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Why This Slow Recovery Is Like No Recovery

The U.S. economy lost about 10% relative to trendline growth. To make up the shortfall, we need to average more than 3% growth for a year for several years.

By ROBERT J. BARRO

Last week's dismal jobs report showed little change in payroll employment for May and a slight rise in the unemployment rate to 8.2%, thereby underscoring the weakness of the economic recovery. Although changes in payroll employment and the unemployment rate are important, the key gauge of recession and recovery is the growth rate of real gross domestic product, and that is where our core problems lie.

The average annual growth rate of U.S. GDP since 1948 has been 3.1%. In the recession starting in the third quarter of 2007 and ending in the second quarter of 2009, GDP fell by nearly 5%. But this decline is 10% when gauged relative to trend—that is, after factoring in normal growth. To make up for this shortfall, the subsequent recovery has to attain growth rates averaging above 3% for several years.

This is not an unreasonable expectation. For instance, the GDP growth rate averaged 4.3% per year from 1982 to 1989 following the deep recession of the early 1980s. Yet in the current "recovery," beginning in the second quarter of 2009, growth has averaged only 2.4% per year, and just 1.8% for the first quarter of 2012. This low growth means that the U.S. economy has actually been falling further and further behind the normal trend. Therefore, it is not a recovery at all.

The Obama administration likes to blame the country's weak economic performance on the Bush administration, Europe's debt crisis, Japan's tsunami and so on. President Obama's advisers are now saying they learned only gradually that the economy was in even worse shape than they had imagined in 2009. But even if this is so, it gets the signals backwards: A bigger recession predicts a stronger recovery (as has to be true for the economy to return to its trend line).

The pattern of strong recoveries following sharp downturns is clear when one examines the history of economic disasters. The worst depressions relate to wartime destruction, and the subsequent peacetime periods typically exhibit strong growth. Examples include the high post-World War II growth rates in Japan, Germany and much of Western Europe.

The pattern applies also to non-war depressions, including the Great Depression of the 1930s. U.S. GDP growth from 1933 to 1940—starting from the trough of the Depression and ending before the economy was heavily influenced by World War II—was a remarkable 7% per year, despite the 1937-38 recession.

A better argument can be made that recoveries are typically sluggish following a real-estate crash and prolonged declines in housing prices, as the U.S. has recently experienced. In a study of international housing crises published May 2 by Global Economics Weekly, Jose Ursua examines long-term house-price data for 11 countries, including the U.S. His sample included 65 housing busts, defined as falls in average house prices by at least 15%. The bottom line is that housing crises do impede subsequent recoveries.

However, the average GDP growth rate during the U.S. recovery since 2009 remains nearly 2% per year lower than would be expected, according to the Ursua study. That is, after factoring in the estimated impact of the typical housing bust, Mr. Ursua found that the U.S. growth rate since 2009 should have averaged a little over 4%, rather than the 2.4% we've experienced.

What's interfering with a real recovery? Perhaps the Obama administration should stop casting blame elsewhere and examine the policies it has implemented to ease the pain of recession and falling housing prices. (Some of those, to be fair, were initiated under the Bush administration.)

Consider the expansion of social-safety-net programs, including food stamps, unemployment insurance, Medicaid (prospectively) and housing and mortgage programs. In a study published last month by the National Bureau of Economic Research, University of Chicago economist Casey Mulligan observed that, because these programs were means-tested (falling or ending as income rises), expanding them raised the effective marginal tax rate on labor income.

Specifically, Mr. Mulligan estimates that the effective marginal tax rate for low-income households went from around 40% in 2007, before the recession started, to about 48% in 2009, at the start of the recovery. Thus, while these programs may be attractive from the standpoint of assisting poor families, they dilute incentives to work.

To achieve a real recovery, government policy should focus on individual incentives to work, produce and invest. Central here are tax rates and regulations, including especially clarity about future policies. In a successful policy package, the government would get its fiscal house in order and make meaningful long-term reforms to entitlement programs and the tax structure.

The Obama administration seems to think that individual incentives and serious fiscal reforms are of no great importance and policy should emphasize Keynesian-style demand stimulus (public works, prolonged benefits) along with bits of industrial policy (loans and grants to "green" energy companies). This approach has failed for three years.

Mr. Barro is a professor of economics at Harvard and a senior fellow of Stanford University's Hoover Institution.