Where Is the Economy Going?
Can the Welfare State Be Preserved?

Edward C. Prescott

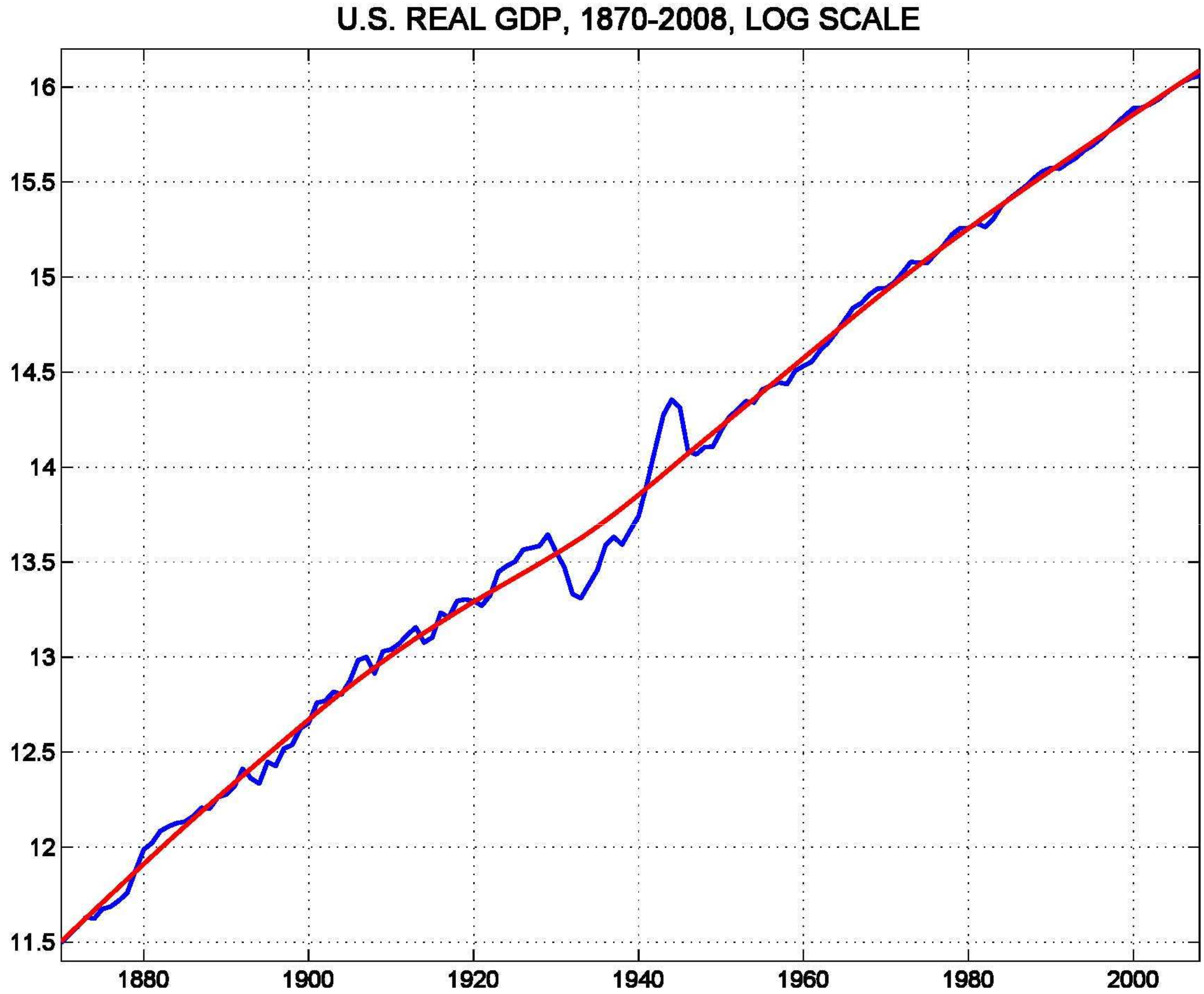
1 December 2010
Rome, Italy

Good to Great Economic Times in Most of the World

- Asia booming
- Latin America growing at a more than healthy rate
- Even Africa is catching up a little after a period of losing ground relative to the industrial leaders
- Most, but not all, of Europe is experiencing reasonably healthy growth

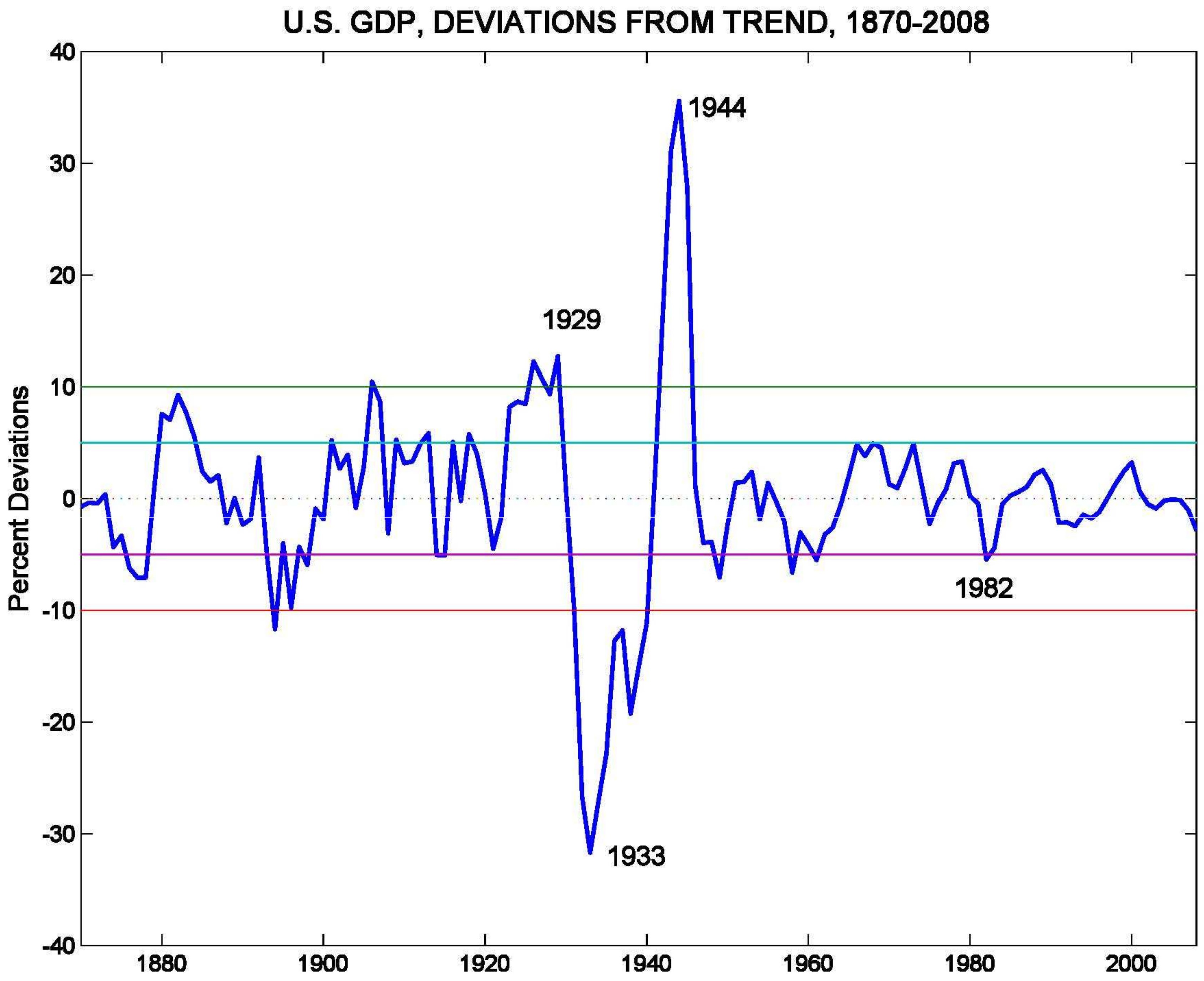
But U.S. and PIIGS Are Experiencing Bad Economic Times

- U.S. first and then Italy


U.S. REAL GDP, 1870-2008, LOG SCALE
16
15.5
15
14.5
14
13.5
13
12.5
12
11.5
1880
1900
1920
1940
1960
1980
2000

Deviations From Trend

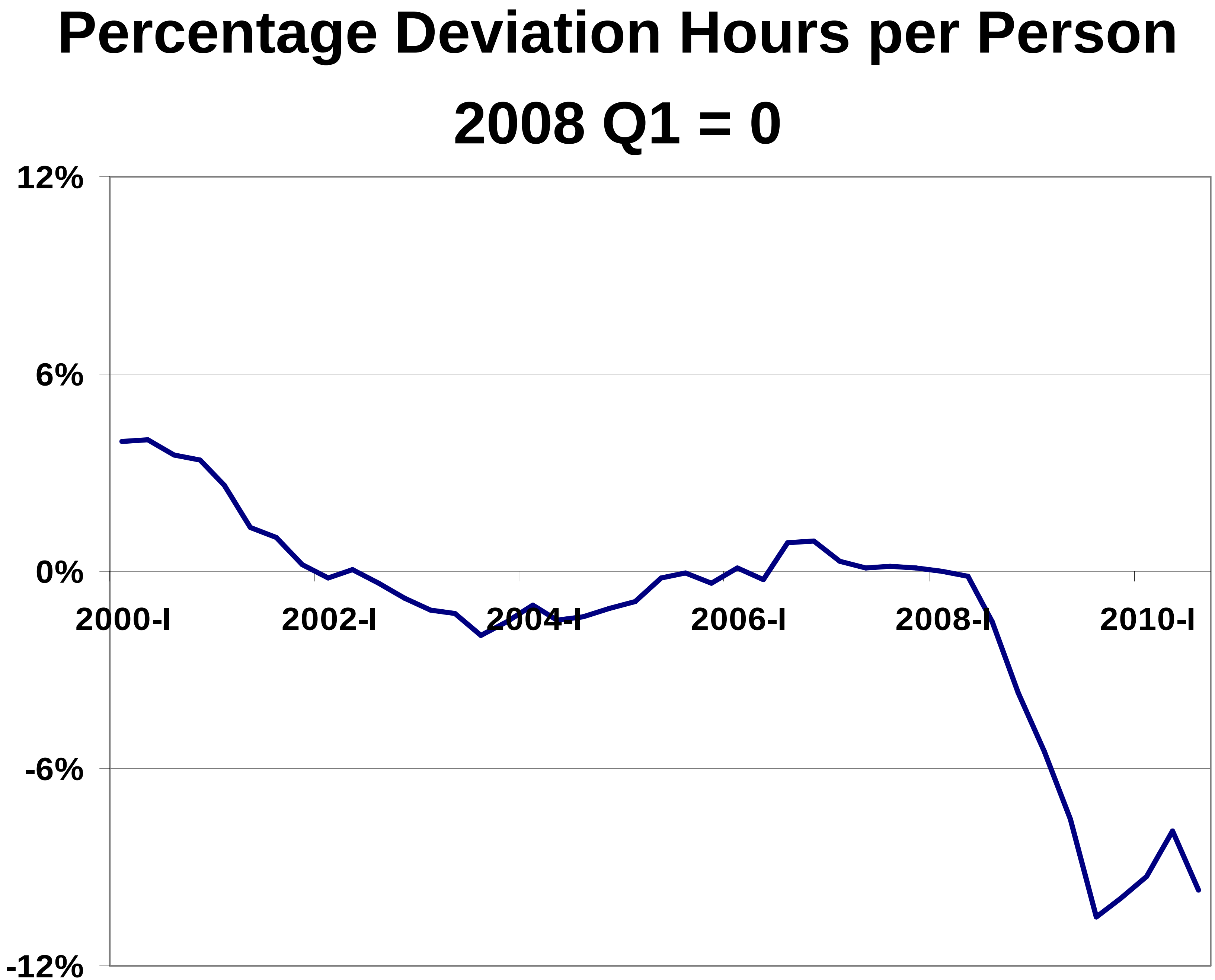
- Relative to trend, GDP 33% below trend in 1933
- Recent loss has been about 10% between May 2008 and October 2009
- Subsequently, the U.S. economy has stopped declining, but has not begun to recover



U.S. GDP, DEVIATIONS FROM TREND, 1870-2008
Percent Deviations
40
30
20
10
0
-10
-20
-30
-40
1880
1900
1920
1940
1960
1980
2000
1944
1929
1933
1982

Best Indicator of Current Situation Is Market Hours, Not GDP!

- I use household survey measures of hours worked (CPS)
- There are serious problems with establishment-based hours estimates
- GDP is only part of output and is revised in major ways as more data become available
- CPS market hours are revised little


Percentage Deviation Hours per Person
2008 Q1 = 0
12%
6%
0%
-6%
-12%
2000-I
2002-I
2004-I
2006-I
2008-I
2010-I

Hours Drop between 2008-II and 2009-III

10%!

What Will Happen in U.S. Depends Upon Future Policy

- Economists can predict what will happen conditional on
  - Future policies
  - and ….

What Will Happen in U.S. Depends Upon the Future Policy

- Economists can predict what will happen conditional on
  - Given future policies
  - and people expect these policies to be followed

So What Will Happen in US is a Guess

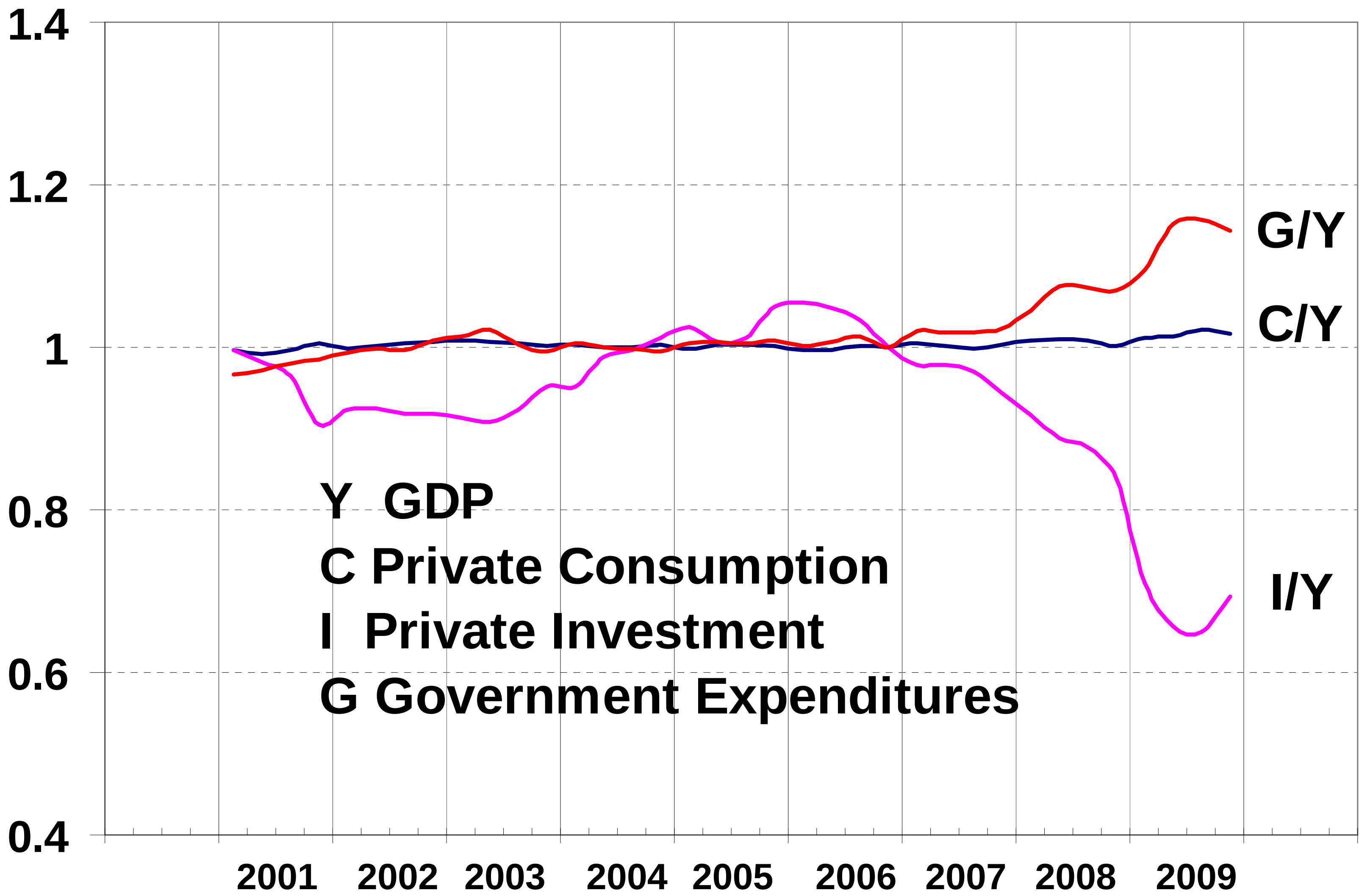
- Maybe the U.S. will follow Japan and Italy and lose a decade of growth
  - A decade of growth is an 18% decline in living standards relative to trend
  - If so, the U.S. would become as depressed as Europe

- Maybe there will be a good policy regime change
  - Leading to recovery from the current Not-So-Great Depression followed by healthy trend growth
  - The recent election may have signaled a policy regime change as did the election four years ago

Private Investment Has Fallen

- Businesses do not know what to expect
- They say that they are waiting and seeing. They want to know the rules
- I conjecture this is depressing hiring and investing, but know of no good measure of this factor

Private Investment Is Depressed (2006 Q4 = 1)



Now the Italian Economy

- The Italian economy is doing poorly.
- Hopefully, Italians will discuss their problems and come to a consensus as to the nature of the needed reforms.
- And then implement these reforms.
- **But is Italy ready to do this?**

The Italian Economy Today

- The Italian economy is doing poorly
- And has been doing poorly for 15 years
- Italy lost a decade of growth due to very low productivity growth over the last 15 years
- I hope the U.S. does not follow in Italy's footsteps
- Japan in the 1992-2002 period lost a decade of growth (Hayashi and Prescott, RED, 2002) due to low productivity growth
  - While productivity grew at a healthy rate in U.S. & EU

Italy’s Problem Is Not a Shortage of Creative and Entrepreneurial People

- The problem is the business environment Italians face
- Given the right environment, businesses will grow the economy
- You don’t want your entrepreneurs to flee the country and set up their operations elsewhere, as some are doing

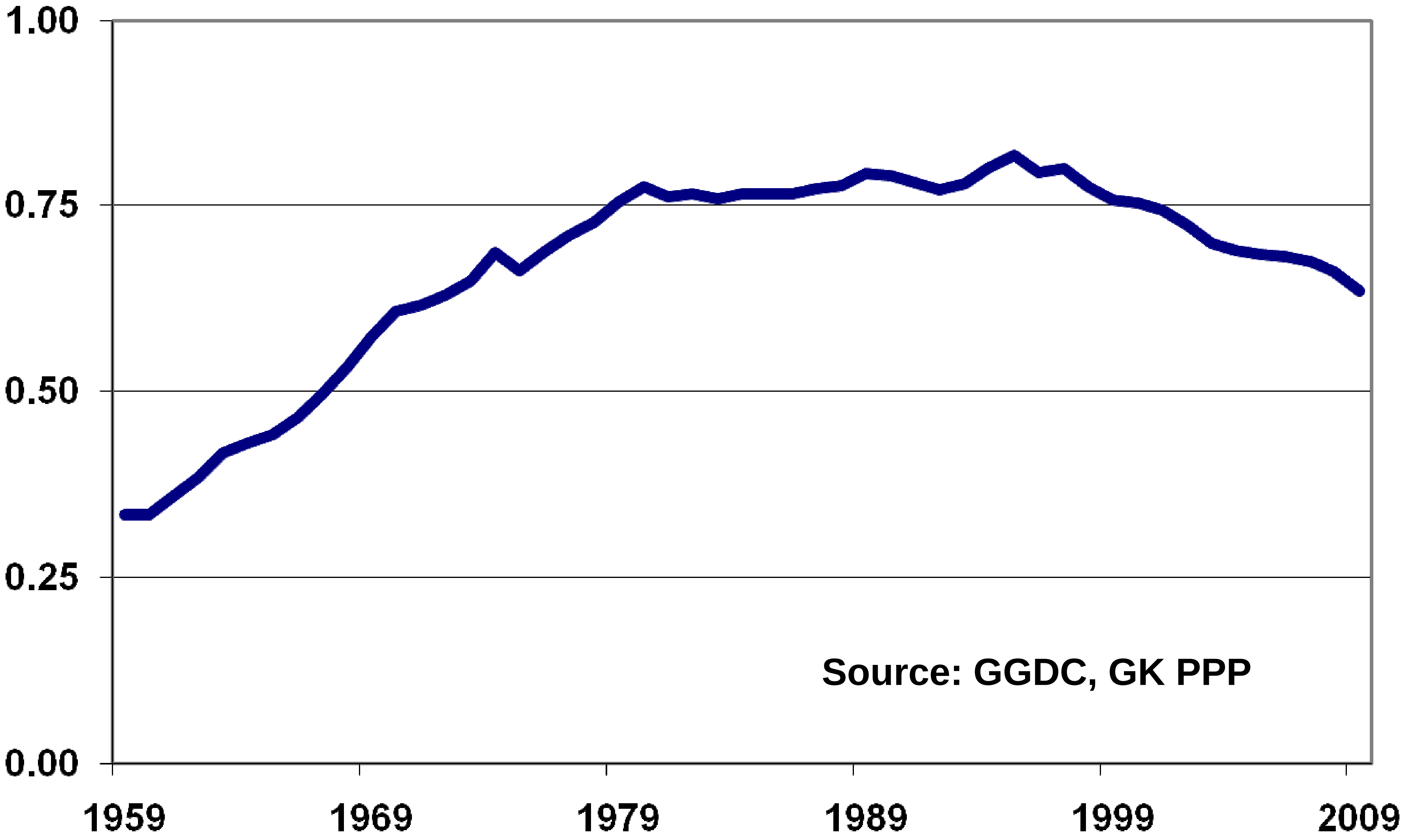
Italy Had a Productivity Growth Miracle

- Growth Miracle 1955-1995
  - From 40% as productive as the U.S. to over 80 percent as productive

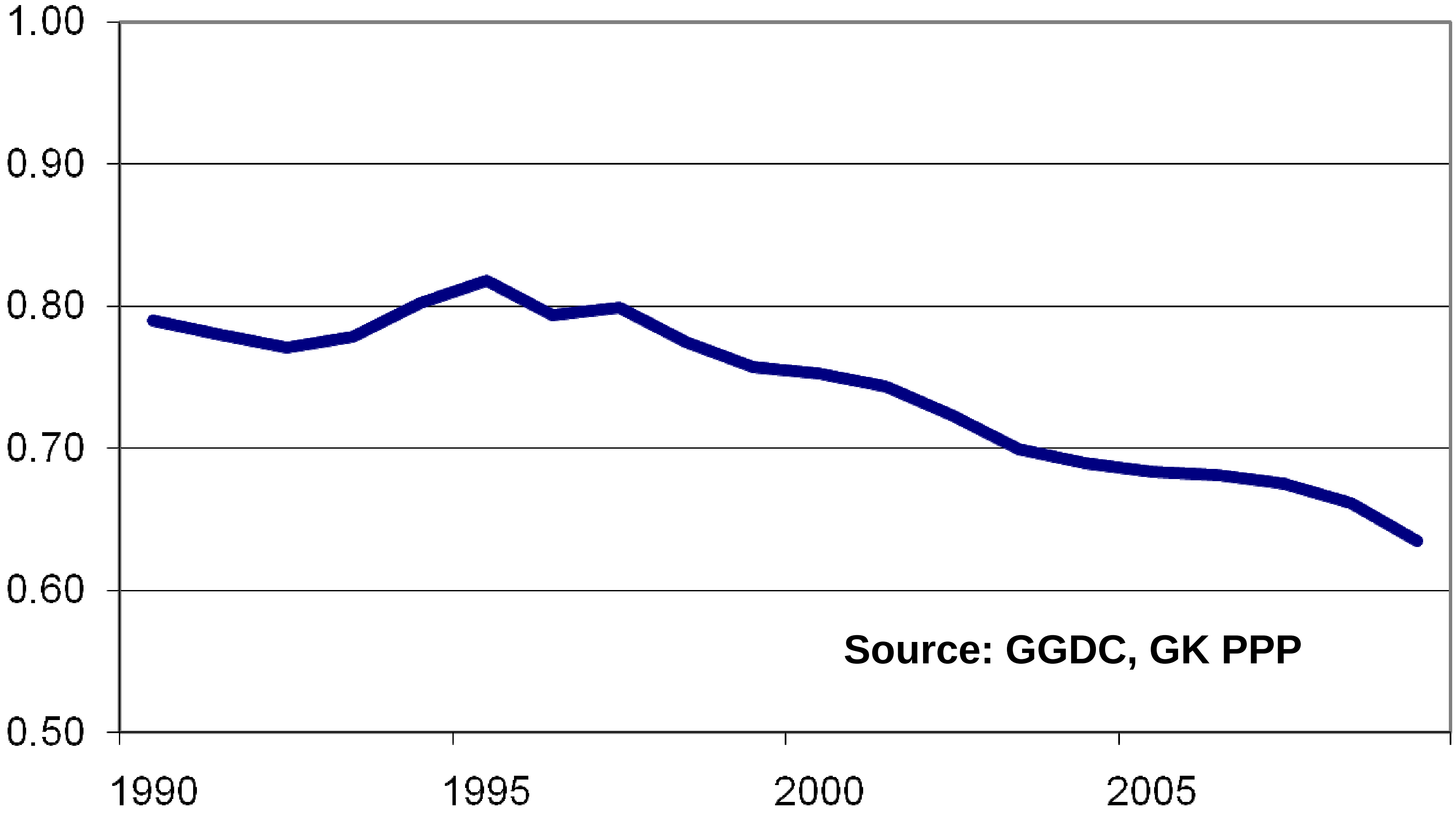
Italian Productivity Growth

- Declined with respect to the U.S. after 1995
- Declined relative to the rest of the EU-15 after 1995

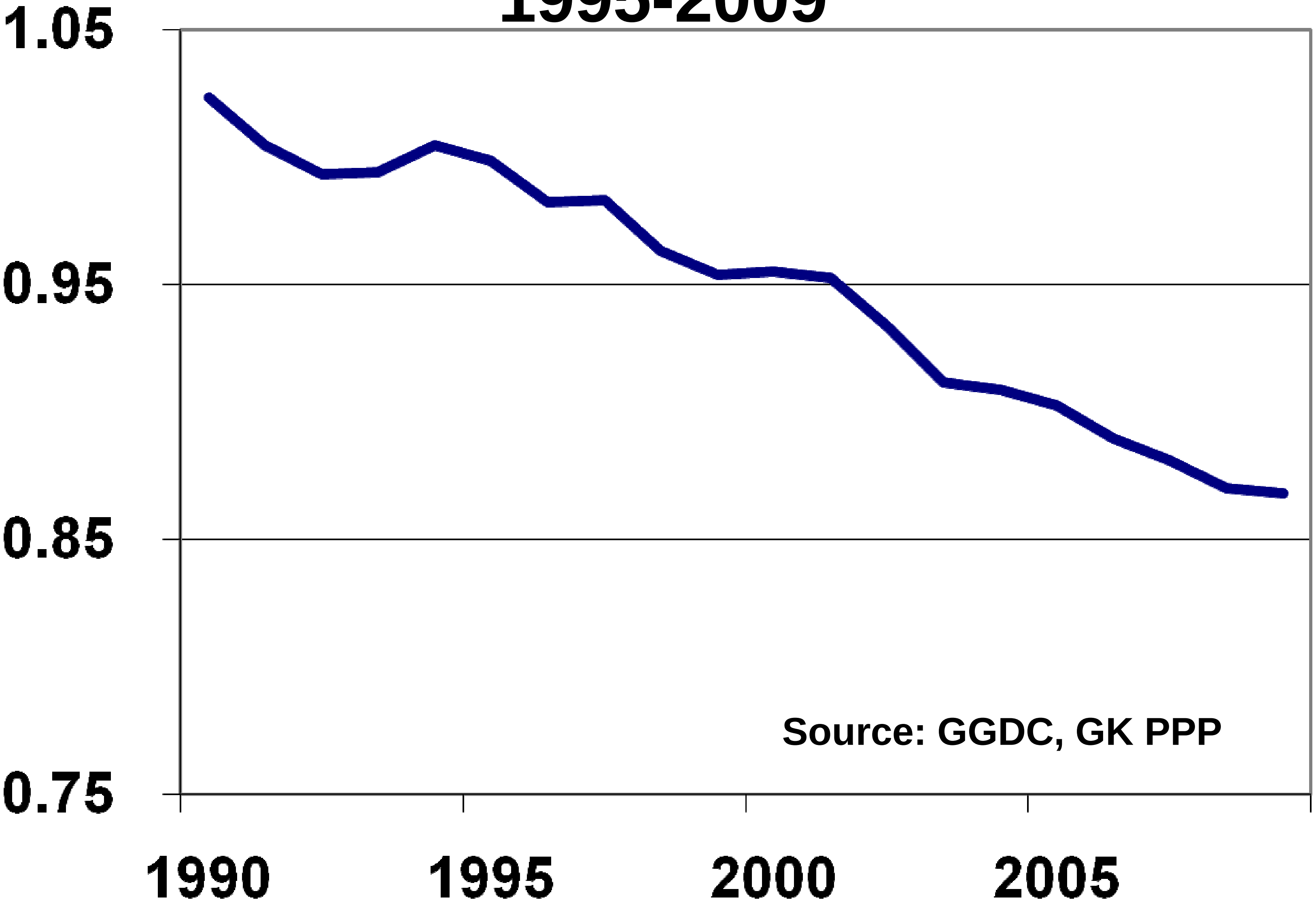
Italian Productivity Relative to USA
1959-2009



Italian Productivity Relative to USA 1995-2009



Italian Productivity Relative to EU-15 1995-2009



Italy Must Take Action to Catch Up

- In 1939, Franklin Roosevelt shifted policy regime
  - Abolished the New Deal cartels
  - Again enforced antitrust laws
  - Shifted away from pro-union policies
  - Shifted away from policies to increase wage of political supporters above market levels
  - Begged businessmen who had fled to UK to return

- As a result, employment and productivity jumped, and the 9-year Great Depression quickly ended
  - Military expenditures jumped ***after*** the recovery

Japan Lost a Decade of Growth 1992-2002

- Why? It followed policies that depressed productivity growth
- Japan subsidized inefficient business
- USA and most of EU did well in this period

Italian Government Must Promote Productivity Growth and Cut Expenditures and Tax Rates!

Increasing Productivity

- More competition will boost productivity growth
- More flexible labor markets will boost productivity growth

Create a Flexible Labor Market

- This will increase productivity
  - Workers will move from where they are less productive to where they are more productive

- This also will increase employment
  - Make finding a new job easy

- Be like the Danes, Swiss, and Americans and have a flexible labor market

Population Is Aging

- Means a higher retirement share of consumption
- Means higher stock of savings relative to GDP

Most Important Function of Financial Sector: Channeling Retirement Savings to Investment

- Want savings to go to most productive investment
- Want it done at low cost
- Want it cheap for savers to diversify idiosyncratic risk
- Want nondiversifiable risk to be shared
  - This risk must be borne by someone

Problem: Shortage of Good Investment Opportunities

- Solution – Get rid of capital income tax
- Will increase the stock of productive assets and will shift economic ownership from public to the private sector
- This shift is important because it increases dramatically savings opportunities
- Let’s look at the U.S., which McGrattan-Prescott and Mehra-Piguillem-Prescott have studied

U.S. National Balance Sheet

Assets Annual GNI		Liabilities Annual GNI	
Tangible capital	4.0	**Private liabilities**	**1.7**
Intangible capital	1.8		
Private debt	**1.7**		
Government debt	1.0		
		Net worth	6.8

Private Sector Balance Sheet

Assets In GNIs		Liabilities In GNIs	
Corporate equity	1.0	Private liabilities	1.7
Unincorporated business equity	0.4		
Household equity	1.4		
Government debt	1.0		
Private debt	1.7	Net worth	3.8

Value of Productive Assets Owned by Private Sector Half Total Productive Assets

- In U.S. government taxes 25% of business distributions, so it effectively owns 25% of business productive assets

- The capital income tax is 40% in the U.S. and intangible capital investments are expensed
  - Effectively the government finances 40% of intangible capital investment and therefore owns 40% of these productive assets

Intangible Capital Investments

- They include
  - Building an organization
  - Building a client base
  - Training employees
  - Advertising expenditures
  - Developing brands
  - Research and development

- These investment are as big as tangible capital investment

Another Way to Increase Private Savings Opportunities Is Privatization

- Italy and U.S. should privatize as much of their public businesses as is practical

- Given public ownership is greater in Italy, there are greater potential gains from privatization in Italy

- An additional benefit is that private businesses subject to competition are more productive than public businesses, which are not subject to competition

Shifting to Individual Savings Accounts Permits a Lowering of Tax Rates

- Moving to the Australian and Singapore mandatory savings account system from the current U.S. Social Security retirement system would
  - Lower government expenditures and therefore tax rates
  - Increase market time and therefore output and income

- Increasing tax rates given current tax rates in U.S. and Italy will not increase tax revenues
    - Total tax revenue changes little as the fall in income offsets the rise in tax rates

Asset Management Sector Will Get Bigger

- This sector performs well in the U.S.
  - Mutual funds permit one to have a highly diversified retirement portfolio at low cost
  - The stock market is highly liquid and efficient
    - Brokerage costs have fallen dramatically
  - A small number of people who make many trades are responsible for this efficiency

People Who Work Longer

- Should not pay Social Security and Medicare taxes after reaching full retirement age

- And should begin getting benefits when they reach full retirement age

- This would reduce the number of retirees and increase the number of people working in the market sector

Summary

- Mandatory savings, not tax and transfers is the way to finance retirement

- If adopted in the U.S., the hourly wage earners would have higher retirement consumption and lower poverty rates

Get Rid of Defined Benefit Program

- Huge unfunded liabilities of state and local government and of union plans in the U.S.

- Federal government and most of private sector have shifted to defined contribution savings accounts

- Some mandatory annuitization makes sense
  - The retirees cannot outlive their savings

What Are Good and Bad Policy Regime Changes?

- Good:
  - Cut expenditures and therefore tax rates
  - Follow pro-productivity growth policies
- Bad:
  - Increase expenditures and therefore future taxes
  - Cater to special interest groups & block changes that increase productivity