monetary policy, high taxes as a share of GDP, and an energy crunch. Fed rate cuts, the tax cut and falling energy prices are now reversing these negative forces. As a result, a rebound in the economy late this year or early next year is highly likely.

Moreover, the underlying trends remain very positive. Technology investment during recent years, even investment undertaken during Y2K, is still boosting productivity, efficiency and profitability. These trends are very positive and should continue to boost the economy back to a long-run trend rate of growth of 4.0% in the years ahead. In short, the economy over the next ten years should look much like the economy did over the last five years.

The U.S. is a special place. We have attracted capital from around the world, at least partially because, as Laurence Meyer observed, “the United States was the only major country in which the dramatic surge in productivity was evident....”

There is a simple explanation for this. Tax rates are much lower in the U.S. than in most European countries or in Japan. In addition, labor markets are much less rigid in the U.S. and government spending is much lower as a share of GDP. This attracts capital to finance entrepreneurial activity, innovation and creativity. These are the building blocks of economic growth and wealth creation.

In order to continue the miracle of rapid economic growth and low inflation in the U.S. we must constantly find a way to keep tax rates and spending levels down. Allowing tax rates to climb, or federal spending to grow faster than GDP, would end the boom. This would reverse the virtuous cycle that created the budget surpluses in the first place.

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² Nordhaus, William. 2000. *Productivity Growth and The New Economy*. NBER Working Paper 8096

³ Greenspan, Alan. January 25, 2001. *Current Fiscal Issues*. Testimony before the Committee on the Budget, U.S. House of Representatives, Washington, D.C.

⁴ Ibid.

⁵ Greenspan, Alan. March 27, 2001. *The Challenge of Measuring and Modeling a Dynamic Economy*. The Washington Economic Policy Conference of the National Association for Business Economics, Washington, D.C.

⁶ Meyer, Laurence. June 6, 2001. *What Happened to the New Economy?* New York Association for Business Economics and the Downtown Economists. New York, NY

⁷ Ibid.

⁸ Bodipo-Memba, Alejandro. July 9, 1999. *Budget Surplus Forecasts May Be Low: White House May have Scanted Productivity Gains*. Wall Street Journal, Page A2