

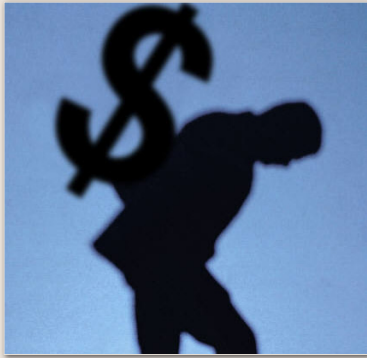
The Deep Causes of Today's Struggling U.S. Economy

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by Ryan H. Murphy

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The American economy is growing. But compared to other recessions in the post-World War II era it has not bounced back to its long-run trend. Optimistically, if real gross domestic product (GDP) per capita were following its 1990-to-2007 trend path, it would have hit \$58,000 in 2015. Instead, it remained at \$51,000.



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Differing Explanations for Slow Economic Growth. Conservatives and progressives have their own narratives about why this is happening. Progressives have argued that the problem is still somehow a lack of nominal spending, even though the world we are in is “the long run” and the unemployment rate is precisely where one would expect it to be, 5 percent.

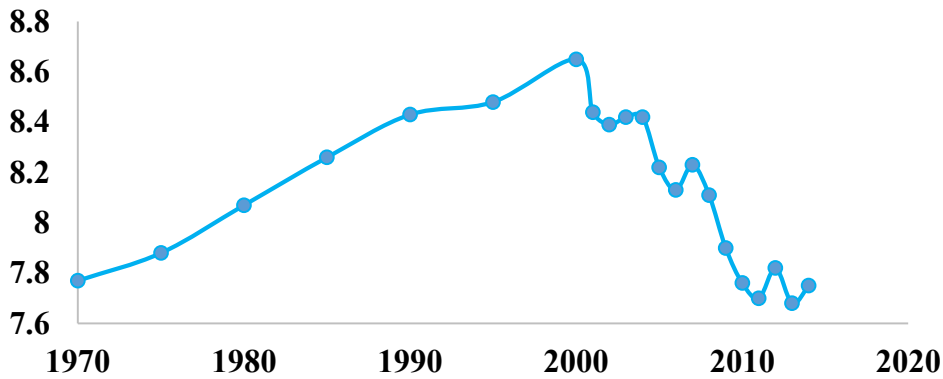
Conservatives blame the policies of Barack Obama, even though the policy changes put into effect are *relatively* small, given the size of the welfare state and the morass of federal regulations. Whether the top marginal tax rate is 43 percent or 37 percent has economic effects, but the change must be contextualized. In 1960, the top rate was 91 percent.

Economic Freedom and Growth. Certainly, departures from the free market model have not had a beneficial impact on the U.S. economy. The issue is relative magnitude. According to the *Economic Freedom of the World* report, which measures the quality of free market institutions on a 10-point scale, the United States’ economic freedom score fell during the first few years of the Obama administration, from 8.11 in 2008 to 7.76 in 2010.¹ It has been approximately stagnant through 2014, for which its preliminary score is 7.75.

But this too must be placed in historical context. First of all, these recent numbers have put the U.S. score back right around where the country was in the 1970s. In other words, we have regressed from the Reagan and Bill Clinton years back to the frustrating economic conditions of the ‘70s. Second, the U.S. score peaked in 2000 and has been on a general downward trajectory since [see Figure I]. The turning point was not 2007/2008, but 2000/2001. The United States ranked third in economic freedom in the world in 2000, behind only Singapore and Hong Kong, both of which are city states. Today it is 16th.

Factors Underlying the Decline Economic Freedom. So what has changed? Looking internationally — to the other countries in the group of seven largest market economies (G7) and the developed economies in the Organization for Economic Cooperation and Development (OECD) — we see pretty much the same pattern. But, when you

Figure I
U.S. Economic Freedom
(10-point scale)



Source: Economic Freedom of the World, available at freetheworld.com.

The legal system quality measures used in the *Economic Freedom of the World* report pertain to the integrity of the legal system and the security of one's property rights — for instance, the independence of the judiciary and the ability to enforce contracts. They originate from three third-party sources: survey questions from the World Economic Forum's *Global Competitiveness Report*, scores from the PRS Group's *International Country Risk Guide* and data from the World Bank's *Doing Business* report.³

The measures of freedom to trade include hard data on tariff rates and other restrictions, as well as additional evaluations

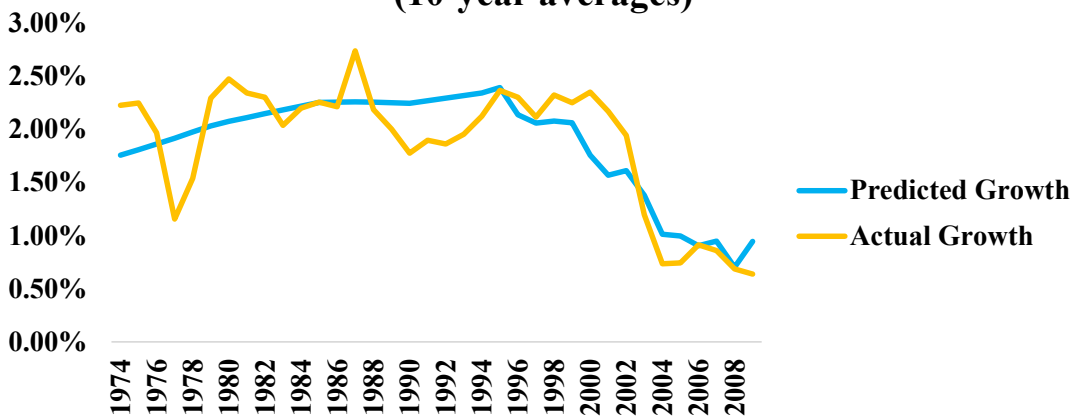
from the *Global Competitiveness Report* and the *Doing Business* report. These measures pertain to the fundamentals of the global economy.

dig into the data, what has driven this change is the decline in the *quality of the legal system* and, surprisingly, a rise in the cost, and declining ease, of *trade* across borders.² Increased government spending, regulation and inflation are not what is giving us this fall in economic freedom — at least so far. Most pundits and policymakers, even many of those friendly to free markets, fundamentally do not understand what is going on.

The other point of confusion is the interpretation of the boom in the years leading up to the Great Recession. To many, this was a normal period of economic growth, and the lack of recovery today is what is to be explained. But in the context of the fall in economic freedom, it seems like the boom is

what is to be explained. Making the assumption that the United States has been on a permanently lower growth path since 2000 clarifies where the abnormality lies.⁴

Figure II
Predictable Effects of the Decline in Freedom
(10-year averages)



Source: Author's calculations.

A Simple Model of Economic Freedom and Growth. Consider 10-year average GDP growth rates and 10-year averages in economic freedom. I created a simple model of the U.S. economy, using nothing but the 10-year average level of economic

freedom and the 10-year change in economic freedom. [See the Technical Appendix.] In other words, if we assume that economic growth rates are driven only by how much economic freedom we have and the change in how much economic freedom we have, how well does that fit the data? The result of this exercise is shown in Figure II. The long run trends, including a collapse since 2000, are predicted very well using only these two variables. The relationship estimated in my model — a one percent decline in economic freedom corresponds to a one percent decline in the growth rate — matches more rigorous research elsewhere.⁵

Conclusion. This model is to some extent a simplification. But we must be careful what we mean when we say economic freedom has declined. What has happened is that, across the world, the fundamental institutions of capitalism and trade are under attack and have been under attack since 2000. Policy debates concern important issues, but the declines in the scores of deep variables concerning property and trade are what underlie the measured decline in freedom. Until these characteristics of the United States improve, we should not expect growth rates to return to where they once were.

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Notes

1. James Gwartney and Robert Lawson et al., *Economic Freedom of the World*, various annual reports, Fraser Institute. Available at <http://www.freetheworld.com/>.
2. Ryan H. Murphy, “What Do Recent Trends in *Economic Freedom of the World* Really Tell Us?” *Economic Affairs*, Volume 35, Issue 1, February 2015, pages 138-150.
3. Klaus Schwab, editor, *The Global Competitiveness Report*, World Economic Forum, available at <https://www.weforum.org/>; International Country Risk Guide, PRS Group, available at <https://www.prsgroup.com/about-us/our-two-methodologies/icrg>; and *Doing Business*, World Bank Group, available at <http://www.doingbusiness.org/>.
4. Ryan H. Murphy, “The Plucking Model, the Great Recession, and Austrian Business Cycle Theory,” *Quarterly Journal of Austrian Economics*, Volume 18, Number 1, Spring 2015, pages 40-44.
5. James D. Gwartney, Randall G. Holcombe and Robert A. Lawson, “Institutions and the Impact of Investment on Growth,” *Kyklos*, Volume 59, Issue 2, May 2006, pages 255-273.

Technical Appendix

The data on economic freedom is interpolated for most of the years from 1970 to 2000, as it is only available every five years.

The complete model estimated is,

$$\frac{\sum_{i=0}^9 \text{growth}_{t-4+i}}{10} = \beta_0 + \beta_1 * \frac{\sum_{i=0}^9 \text{EFW}_{t-4+i}}{10} + \beta_2 * (\text{EFW}_{t+5} - \text{EFW}_{t-4}) + \varepsilon$$

The value of the effect of the level of economic freedom, β_1 , is 0.01099 (1.099 percentage points) and is statistically significant at the 99% level.

The value of the effect of the change in economic freedom, β_2 , is 0.01174 (1.174 percentage points) and is statistically significant at the 99% level.

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