The National Bureau of Economic Research recently announced that the trough of the recession occurred in June 2009. The recession was the longest and the deepest in the postwar era and the rate of recovery since the trough has been sluggish. The slow recovery can be attributed in large part to a handful of policies that have made Americans less confident about their future economic prospects. These policies include the health care bill that was signed in March, the financial reform bill signed in July, and federal government deficit spending that began in 2002 and is forecasted to continue indefinitely. All three produce uncertainty in the minds of investors and business owners and inhibit making long-range plans. With the health care and financial services accounting for almost one-quarter of Americans’ consumption, it is no wonder that the major reforms of these sectors have left many wondering about how the future will pan out.

Since its passage, the Patient Protection and Affordable Care Act or ACA has been assailed with legal challenges from the states on the issue of individual mandates. Also, much of its implementation will be at the discretion of the Secretary of Health and Human Services. Thus, health care providers and insurers will have to wait and see what course the Secretary takes on regulations that will dramatically affect their profitability. Employers who currently provide health insurance are in a state of limbo as they consider whether to pay the penalties and drop coverage from their compensation packages. Small businesses who do not currently offer insurance or offer only catastrophic insurance may face large increases in their labor cost through penalties or because they will be required to provide health insurance. Either way, these firms must now face a new mix of labor costs and have less control over the incentives they can offer employees. Altogether, these factors affect all employers’ abilities to plan ahead.

Further, forecasts that incorporate the provisions of the health care bill indicate that one of the primary selling points of reform – bending the health care cost curve downward – will not be achieved. Early assessments of the effect of ACA on national health care spending, as well as a recent forecast by Centers for Medicare and Medicaid Services, suggest that spending will remain on the same path as before. However, the composition of health care spending will definitely change with Medicare spending being cut dramatically compared to last year’s projections. The cuts to Medicare were made to expand coverage to the uninsured and to assure that, at least on paper, the bill would receive a favorable score. These cuts are accomplished through what are effectively price ceilings on the reimbursements Medicare will pay in the future on behalf of seniors. If seniors are not allowed to supplement Medicare’s payments, there will be serious access to care issues with many seniors potentially leaving Medicare.

But as the Medicare Trustees Report released in August noted, it is unlikely that the caps on Medicare spending can be maintained in the long run. This means that Medicare spending will actually be higher than is projected in the CBO’s budget forecasts, and, consequently, the projected large deficits and debt burden will increase.

Like the health care reform bill, the Dodd-Frank Wall Street Reform and Consumer Protection Act continues the theme of expanding the role of government in another sector of the economy. The financial reform bill creates the Financial Stability and Oversight Council. The council is to act as a watchdog over large bank holding companies and nonbank financial companies. It can require supervision by the Federal Reserve of a nonbank financial company if it poses risks to the financial stability of the country. The nonbank financial institutions that may come under the Fed’s authority include both hedge funds and insurance companies. The bill also
creates the Consumer Financial Protection Bureau; this bureau has a wide range of regulatory powers and has jurisdiction over the activities of financial firms ranging from extending credit and servicing loans to providing financial advisory services. These sorts of yet-to-be-defined regulatory powers have a stagnating effect on innovation in the financial services sector.

Un fortunately, the bill did not address some of the inherent problems faced by Fannie Mae and Freddie Mac. The bill chronicles that the two agencies are required to provide loans to lower income home buyers and how the agencies ended up in their present conservatorships. According to the bill, the “sense of Congress” is that there must be meaningful structural reforms of the two agencies. It tasks the Treasury Department with preparing recommendations on the future of the agencies including liquidation, privatization, and dissolution. However, this is as far as the bill goes, and any structural changes must be brought about by further legislation.

The mounting debt burden is the other major factor weighing on the minds of investors and affecting firm investment decisions. We are now in the eighth year of federal deficits and the accumulated debt will rise to over 60 percent of GDP this year. Based on the CBO’s recent forecast, deficits are expected to continue at about 3 percent of GDP out to at least 2020. In that year the CBO estimates that the debt held by the public will be equal to 69 percent of GDP almost double the last 50 years’ average of 36 percent. Deficits cannot continue indefinitely, and ultimately past and current borrowing must be paid back. Apart from unlikely cuts in federal spending, taxpayers know that they will have to pony up the money to pay back the debt. Taxpayers at both the individual and corporate level face the unenviable situation of deciding what assets to hold in their portfolios or which venture to pursue in an unpredictable tax environment. This has left many taking a wait-and-see attitude.

Before the NBER’s dating of the business cycle’s trough to June of 2009, many economists had expressed concern about the rate of recovery. Across all US cities, housing prices bottomed out in March of last year, but they have risen less than 5 percent since. New housing starts reached their minimum in January of 2009 and have risen slowly, but the July 2010 housing starts were lower than 97 percent of the monthly housing starts dating back to 1987. Other measures indicate that the trough of this business cycle occurred in the second quarter of 2009. Capacity utilization, industrial production, and the Conference Board’s coincident index were all at their recent minimums in June of 2009.
and have recovered slightly. Initial unemployment claims peaked in March of 2009 and the unemployment rate peaked in October of 2009.

Figure 1 illustrates the sluggishness of the current recovery. The figure depicts the growth in real GDP one year after the trough for all postwar business cycles as well as the previous peak in GDP relative to the trough. This serves as an indicator of the lost ground to be regained. The lost ground with the current business cycle is 4.3 percent of GDP, representing the largest decline among all postwar cycles. The real annual growth in GDP since the recent trough is 2.9 percent, a rate that is only higher than the two most recent recoveries. But most importantly, we are now one year into the present recovery and the economy has yet to regain its lost ground. This is unique among all postwar recoveries.

Contributing to the sense that this is a slow recovery is the stock market’s performance. In real terms, the current level of the S&P 500 is about where it was at the beginning of 1997 and is 72 percent lower than the peak in 2000. Most families have seen their wealth, comprised of housing values and equities in their retirement plans, take a serious hit over the last four years. How long will it take to recover some of the lost ground in housing and equities? Nationwide, real housing prices are about 52 percent less than at their 2006 peak. It will take 6 years for housing prices to again reach the 2006 level if housing prices grow at the annual rate of the first three years of this decade.

There is a long run relationship between price-earnings ratios and subsequent earnings that has been widely referenced as a result of predictions made by economists John Campbell and Robert Shiller in the late 1990s. Figure 2 presents the relationship between 10-year forward annual stock return and the seasonally adjusted price-earnings ratio (earnings are averaged over the last ten years). Each point reflects the combination of future returns and the price-earnings ratio in the month of June for all available years since 1871. The red line depicts the negative relationship between the 10 year returns and price-earnings ratios. The current price-earnings ratio is relatively high at 19.7, which yields a predicted real return for the next ten years of about 2 percent. Of course there is significant variance around this estimate, but it suggests that the stock market recovery could take time.

While there is evidence the economy is showing signs of recovery, the recovery is definitely slow in coming. As we have suggested, the recovery is hampered by the uncertainty brought about by the expanded reach of government. Investment stifling marginal tax rate increases have been codified in the health care legislation and are being discussed now as Congress is debating extensions of the Bush tax cuts. Health care reform missed the opportunity to reduce the tax preference afforded health insurance that encourages higher health care consumption. Reducing the tax preference would lower the expected costs for the government programs for low income Americans as well as for retirees through Medicare because expensive first dollar coverage would no longer be the norm. The extent of the financial reform bill’s provisions simply introduces uncertainty into the financial markets. The best path forward for the economy is to reduce the disincentives to innovation and investment and to lessen the tax incentives that favor one type of consumption over another.