

Government Regulatory Policies and the Delayed Economic Recovery

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Chairman Smith, Ranking Member Conyers, and other members of the committee, thank you for the opportunity to testify at this hearing on “Regulation Nation: The Obama Administration’s Regulatory Expansion vs. Jobs and Economic Recovery.”

In order to address this important issue systematically, I first discuss the disappointing economic recovery and resulting weak job growth. Second I consider the role of the recent expansion of regulations and other government actions in delaying the recovery and job creation. Third, I review the legislation that has been put forward to control the regulatory expansion.

Jobs and the Economic Recovery

The persistently high unemployment rate—especially long term unemployment—is one of the most disturbing aspects of today’s economy. The high unemployment rate is mainly the result of the slow pace of economic growth, which has failed to bring the economy and the labor market back to their potentials. Slow economic growth means that firms are not expanding or hiring many workers. Hence, slow economic growth means slow job growth, and that is what we are seeing now. In addition, many people are dropping out of the labor force. If they had not dropped out and thus were still counted as unemployed, the unemployment rate would be even higher than the current 8.1 percent.

While some jobs are being created, the pace of job creation is barely enough to keep pace with the growing working-age population. For example, during the past two years, employment increased by 3.1 million. This may sound ok, but really is quite poor for a recovery from a deep recession. Over the same two year period, the working age population (16 and over) increased by 5.7 million, which is about the same percentage growth as employment. With employment growing at about the same pace as the working age population, the percentage of the working age population that is actually working has not increased as it does in most recoveries.

The following chart illustrates this. It shows the change in the percentage of the working age population that is working and compares it with the recovery from the previous deep recession in the early 1980s. Note that there is little or no improvement in the employment-to-population ratio in this recovery. It is still lower than it was at the bottom of the recession. It is

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as if the typical lift-off has been delayed. In comparison, the percentage of the population with jobs rose much more rapidly during the recovery from the back-to-back recessions of 1980 and 1981-82.

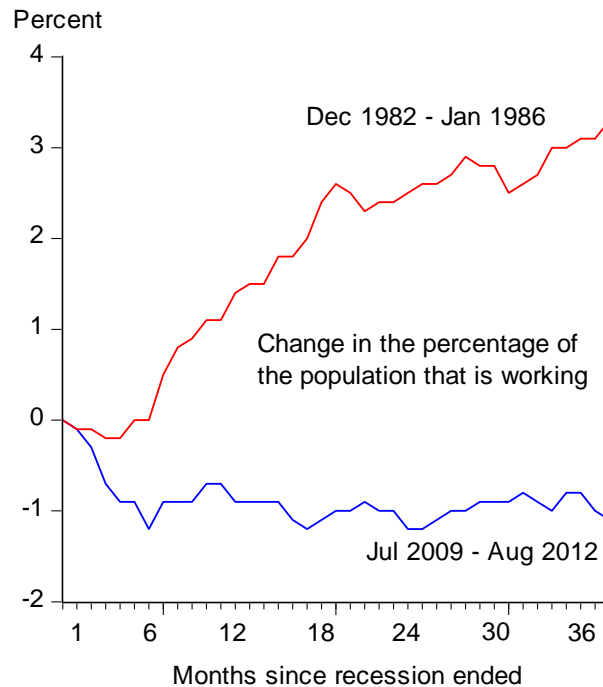


Figure 1: The Delayed Recovery in Historical Perspective

The current recovery began in the third quarter of 2009, and it was weak from the start. By its second anniversary, the recovery was still so weak that I called it “a recovery in name only, so weak as to be nonexistent.” The normal rebound in job creation and economic growth was delayed. Now the recovery has been delayed yet another year. It’s the worst recovery from a deep recession since the recovery from the Great Depression, and perhaps in American history—a tragedy that should not be minimized.

Figure 2 shows real GDP during the 12 quarters since the end of the recession. It also shows CBOs estimate of potential GDP. Clearly the economy has not yet recovered back to its potential. This delay is very unusual. Throughout American history, recoveries from deep recessions have tended to be much faster than recoveries from shallow \recessions, as Milton Friedman (1988) showed long ago and Michael Bordo and Joseph Haubrich (2012) have recently confirmed. The recovery of the economy back to potential GDP in the 12 quarters following the 1981-82 recession was much quicker.

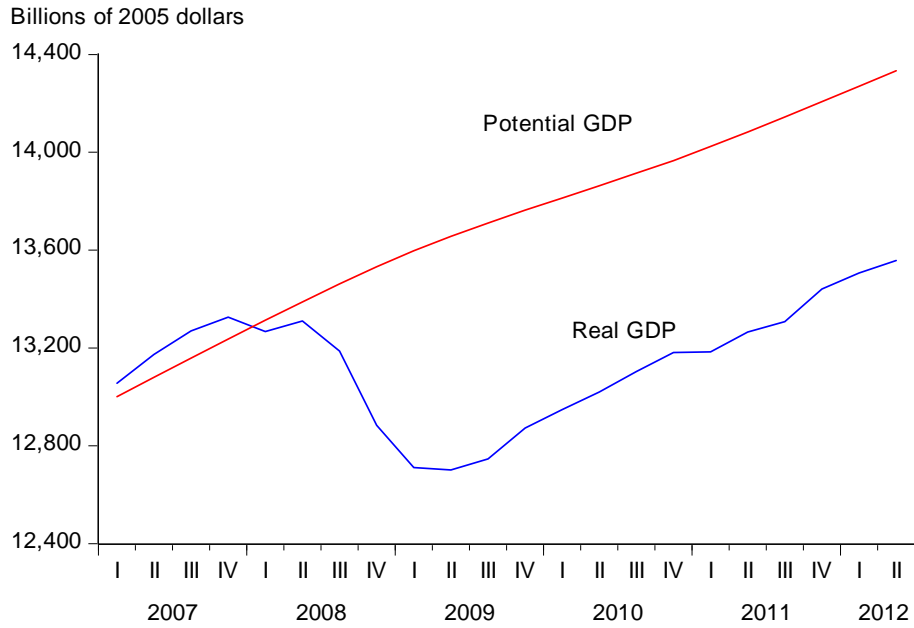


Figure 2: Economic Growth Is Too Slow to Close the Gap

The two recoveries can also be compared by examining real GDP growth rates in the recovery periods. The growth rates in each of the 12 quarters of the two recoveries are shown in Figure 3. The comparison is striking: Economic growth averaged 2.2 percent in the recent 12 quarters compared with 5.7 percent in the 1980s recovery.

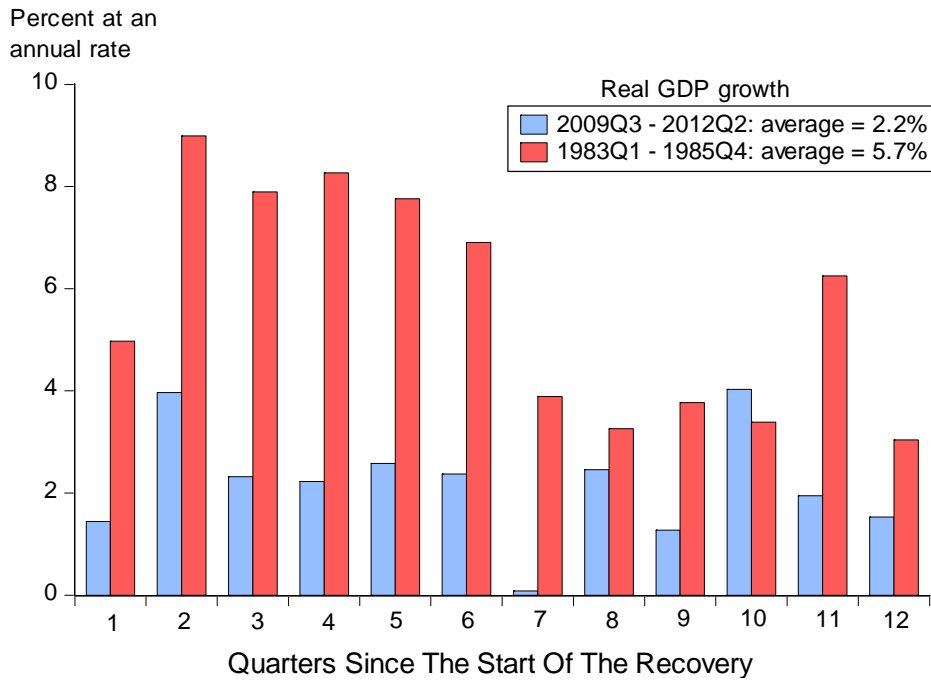


Figure 3: Recent Slow Growth in Historical Perspective

Unfortunately recent data are even more disappointing. In the months of July and August alone—the most recent data we have—518 thousand people have given up looking for work and have dropped out of the labor force, while the number employed has dropped by another 314 thousand. With economic growth slowing to 1½ percent in the second quarter of this year, perilously close to another recession, it is not surprising that few firms are hiring.

Why the Delayed Recovery?

Some argue that the weak recovery is due to the seriousness of the preceding financial crisis where people took on too much debt and now must cut back on consumption to pay back debt, commonly called deleveraging. However, the stronger recovery in the early 1980s occurred while people were consuming a much smaller fraction of their income than in the recent recovery. The saving rate was as much as 10 percent then and only 3 to 4 percent now.

Others argue that the slow recovery is due to the weak housing market. But strong recoveries frequently have weak sectors, and housing is less of a drag now than other sectors, such as foreign trade, were in the strong 1980s recovery. Still others point to Europe, but the recovery has been continuously weak from the start even as the European situation has had its ups and downs. Moreover, through most of the recovery, economic growth in most of the world has been strong, and net exports have not been a drag on the economy.

Having considered the various explanations, I have come to the conclusion that the delayed recovery is due to poor government policies, of which regulatory expansion and policy uncertainty are a substantial part. Indeed, this is the general conclusion of a number of researchers whose findings we have collected in the just released book: *Government Policies and the Delayed Economic Recovery* (see Ohanian, Taylor and Wright (2012)). As discussed in the book's Introduction, "the delayed recovery has been due to the enactment of poor economic policies and the failure to implement good economic policies.... The clear implication is that a change in the direction of economic policy is sorely needed. Simply waiting for economic problems to work themselves out, hoping that growth will improve as the Great Recession of 2007-2009 fades into the distant past, will not be enough to restore strong economic growth in America." Here is a summary of some of the findings:

Scott Baker, Nick Bloom, and Steve Davis (2012) investigate whether policy uncertainty could be a factor in the recent slow growth. They develop a quantitative index of policy uncertainty. For example, they include the number of provisions in the tax code which expire each year. Indeed, this type of temporary tax change is making the entire tax and regulatory system unpredictable, as I illustrate in Figure 4 below using data collected in the years shown by the Joint Committee on Taxation.

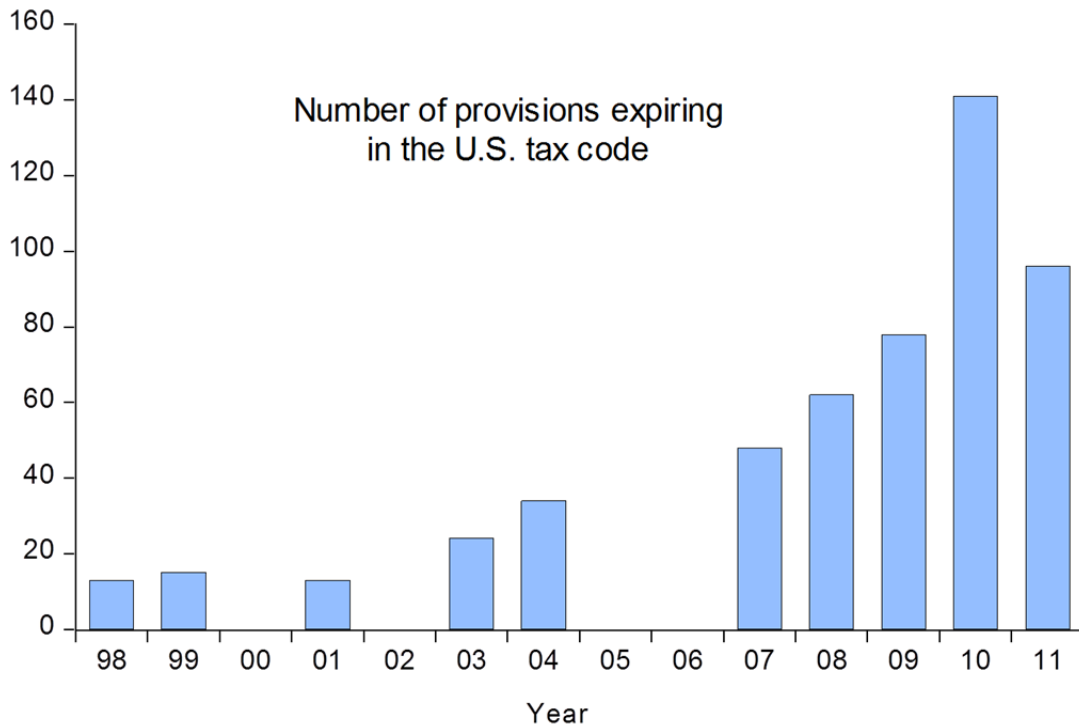


Figure 4: The Increase in Tax Policy Uncertainty

Baker, Bloom and Davis use statistical techniques to test whether changes in their overall index are correlated with changes in economic growth over time. They find that increases in the index—greater policy uncertainty—tend to be associated with reductions in economic growth. The effect is statistically significant and the timing indicates that increases in the index lead to reductions in economic growth, suggesting causation. They found that this overall policy uncertainty reduced GDP by 1.4 percent in 2011 alone, and that restoring pre-crisis levels of certainty would add 2.3 million jobs in 18 months.

Using an entirely different approach Greenspan (2012a) presents empirical evidence that too much policy activism has been a major factor holding back economic growth in the recent recovery. Additional corroborating evidence that policy uncertainty has reduced growth and employment comes from work at the research department of the Federal Reserve Bank of San Francisco, where Leduc and Liu (2012) find that “higher uncertainty is estimated to have lifted the U.S. unemployment rate by at least one percentage point since early 2008.”

McGrattan and Prescott (2012) provide data on the increased federal government regulations which suggest that these regulations are a source of the slow economic growth. They look at spending on regulatory activities and the number of federal workers involved in these activities. Figure 5 below illustrates the type of data they use, which shows a recent expansion of regulatory activities. The chart uses data from research by Susan Dudley and Melinda Warren (2012). It takes their series on the number of “full time equivalent” federal employees in regulatory activities and subtracts out the number of Transportation Safety Administration (TSA) workers. (The years 2002 and 2003 when TSA was expanding and moving from DOT to DHS

are interpolated). There has been a 25 percent increase just since 2007. And these data barely reflect the increased regulations from the health care and financial reform legislation.

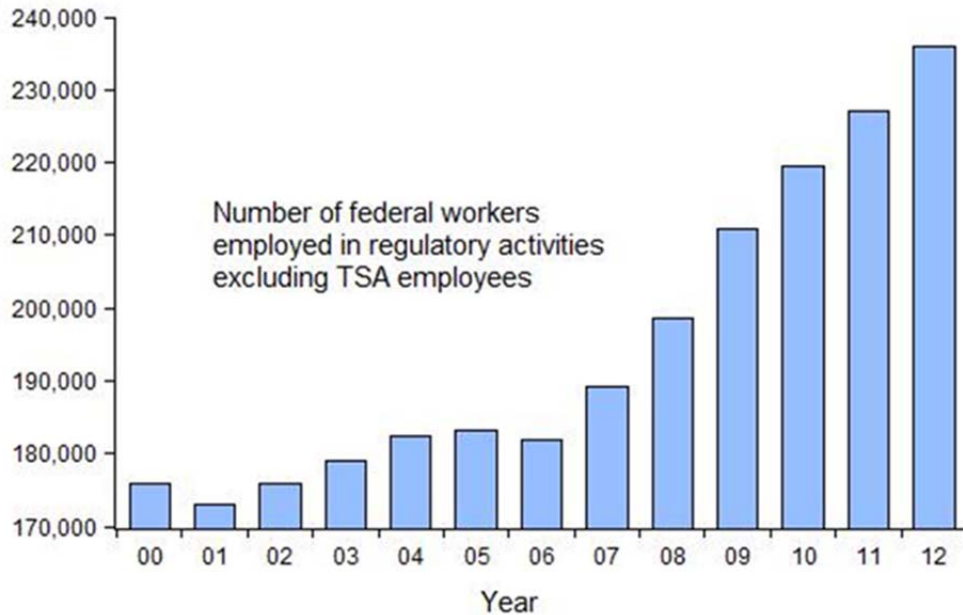


Figure 5: The Recent Government Regulatory Expansion

To test their results McGrattan and Prescott develop a model of the economy that features intangible capital investment and technological change. They then show that intangible investment declined in the recent recession and has not yet recovered. Thus actual economic growth is likely to have experienced a negative shock which is correlated with the increase in regulations. Using a formal economic model, Herkenkoff and Ohanian (2012) also find that employment has not recovered because various government interventions have depressed labor markets by negatively impacting the incentives for business to hire workers and for workers to accept offers.

Alan Greenspan (2012b) considers some of the economic impacts of the regulatory expansion. He argues that the Wall Street Reform and Consumer Protection Act of 2010 is largely un-implementable based on his knowledge of how the Federal Reserve and other regulatory agencies operate. This act requires more than 200 rulemakings by the Federal Reserve and other agencies, far more than they had to implement in comparable periods in the past. The general regulatory principles are put in the law but the detailed regulations must be implemented by the regulatory agencies. The bill is riddled with many new regulations that are not related to the crisis. These require very complex rulemakings to implement, and the very complexity makes them difficult to enforce. As Greenspan put it, "There are innumerable hidden problems like this in the law and the sooner we decide to start from scratch, the better off this country will be." A far better way to deal with the risks that led to the financial crisis would be to

make sure that financial institutions have adequate capital and that the regulations in the books are rigorously enforced by the regulators.

Quantitative reports from the Office of Management and Budget (OMB) show that the costs of regulation have been growing over the past few years. The Government Accountability Office reports that federal agencies issued 43 major new rules in fiscal year 2010, including 15 in the financial area, 10 in the environmental area, and 5 in the health care area. See Gattuso (2011). Many more regulatory rules are in the process of being written and issued, including from the Patient Protection and Affordable Care Act of 2010. While Washington is worried about a fiscal cliff, a regulatory cliff is also looming.

Earlier this year, *The Economist* magazine published a report entitled the “Over-Regulated America” which provides specific examples of how the United States “is being suffocated by excessive and badly written regulation,” and data support these examples. It focusses on the “flaws in the confused, bloated law passed in the aftermath of America’s financial crisis.” The sheer complexity of the regulations increases uncertainly which holds back investment and firm expansion.

Legislative Efforts to Slowdown the Regulatory Expansion and Raise Economic Growth

The House of Representatives recently passed a number of regulatory reform bills. Perhaps most significantly the House passed the Red Tape Reduction and Small Business Job Creation Act of 2012 (H.R. 4078), a comprehensive package of seven regulatory reform bills, which, as I briefly describe below, are designed to contain the recent regulatory expansion.

- Regulatory Freeze for Jobs Act of 2012 (H.R. 4078)
 - The bill would create a moratorium on new significant regulations until the national unemployment rate stabilizes at or below 6 percent.
 - As I testified in February (Taylor (2012), in order to help strengthen the weak economic recovery, I joined several other economists—George Shultz, Michael Boskin, John Cogan, Allan Meltzer—with a similar moratorium recommendation, but for three years. We regret that a moratorium did not become law.
 - But the 2012 bill has an advantage over the three-year moratorium because it is tied to unemployment, which should be a major focus of government policy now.
 - Under the proposed legislation, the President could waive the moratorium for national security, but would have to explain the need for the waiver in writing, and the regulation would be subject to judicial review.
- Midnight Rule Relief Act of 2012 (H.R. 4607)
 - This act would prohibit agencies from proposing or finalizing significant regulations from the day after the November election to inauguration day.
 - This period has traditionally been one where costly regulations are promulgated.
- Sunshine for Regulatory Decrees and Settlements Act of 2012 (H.R. 3862)

- This act would help cut down on the “sue and settle” practice whereby special interest groups seeking new regulations sue regulatory agencies and then settle with a new regulation that is often quite costly.
- The bill would require that the consent decrees and settlement agreements and attorneys’ fees be published. In addition, any proposed consent decree or settlement agreement would have to be published in the Federal Register 60 days prior to filing with the court.
- Unfunded Mandates Information and Transparency Act of 2011 (H.R. 373)
 - This bill would help cut down on the practice whereby Congress mandates that business firms or state and local governments carry out tasks rather than creating and funding a federal program to carry out the task directly.
 - The bill simply requires that the costs of unfunded mandates on firms for local governments be disclosed.
- Responsibly and Professionally Invigorating Development (RAPID) Act of 2012 (H.R. 4377)
 - This bill would streamline the permitting process for infrastructure projects.
 - It would require that developers be able to obtain environmental permits and approvals for their projects in a timely and efficient manner.
- SEC Regulatory Accountability Act (H.R. 2308)
- Commodity Futures Trading Commission–Cost-Benefit Analysis Legislation (H.R. 1840)
 - These two bills would require the SEC and the CFTC to perform cost benefit analysis much as executive branch agencies are required to do.
 - Basic economics says that these agencies should follow cost benefit analysis in their rule making, just as executive branch agencies. A report of the President’s Job Council found that many rules issued by the SEC did not undergo comprehensive cost benefit analysis as in executive branch agencies.
 - An extension would be to apply the requirements for cost-benefit analysis and centralized review to all independent agencies, including the Federal Reserve. Assuming that the centralized review can occur in a timely manner this reform would reduce the costs and uncertainty of regulation on the economy.

As this summary shows, a common feature of these bills is that they increase transparency, accountability, serious cost-benefit analysis, and use of sound science and reliable data. The same is true of regulatory bills passed by the House in the last session: the Regulatory Flexibility Improvements Act of 2011, the Regulatory Accountability Act of 2011, and the Regulations From the Executive in Need of Scrutiny Act of 2011. Good government bills like these are essential for controlling the regulatory process. Because the regulatory expansion along with other government policies is a likely cause of the poor economic growth and job performance, they should also be an essential part of an economic recovery program.

Conclusion

I have argued in this testimony that the weak recovery and high unemployment have been caused by poor economic policy of which the recent expansion of costly regulations is a part. If the bills reviewed here and passed by the House had also been passed by the Senate and signed into law by the President, the regulatory process would have become far more streamlined and far less costly to the American economy. To the extent that the bills would have halted or mitigated the regulatory expansion, the economic recovery would have been stronger. In other words, they are as much jobs bills as they are regulatory reform bills. The actions to block them have adversely affected the high priority goal of increasing growth and creating jobs.

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