Economic Growth

Part of the Problem or Part of the Solution?

15

Goal: *This unit examines how economic growth is measured, managed and stimulated. Public policy debates on the role of spending, stimulus packages, and/or tax cuts go beyond the classroom and the newsroom to help determine the economic health of our nation as a whole.*

Economic growth refers to the increase in the quantity of the goods and services produced and compared to a prior period. As a nation develops new resources, goods and/or services, economic growth also increases. Growth can also occur by making existing resources (material and labor) more productive, primarily by improvements in education and technology.[1] An example is the large growth in the U.S. economy following the introduction of the automobile in the early 20th century. Productivity was positively impacted by the more recent technological development of the Internet.

A. Measuring Economic Growth

The economic growth rate is measured by the changes in the ***Gross Domestic Product*** *(GDP)*, the government's official measure of the economy's production. The GDP refers to the total dollar or market value of all the goods and services produced within a country during a given period of time, usually a year.[2] The dollar figure compresses the immensity of a national economic output into a single data point of incredible density.

Why do we hear so much about the GDP?

The GDP, the most comprehensive overall measure of economic output, is the base line that is regularly referred to by politicians, the media, as well as economists. It provides insight into the general direction and magnitude of growth for the overall economy. The long-term economic growth rate in the U.S. fluctuates from 2% to 5%; it is approximately the same as most highly industrialized countries. Fast-growing economies such as China and India have seen rates as high as 10% although they typically cannot sustain this high rate of growth over the long-term.

In the U.S., the National Income and Product Accounts maintained by the Bureau of Economic Analysis tabulates and reports the GDP. When comparing one country's economic growth to another it is best to use the GDP or GNP (Gross National Product) per capita as these numbers take into account differences in the size of a nation's population.[3]

B. Two Different GDP Rates

GDP can be misleading if one does not know how much of the difference from year to year stems from changes in the prices of goods and services and how much represents actual (real) growth.

For example, if price increases (i.e. inflation) are not factored into the measure, the GDP will appear higher than it actually is. If the GDP figure shot up 8% but inflation had been 4%, the real GDP would have only increased 4%.

Therefore, the GDP is measured in two ways: 1) based on current dollars (does not take inflation into account) and 2) based on constant dollars (takes inflation into account).

1. ***Current (or Nominal) GDP***[4] refers to the GDP in today's prices. It can increase due to greater output or to higher prices or decrease if output falters or prices drop. The current or nominal GDP includes all of the changes in market prices that have occurred during the current year due to inflation or deflation. Because inflation and deflation can dilute the usefulness of the nominal GDP as a gauge for economic production, the real GDP often serves as the headline figure for a country's growth.

2. ***Constant (or Real) GDP***[5] This measure of economic growth takes the effects of inflation and deflation into account. That is, it controls these price changes. The real GDP reflects the value of all goods and services produced in a given year, expressed in relation to prices in a specified base year.

It takes nominal GDP and expresses the number as reflected on the prices of a base year. Any differences in the dollar figure reflects the real difference in the amount of goods that a specified amount of money/income could buy in each year. For example, if the 2014 nominal GDP stood at $200 trillion due to increased prices from 2000 (the base year) to 2014, the real GDP might actually amount to $170 trillion.

The real GDP typically falls below nominal GDP. Figure 15.1 shows the growth of the GDP between 2003 and 2008 in both nominal and real terms.

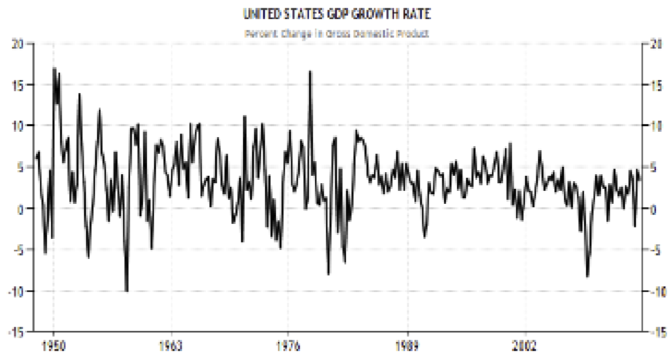

Fig. 15.1 United States GDP Growth Rate: 1947-2014 [6]

C. How Does The Government Manage Economic Growth?

The government promotes economic growth by creating the conditions that support a healthy and well-functioning market. This includes protecting national defense and private property; providing a legal framework for commerce; establishing regulatory standards for business, labor, consumers and the environment; providing credit; building and maintaining a physical infrastructure; and, if necessary, temporarily acting as an employer or investor of last resort.

Government has the wherewithal to help keep the economy stable

The government uses its fiscal and monetary tools to achieve these ends. As noted earlier, when the economy is sagging, the government can stimulate economic growth by increasing spending, lowering taxes and/or increasing the money supply. The New Deal programs, spending for World War II, and the 2008 stimulus package are examples of the government increasing spending to jump-start the economy. At other times the government has cut spending, raised taxes and/or contracted the money supply to slow down or cool off the economy.

D. Policy Debate: How Best to Stimulate Economic Growth

Many public policy debates during and after the Great Recession centered on what the government should do to stimulate economic growth: increase government spending or reduce taxes. The following are recent tax related debates:

After considerable argument, President Obama's final stimulus package included less direct spending than favored by most of the Democrats and fewer spending and tax cuts than favored by the Republicans.

To extend the Bush tax cuts or not. The effort to answer this question for the tax cuts that expired in December 2010 set off a heated debate. Most Republicans wanted to extend the tax cuts to all taxpayers. Most Democrats agreed except that they preferred to let the tax cuts for households earning more than $250,000 expire. Still others argued that tax cuts for everyone should be ended.[7]

A heated debate surrounded the report of President Obama's National Commission on Fiscal Responsibility and Reform that called for spending cuts and tax cuts for the affluent among other provisions.

1. The proponents of these and other tax cuts say that they are the best way to stimulate the economy. They argue that reducing taxes for businesses increases the funds available for new investment, providing both the means and incentive for firms to expand production, which in turn creates jobs and economic growth. Lowering taxes for households leaves more take-home pay available for consumer spending. When consumers buy more, business expands production to meet the increased demand, leading to the creation of more jobs.[8]

2. The opponents of tax cuts as an economic stimulus argue that tax reductions may not spark growth because workers may save added dollars for a future rainy day rather than spending the money immediately. In addition, they may use the added income to pay down debt.

These steps would not have a large stimulus impact although tax cuts to low-income groups may have a somewhat greater impact as these households are forced to spend income more quickly. The opponents also argue that past cuts have failed to generate robust economic growth.

Despite major tax cuts in 2001, 2002, 2003, 2004, and 2006, the economy's performance during the 2001 to 2007 expansion was among the weakest since World War II.[9] In addition, the period in which Congress increased taxes (1993 and 2001) showed more growth than in the two surrounding periods when taxes were cut (1981-1993 and 2001-2007).[10]

3. The opponents of extending the tax cuts to household earning more than $250,000 a year argue that these households: do not need the added dollars; will not spend them right away, and will reap greater benefits from the tax cuts than do lower income households.

They present data showing that from 1979 to 2007, the after-tax income of the top 1% grew by 281% compared to 95% for the top fifth, 25% for the middle fifth, and 16% for the lowest group.[11]

4. The advocates of direct government spending see this as the best way to stimulate the economy. They argue that a direct infusion of cash quickly translates into increased spending throughout the economy and creates jobs. They point to temporary increases in Unemployment Insurance or food stamps spurring growth because the recipients spend these dollars immediately to meet their daily needs.

Advocates of direct government spending also support public investment in the nation's infrastructure (i.e. transportation, school buildings, and information networks), which can operate as a stimulus in the short-term for spending and new jobs.[12]

Did you know government spending on benefits not only helps Americans, but it also stimulates the economy?

Many economists say that government spending is a good stimulus because it yields a greater "fiscal multiplier" than tax cuts. That is, the initial amount of spending (usually by the government) increases consumption spending in ways that lead to increases in national income in amounts greater than the initial amount expended.

For example, every dollar spent on unemployment benefits creates an estimated $1.60 in economic growth; every dollar spent on food stamps creates an estimate $1.74 in economic growth but every dollar spent on the Bush tax cuts only created 35 cents in economic growth. The increased spending, in turn, increases the demand for goods and services and then jobs.[13]

The debate over the relative merits of taxes versus government spending as an economic stimulus also grounded in major ideological differences regarding the proper role of government in the economy.

Tax Cuts or Government Spending: here are the arguments

Advocates of tax cuts support the cuts because reduced revenues weaken the role of the government. In this view, less government intervention frees competitive markets to allocate resources in ways that are better than government-driven policies.

Free markets, in turn, allow consumers to pursue their self-interest, which according to market theory achieves the greatest good for the greatest number. That is, the pursuit of self-interest advances the public interest. They also charge that the 2008 economic meltdown stems from interference by the government.[14]

Advocates of government spending believe that the economy is not self-regulating and that if left to its own devices it creates problems such as cyclical recessions, structural unemployment, inflation and inequality that it alone cannot solve.

They add that the individual pursuit of self-interest is problematic because special interests often collude with each other or with the government in ways that benefit special interests and that harm the welfare of the wider public.

They charge that the pursuit of self-interest promotes competition rather than cooperation and that others dismiss the idea of social purposes or collective goals. In this theory, the crisis of 2008 stemmed not from government intervention but from the failure of the government to place checks on destructive market practices.

E. Economic Growth: The Debates

A healthy economy depends on an adequate level of economic growth. But this does not address whether or not the outcomes are socially valuable or cause good or harm. As a result economists, politicians and policy makers fiercely debate: 1) the advantages and disadvantages of economic growth[14] and 2) whether or not measures of economic growth capture well-being.

Advantages. The advantages of economic growth include increased production capacity, higher business profits, improved individual living standards, more personal choice, greater employment, less poverty, greater tax revenues, and enhanced international power.

Disadvantages. Economic growth is not risk free. The disadvantages include: the dangers of inflation (i.e. rising prices that push some people out of the market); the negative impact on the environment (i.e. noise, air and water pollution, road congestion, creation of waste, overpopulation; destruction of rain forests, the over-exploitation of fish stocks and loss of natural habitat); and its contribution to inequality.

The heart of the economic political argument...

Does the GDP Capture Well-Being? The conventional feeling about the GDP is that the more an economy grows, the better a country and its citizens are doing. However, a variety of world leaders and a number of international groups have challenged this assumption in recent years, including the Organization of Economic Cooperation and Development (OECD). They suggest that the GDP tells us a good deal about the economy but it leaves out many important economic activities that are related to well-being such as negative environmental impact of production and the value of non-wage work often done in the home.[16]

The median income kept pace with the GDP from 1947 to the mid-1970s, the period with an expanding welfare state. However, Figure 15.2 reveals that since the mid-1970s (when public policy moved to less government intervention), the GDP rose much faster than the median family income. Nobel Laureate and economist Joseph Stiglitz recently observed that "one reason that most people may perceive themselves as being worse-off even though average GDP is increasing, is because they are indeed worse-off."[17]

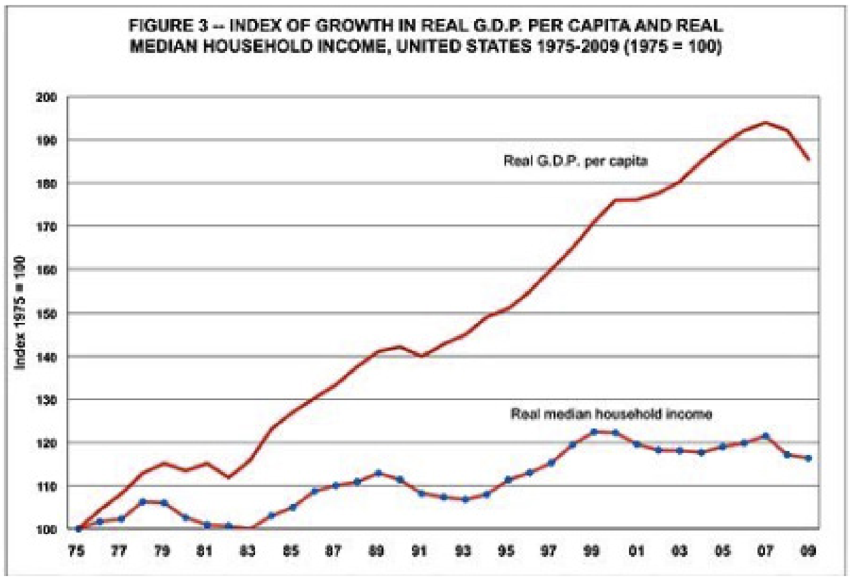

Figure 15.2 GDP per Capita & Median Family Income [18]

Stiglitz added that we would have had a much clearer picture of our progress over the past decade if we had focused on median income rather than GDP per capita. The latter, he says, is distorted by top earners and corporate profits. Real median household income has actually dipped since 2000. But GDP per capita has gone up.[19]

Since 1975, the growth of the economy has not trickled down to average households. The disconnect between increased GDP per capita and increased median income since 1975 suggests that the benefits of the economy's growth did not trickle down to the average household. A measure known as the Human Development Index (H.D.I.) has challenged the direct connection of GDP to well-being. Seeking to capture well-being as well as growth, The H.D.I. adopted by the UN incorporates a nation's GDP, educational attainment based on adult literacy and school-enrollment data, and health status based on life-expectancy statistics.[20]

For Discussion:

Whether tax cuts or government spending are used to stimulate the economy, Congress has to make choices about how to spend. One of the major big trade-off questions is how much should be spent on war and how much should be spent on domestic concerns. Some ask, "Where does one get their biggest bang for the buck?"

How do you think the government should allocate its money? What would be your funding priorities? What trade-offs do you think the government should make?

What spending choices are best for human services clients and programs?

What National Priorities Project is a helpful resource. Go the web site of the National Priorities Project (see below) to explore the trade-offs between different spending choices.

RESOURCE:

1. Trade-Offs ($$)
   https://www.nationalpriorities.org/interactive-data/da-tabase/
2. Federal Spending and Human Needs
   https://www.nationalpriorities.org/interactive-data/da-tabase/

Follow the steps of this interactive program to see how much money the federal government has spent in New York State on a program of interest to you. Be sure to adjust the number for inflation at the end.

Try it for New York State and then one other state. For example, the state in which you were born if it was not New York or another state that you are interested in learning more about.

NOTES
UNIT FIFTEEN

1. Economic Glossary (n.d.) Definition of Source of Economic Growth. Retrieved from http://glossary.econguru.com/economic-term/economic+growth,+sources

2. Economic Glossary (n.d.) Economic Definition of Gross Domestic Product. Defined. Retrieved from http://glossary.econguru.com/economic-term/gross+domestic+product

3. Economic Glossary(n.d.) Economic Definition of Gross Domestic Product. Defined. Retrieved from http://glossary.econguru.com/economic-term/gross+domestic+product

4. Moffatt, Mike. (n.d.) What's the Difference Between Nominal and Real? Retrieved from: http://economics.about.com/cs/macrohelp/a/nominal_vs_real.htm

5. Moffatt, Mike. (n.d.) What's the Difference Between Nominal and Real? Retrieved from http://economics.about.com/cs/macrohelp/a/nominal_vs_real.htm

6. Trading Economics (n.d.) US DP Growth Rate 1947-2014. Chart Retrieved from: http://www.tradingeconomics.com/united-states/gdp-growth

7. Carreira, Robert, (2010, Sept. 22) Tax cuts versus government spending. Center for Economic Research at Cochise College. Douglas Dispatch, Arizona. Retrieved from http://www.douglasdispatch.com/articles/2010/10/09/news/business/doc-4c99300d29119763286409.txt

8. Carreira, Robert, (2010, Sept. 22) Tax cuts versus government spending. Center for Economic Research at Cochise College. Douglas Dispatch, Arizona. Retrieved from http://www.douglasdispatch.com/articles/2010/10/09/news/business/doc-4c99300d29119763286409.txt

9. Aron-Dine, Aviva, Richard Kogan, & Chad Stone (2008) How Robust Was the 2001- 2007 Economic Expansion? Center on Budget and Policy Priorities. Retrieved from http://www.cbpp.org/cms/?fa=view&id=575

10. Ettlinger, Michael, & John Irons (2008). Take a walk on the supply side: Tax cuts onprofits, savings, and the wealth fail to spur economic growth. Center of American Progress and the Economic Policy Institute. Retrieved from http://www.americanprogress.org/issues/2008/09/pdf/supply_side.pdf

11. Sherman, Arloc & Chad Stone (2010, June 25) Income Gaps Between Very Rich and Everyone Else More Than Tripled In Last Three Decades, New Data Show. Center on Budget and Policy Priorities. Retrieved from: http://www.cbpp.org/cms/index.cfm?fa=view&id=3220

12. Irons, John (2008, April 29) Investing in U.S. infrastructure, Promoting economic stimulus and growth. EPI Briefing Paper, #217. Retrieved from http://www.sharedprosperity.org/bp217.html

13. Shaw, Hannah & Chad Stone (2010, December 22) Zandi Analyses Show "Democratic" Measures in Tax Cut-UI Deal Boost Economy, "Republican" Measures Add to Deficit Risks. Retrieved from http://www.cbpp.org/cms/index.cfm?-fa=view&id=3349; Rosenbaum, Dottie (2010, July 23) The Food Stamp Program Is Effective and Efficient. Center on Budget and Policy Priorities, Retrieved from: http://www.cbpp.org/cms/index.cfm?fa=view&id=3239

14. LeRoy, Stephen, (2010, May 3) Is the "Invisible Hand" Still Relevant? Federal Reserve Bank of California (FRBSF) Economic Letter. Retrieved from: http://www.frbsf.org/publications/economics/letter/2010/el2010-14.html

15. Nørgård, Jørgen Stig; John Peet; Kristin Vala Ragnarsdóttir (2010, February 26) The History of The Limits to Growth. Retrieved from http://www.thesolutionsjournal.com/node/569

16. Gertner, Jon (2010, May 13) The Rise and Fall of the G.D.P. The New York Times. Retrieved from http://www.nytimes.com/2010/05/16/magazine/16GDP-t.html

17. Calabrese, Anthony (2010, July 6) Measuring Economic Well-being: GDP vs. Median Income. The State of the USA. Retrieved from: http://www.stateoftheusa.org/content/measuring-economic-well-being.php

18. Econproph (n.d.) The Mean and the Median Tell Two Different Stories Retrieved from: http://econproph.com/2011/09/08/the-mean-and-the-median-tell-twodif-ferent-stories/

19. Gertner, Jon (2010, May 13) The Rise and Fall of the G.D.P. The New York Times Magazine, May 13. Retrieved from: http://www.nytimes.com/2010/05/16/magazine/16GDP-t.html

20. Gertner, Jon (2010, May 13) The Rise and Fall of the G.D.P. The New York Times Magazine, May 13. Retrieved from http://www.nytimes.com/2010/05/16/magazine/16GDP-t.html