Economics focus

Stagnation or inequality

Has the American economy exhausted the easy sources of growth?

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YOU could be forgiven for missing the publication of the most talked-about economics book of the year so far. The author, Tyler Cowen, an economist at George Mason University, quietly announced its release in a post on his blog. “The Great Stagnation” is an e-book* (#footnote1), and at just 15,000 words, a slim one at that. But it has inspired a raucous discussion in the blogosphere which has spilled over to mainstream media.

The book explores the puzzling stagnation in the typical American wage since the 1970s. The prevailing view has been that soggy median wages can be explained by widening income inequality. But Mr Cowen blames lagging pay on a shortfall in growth itself. Output data have been overstated, he reckons, thanks to rising contributions from hard-to-value industries. Worse, economic engines in the rich world are running ever slower as countries exhaust easy sources of rapid growth.

The numbers do not appear to support Mr Cowen’s story. Growth and productivity performed badly in the years after the oil shock of the 1970s, but by the 1990s a turnaround was under way. Productivity rose by 2.8% a year from 1996 to 2000, and faster still in the next five years. Real output growth topped 4% a year from 1997 to 2000. This is stagnation? But Mr Cowen says these figures are illusory. Rising output in the health-care or government sectors may not correspond to real improvements: expensive surgery may become more common without improving health. Finance enjoyed impressive productivity gains before the crisis but produced many goods of questionable value.

If America’s past was not as impressive as it seemed, its future is even more troubled. Mr Cowen argues that there is a dwindling supply of “low-hanging fruit”: opportunities for fast
development that cannot easily be repeated. The plentiful supply of land once available to settlers moving west is one example. Educational gains are another. In 1900 many of America’s best minds were to be found on farms. Now most go to college. But that momentous shift was a one-off. To move students not currently earning degrees through university will be far more difficult.

Worse still, Mr Cowen reckons that the gains from two centuries of rapid technological innovation are largely exhausted, and that new discoveries lack the same revolutionary quality. To take one example, a kitchen from 1973, complete with refrigerator, microwave oven and dishwasher, would strike a person living in 1900 as a marvel. A time-traveller from 1973, on the other hand, would find a modern kitchen fairly ordinary. The world has gone from great leaps to refinements, and the refinements are petering out. Mr Cowen cites Charles Jones, an economist who uses deconstructed growth statistics to determine the drivers of progress across eras. Mr Jones reckons that 80% of the growth between 1950 and 1993 came from the new application of old ideas, and these old ideas are now mostly wrung dry. Other data point in a similar direction: rich economies spend more than ever on research, but the number of new patents has plateaued.

Innovation continues, of course. Those ubiquitous smartphones are not a figment of your imagination. But new discoveries no longer translate into broad income gains, the book argues. A nifty fashion design or structured financial product may enrich its creator without benefiting society as a whole. The most transformative of modern innovations—the internet—generates fewer jobs and revenues than past technologies. General Motors once employed over 600,000 people; Facebook serves 500m customers with a staff of 2,000. Americans spend and borrow much as before the advent of the web.

Mr Cowen’s thesis contrasts with what might be called the “Great Divergence”, which argues that the distribution of income gains is the problem, not the actual growth rate. Some economists, such as Claudia Goldin and Lawrence Katz, trace the growing pay gap to increasing demand for skilled workers. Others fault the policy environment. Paul Krugman credits the Reagan-era assault on labour unions and regulations with a decline in workers’ bargaining power. The result is a new gilded age, in which plutocrats capture the surplus generated by an exploited class of workers. These competing views of America demand very different policy responses. For the likes of Mr Krugman, progressive taxation and redistribution are needed to offset labour’s position of weakness. A stagnating world, on the other hand, requires a more limited state, lest expanding commitments outrun a slow-growing economy’s ability to fund itself.

**Stay out of the kitchen**
The divergence camp seems to have the better arguments. Productivity improvements eliminated many middle-skilled American jobs just as emerging-market industrialisation undermined the position of low-skilled workers. After adjusting for these factors there may not be much wage stagnation left to explain. Nor is it clear that innovation has slowed. The evidence of improvement is all around. Communication is dramatically cheaper, easier and better than it was just a decade ago. Kitchens may look much as they did 30 years ago but living rooms and desktops look remarkably different. Innovation plateaus have been identified before, often to the later embarrassment of their spotter.

And yet the idea of a great stagnation cannot be dismissed entirely. Rich countries have captured the easy gains from land use and education. Rising dependency ratios are starting to weigh on growth. Rapid industrialisation across the emerging world poses big challenges, not least to the rich world's reliance on cheap resources. Fast rates of expansion cannot be taken for granted; nor can the ability of the state to offer ever more protection to its citizens. A small book but a big, worthwhile question.

* “The Great Stagnation; How America Ate All the Low-Hanging Fruit of Modern History, Got Sick, and Will (Eventually) Feel Better”, by Tyler Cowen, January 2011

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