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The U.S. Underestimates Growth

The official statistics are missing changes that are lifting American incomes.

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Today's pessimists about the economy's rate of growth are wrong because the official statistics understate the growth of real GDP, of productivity, and of real household incomes. Understanding this problem should change the political debate about income growth and income inequality. But it should not change the focus on what matters: policies to increase everyone's real incomes even faster.

Government statisticians are supposed to measure price inflation and real growth. Which means that, with millions of new and rapidly changing products and services, they are supposed to assess whether $1,000 spent on the goods and services available today provides more "value" or "satisfaction" to American consumers than $1,000 spent a year ago. Even more difficult, they are tasked with estimating exactly how much it costs now to buy the same quantity of "value" or "satisfaction" that $1,000 could buy a year ago.

These tasks are virtually impossible, and the problem begins at the beginning—when an army of shoppers go around the country at the government's behest to sample the prices of different goods and services. Does a restaurant meal with a higher price tag than a year ago reflect a higher cost for buying the same food and service, or does the higher price reflect better food and better service? Or what combination of the two? Or consider the higher price of a day of hospital care. How much of that higher price reflects improved diagnosis and more effective treatment? And what about valuing all the improved electronic forms of communication and entertainment that fill the daily lives of most people?

In short, there is no way to know how much of each measured price increase reflects quality improvements and how much is a pure price increase. Yet the answers that come out of this process are reflected in the consumer-price index and in the government's measures of real growth.

This is why we shouldn't place much weight on the official measures of real GDP growth. It is relatively easy to add up the total dollars that are spent in the economy—the amount labeled nominal GDP. Calculating the growth of real GDP requires comparing the increase of nominal GDP to the increase in the price level. That is impossibly difficult.

The measurement problem is particularly severe for new products. Consider a new drug that improves the quality of life, reducing pain or curing a previously incurable disease. The ability to buy that new product means that a dollar is worth more than it used to be, and that the properly measured level of real GDP is higher.

The official method of calculating the price index doesn't incorporate this new product until total spending on it exceeds some threshold level. It is then added to the government's price calculations, but only to record whether the cost of the drug goes up or down. The main effect of raising well-being when the drug is introduced is completely ignored. The same is true of other new products.

The result is that the rise in real incomes is underestimated, and the common concern about what appears to be the slow growth of average household incomes is therefore misplaced. Although the dollar amount of median household income nearly doubled in the past two decades, the increase in the official price index has cut the corresponding increase of real household income down to less than 5%.

Official statistics also portray a 10% decline in the real median household income since 2000, fueling economic pessimism. But these low growth estimates fail to reflect the remarkable innovations in everything from health care to Internet services to video entertainment that have made life better during these years, as well as the more modest year-to-year improvements in the quality of products and services.

While changes in officially measured real GDP statistics don't fully capture increases in Americans' standard of living, year-

to-year fluctuations are still useful as one indicator of business-cycle conditions. Similarly, while small changes in measured inflation are not a good indicator of changes in real incomes, there is no doubt that true inflation was too high in the early 1980s, when the official consumer-price index was rising at a double-digit rate.

Americans are enjoying faster real income growth than the official statistics indicate, but we can achieve even faster growth with more capital accumulation, increased labor-force participation, and greater innovation that leads to new products and more efficient means of production. Better tax policies can help achieve all three.

Current tax laws hurt capital accumulation. Taxes on interest and dividends reduce the after-tax return to savers. High corporate tax rates encourage U.S. firms to invest abroad. The mortgage-interest deduction shifts capital from productive business investments into less productive investments in owner-occupied housing.

High marginal tax rates discourage labor-force participation, particularly for second-earners in families. These high rates on the last dollar earned reflect the personal-income tax schedules as well as the rules of means-tested programs like food stamps and ObamaCare, which reduce individuals' benefits when their incomes rise.

High tax rates on income and capital gains also discourage risk-taking and entrepreneurial activities that contribute to the dynamic nature of the American economy. Changes in these tax rules should be high on the agenda of the next president.

In short, we should worry less about the appearance of slower growth of middle-class incomes and do more to increase that growth in the future.

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