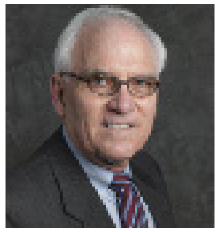
Can Slow and Steady Win the Race?

Economic Recovery Continues at a Snail's Pace



By J. Fred Giertz

In a narrow sense, 2013 was a good year for the U.S. economy. Growth accelerated in the second half of the year after falling to a near standstill in the last quarter of 2012. Prospects for 2014 are good. More broadly, however, the economy still has a long way to go to return to its pre-recession levels of unemployment. More than four years after the end of the 2007-2009 recession, it is apparent that the economic downturn and financial crisis were not only unusually severe, but that the recovery has been among the most anemic since World War II. The question is whether this is the new normal for economic growth, or if the economy will return to pre-recession performance levels.

In some ways, the Illinois economy in 2013 mirrored the national economy. Growth picked up and the unemployment rate fell. However, Illinois continued to lag the U.S. economy in a number of dimensions, most notably the unemployment rate. Illinois' rate was higher than all but three states at the end of 2013. Illinois faces the challenge of not only riding the general

CURRENCY: KELSEY MCCOY, IGPA; SNAIL: ©ISTOCK.COM/AUTAHEU wave of recovery, but also of finding a way to make up the ground lost to other states.

The U.S. economy in 2013

National economic growth accelerated during 2013. In the last quarter of 2012, GDP growth was 0.1 percent. Yet by the third quarter of 2013, GDP growth reached 4.1 percent. This was only the second quarter where growth exceeded 4 percent in the past eight years. The national unemployment rate had fallen to 7 percent by year’s end, beginning the year at 7.9 percent and down from a post-recession high of 10 percent in October 2009. This was welcome news, but the rate was still far above the 2006-2007 levels that held in the 4 to 5 percent range. Further, the official unemployment rate did not reflect the fact that many people had left the workforce and were not counted as unemployed.

For continued progress on the unemployment front, GDP growth must continue well above 2.5 percent in 2014 because productivity growth has advanced at more than 2 percent per year. While productivity increases are important for the long-term health of the economy, it also means that, in the short term at least, firms do not need as many workers to produce their goods and services. This is also one of the most important reasons for the strength of business profits during a period of high unemployment.

The long-term prospects for dealing with inequality hinge on the nature of the problem facing the unemployed and low-wage workers.

The economic recovery has been hindered by a number of factors that have come to be known as headwinds. Fortunately, many of these forces have receded recently. Most important, the lingering uncertainly in regard to the overall financial system has been largely resolved. There is still great concern about the recovery, but there is little worry about the overall soundness of the financial system. Even though the lingering European financial problems had not been resolved in 2013, they appear to have been contained. Based on the profitability of the corporate sector, equity markets have been surprisingly strong, more than doubling since the low point in March 2009 and up around 25 percent in 2013.

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Inflation also remained tame. There was great concern that the aggressive intervention of the Federal Reserve during the financial crisis would eventually result in substantial inflation. This simply has not materialized and now the Fed is worried that inflation may actually be too low. This has given the Fed more flexibility in reducing its monetary stimulus, the so-called tapering process. The financial markets now appear to have accepted the inevitability of the taper and are incorporating it into their plans. In fact, the advent of tapering is actually a strong positive sign because it demonstrates that the Fed believes the economy is in a firmer position.

An unexpected plus for the economy comes from the surprising increase in domestic oil and gas production due to the wider use of hydraulic extraction methods, or "fracking." This private market initiative has restrained energy prices saving both consumers and businesses money while reducing dependence on foreign oil. This has benefitted American manufacturing in the process.

For the last few years, Illinois' unemployment rate has ranked among the highest in the nation.

Even the ongoing drama of the federal budget process that has resulted in "fiscal cliffs" and real or threatened government shutdowns seems to have been subdued with the December 2013 two-year agreement in Congress. Unfortunately, that agreement falls far short of dealing with the nation's long-term fiscal imbalance, but it does provide some near-term stability.

One negative is the headwind of the uncertainty resulting from the rollout of the Affordable Care Act (ACA). While the long-term effects of the ACA are still not known, the implementation process has been and promises to be a disruptive force in the economy for some time. Uncertainty is damaging to the economy and the ACA process has clearly added to this.

The relatively rosy outlook for the next year is a welcome change, but there are important longer-term issues, such as how to maintain continuing high rates of economic growth, how to address the looming structural deficits in future years resulting from promised entitlements, and the problem of growing income inequality. Inequality was a major issue in the 2012 presidential campaign and has been re-emphasized by the president. Inequality has increased markedly in the past few decades, not because of government policies, but from basic changes in the economy that have provided high returns to education and specialized skills, especially to the very highest earners. Five years of the Obama administration appear to have had no impact in reversing these trends. Increasing the minimum wage would do little to reverse this trend and might have a negative impact by reducing the number of jobs.

The long-term prospects for dealing with inequality hinge on the nature of the problem facing the unemployed and low-wage workers. Is the problem simply the result of an unusually severe recession? If this is the case, it may be simply a matter of time until the economy finally recovers, with some observers calling for more government stimulus to hasten the process. On the other hand, the problem may be structural in nature, with many workers lacking the skills to compete effectively in the modern economy. If the problem is structural, time will not automatically correct the situation. It will take longer-term policies to increase the human capital of workers so they can function more effectively.

The Illinois economy

Similar to the nation, the Illinois economy expanded at a good pace in 2013. Most of the national factors applied to Illinois as well. The U of I Flash

Index – which measures the state economy by tracking corporate income, personal income and retails sales taxes – increased strongly for the year, finishing at 107, well above the 100 dividing line between growth and decline. This reading matched the post-recession high and the highest level since April 2007 (see Figure 1). Unemployment in Illinois actually increased early in the year before falling below 9 percent in November to 8.7 percent. Higher-than-national unemployment rates have become a persistent trend in Illinois (see Figure 2). For the past few years, Illinois' unemployment rate has ranked among the highest in the nation, which illustrates Illinois' problem. Even though the state economy is expanding, it is falling behind the overall U.S. economy.

Illinois is still a rich and prosperous state, but its margin of superiority is slowly eroding. Illinois' GPD growth rate has fallen short of the national rate in 14 of the last 15 years. In 1960, per capita income in Illinois was 18 percent higher than the U.S. average. In 2012, the margin had shrunk to 5 percent (see Figure 3). This is not totally unexpected since there are long-term factors that lead to a degree of convergence for state per capita income levels. Capital tends to move to low-wage areas and workers often migrate to high-wage environments, leading to a reduction in interstate income variations. However, this is not the full explanation for Illinois.

The migration of people from northern to Sunbelt states over the past several decades was clearly not under the state's control. Illinois, however, has done little to make the state more attractive. Illinois is not a particularly high-tax state, but it does have a reputation for the poor management of its fiscal affairs along with a less-than-friendly regulatory environment. Illinois has a long-term structural deficit that needs to be addressed through long-term fiscal discipline. This will likely require changes in the tax structure along with a reduction in the rate of growth in spending.

A sounder fiscal situation is not the solution to all of the state's economic challenges, but it is an important first step.

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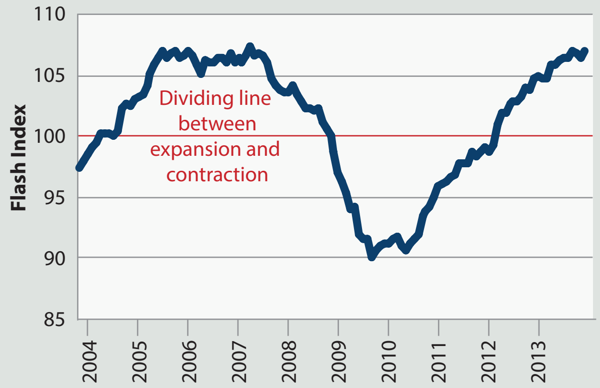
Figure 1

Flash Index November 2003 – December 2013



Note: The Flash Index is a measure of future ecomomic activity (100 = no growth).
Source: Analysis by the Institute of Government and Public Affairs, University of Illinois.

Figure 2

U.S. Unemployment Rate Compared with Illinois Unemployment Rate January 2003 through December 2013

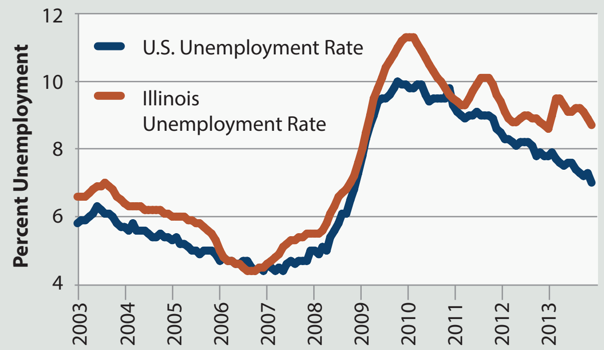


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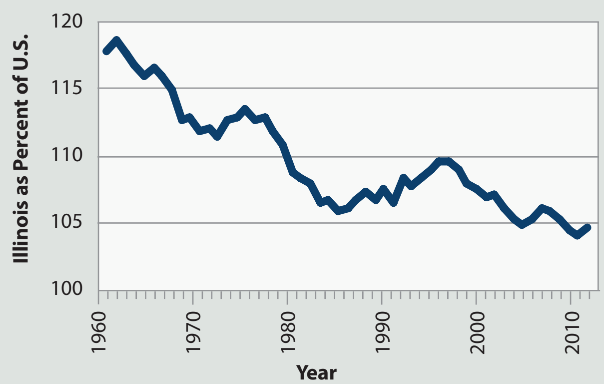
Figure 3

Illinois Per Capita Personal Income as Percentage of U.S.



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