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On the Prospects for Higher Economic Growth

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Since the economic recovery began eight years ago, the rate of economic growth has averaged only two percent per year, the weakest economic expansion since World War II. Participation in the labor force is near its lowest level since the malaise of the late 1970s. The country is experiencing the worst five-year run for productivity ever measured outside of a recession. And the median wage is growing only slowly.

We do not share the view that the recent period of weak economic growth was simply an inevitable result of the financial crisis. Economic recoveries tend to be stronger after deep recessions, and any residual headwinds from the crisis should have long been remedied had pro-growth policies been adopted. Historically, some post-crisis periods are marked by lower economic growth, but we believe that the poor conduct of economic policy bears much of that burden.

For individuals and households, the recent economic performance is insufficient to improve standards of living at a rate to which most Americans are accustomed. And it is at odds with a society that promises opportunity and upward mobility for the next generation. Most Americans rely largely on wage income. The conduct of economic policy during the past several years, however, has failed to address structural impediments to more rapid growth in productivity and wages.

For businesses, the underlying economy lacks dynamism in output, investment, and employment. Start-up activity outside of a few regions remains poor. Business investment in real assets, such as real and intellectual property, plant, and equipment, is stuck at very low levels. Companies have instead used cash flows for share buybacks and corporate consolidation.

Focused primarily on "stimulus" in the short-term, the conduct of economic policy in the post-crisis years did little to reset expectations higher for long-term growth. That policy failure restrained those expectations, adversely affecting consumption and, especially, investment spending.

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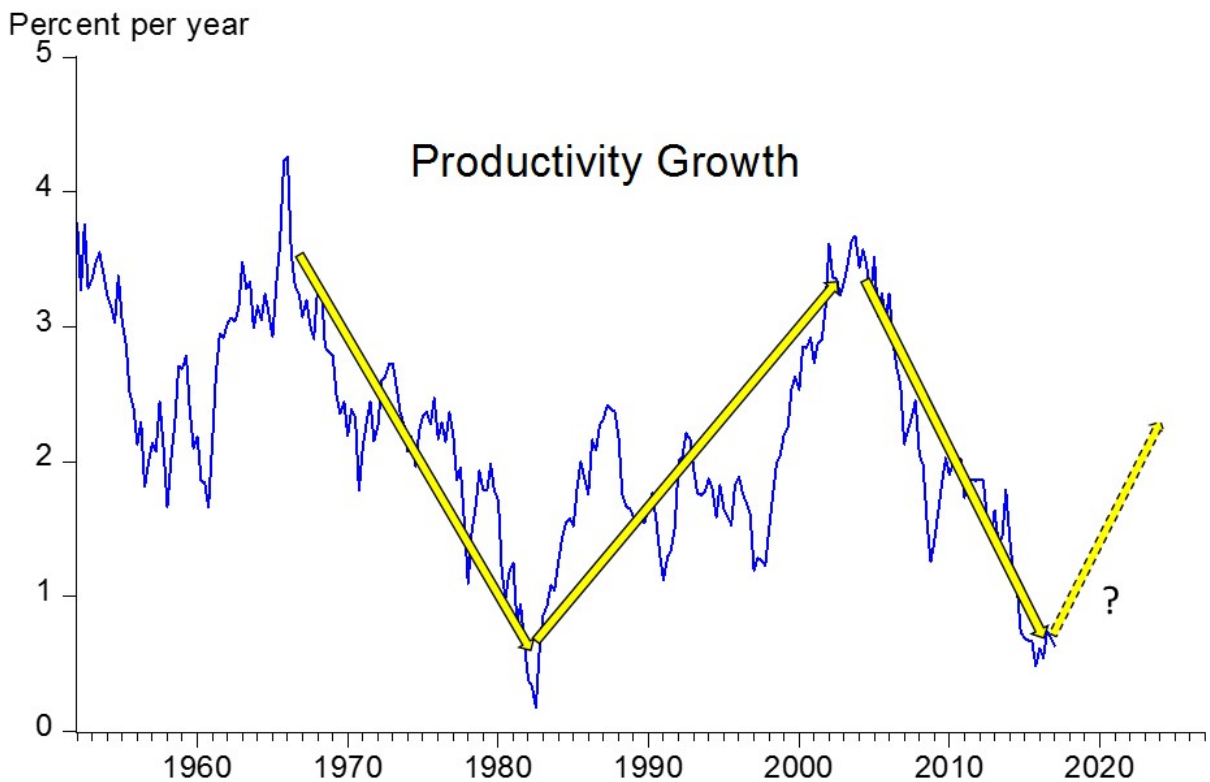
What explains the slow economic growth? Economists focus on the two proximate determinants of growth: productivity growth—the increase in production of goods and services per hour of work—and total hours of work. And, as we review each factor in turn, we are confident that U.S. growth can be materially higher than the reality of the post-crisis era.

Productivity increases arise from human capital (labor), technology, and real capital investment. The chart below illustrates the importance of economic policy to productivity trends. The chart smooths through short-term changes in productivity in nonfarm businesses and reveals clear, cyclical trends in productivity growth.[2] Productivity growth declined in the 1970s, rose markedly through the 1980s and 1990s, and fell again sharply in recent years. The data are not supportive of the popular contention that the United States is in the midst of a long-term decline in productivity growth.



Productivity in the non-farm business sector grew at only 0.5 percent per year in the past five years (measured from 2012 to 2016). Economists have long emphasized capital accumulation as an important contributor to productivity. Data from the Bureau of Labor Statistics (BLS) show that a lack of investment in new capital equipment and software lies at the heart of the recent productivity slowdown.[3] Remarkably, capital per hour of work—a measure of the equipment and

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[2] The measure of productivity growth is the five-year average annual growth rate of BLS business sector output per hour https://data.bls.gov/pdq/SurveyOutputServlet

[3] Multifactor Productivity Trends- 2016, March 30, 2017, Bureau of Labor Statistics

tools that workers use in production—was basically flat during this period, contributing virtually nothing to growth. In contrast, during the period from 1996 to 2005, productivity grew 3.0 percent per year, with the growth rate of capital per hour of work contributing 1.2 percent per year.

An especially weak labor market is the second factor contributing to recent years of slow economic growth. From mid-2007 to the bottom of the Great Recession in June 2009, the labor force participation declined only slightly, from 66 percent to 65.5 percent. It is now only 62.7 percent, far lower than predicted in the immediate aftermath of the financial crisis. And, it has failed to meaningfully recover in the most recent years.

Economic theory and historical experience indicate economic policies are the primary cause of both the productivity slowdown and the poorly performing labor market. High marginal tax rates, especially those on capital formation and business enterprises, costly new labor market and other regulations, high debt-financed government spending (largely to fund income transfer payments), and the lack of a clear monetary strategy have discouraged real business investment and reduced both the supply of-- and the demand for-- labor.

The policy changes of the kind proposed by the Congress and the Administration, if enacted, would significantly improve the economy's growth prospects.

The tax reform plans propose significant reductions in marginal tax rates on corporate income (to 20 percent or lower), reductions in marginal tax rates on business income and earnings from work at the individual level (to 33 percent or lower), fundamental tax reforms to limit special interest benefits and increase employment opportunities. These proposals, if enacted, would raise both productivity and employment, and provide opportunities for broad-based prosperity. These needed reforms would help turn the recent upswing in animal spirits into a significant improvement in economic activity by resetting long-term higher economic growth expectations.

The Administration's proposed regulatory reform agenda – including the reinvigorated presidential effort to remove unnecessary, antiquated federal rules, a rigorous, independent benefit-cost analysis of proposed rules, and a regulatory directive to ensure that regulations are pro-competition, not pro-incumbent – would further enhance economic growth by boosting net returns to investment in physical and human capital, and by reducing barriers to employment.

Spending restraint, especially through legislation, along the lines proposed in the House Budget Committee's 2018 Budget Resolution, that slows the growth in entitlement spending, is essential to achieving higher economic growth. In the absence of spending restraint, entitlements will cause annual federal spending projected to increase by 60 percent in 10 years. The higher spending will cause the annual federal budget deficit to increase to $1.4 trillion. These increases will eventually crowd out private investment and thereby act as a brake on economic growth. A comprehensive set of changes in entitlement laws that limited the growth in federal spending to the rate of inflation plus population growth would, in contrast, free up resources for greater private sector investments to enhance productivity.

It is important to emphasize that tax reform and spending reductions go hand-in-hand. Without significant spending restraint, even with positive effects on economic growth, the tax rate reductions would likely be limited and temporary, limiting their economic benefits.

Enacting this comprehensive set of economic policies is a heavy lift; as difficult a challenge as confronted policymakers in the 1980s. But, the rewards measured in terms of higher economic growth, more jobs and improved living standards are huge.

The Congressional Budget Office (CBO) now projects that absent fundamental changes in economic policies, real GDP will grow at only 1.8 percent per year. But, as we discussed, historical experience suggests that the economic reforms can raise both productivity growth and employment growth.

Could implementation of such a comprehensive economic plan raise the economic growth rate to 3 percent? We believe it can. We judge that such a policy package, in part by encouraging firms to expand by bringing new investment to production, can help raise trend labor productivity growth to around 2.3 percent per year in the nonfarm business economy and perhaps higher, which translates into approximately 2.0 percent labor productivity growth in terms of GDP.

With the proper set of pro-growth economic policies, our productivity growth expectation is not overly optimistic. During the post-WWII era up to 2012, the 10-year average annual productivity growth rate equaled or exceeded 2.3 percent nearly two-thirds (63 percent) of the time.[4] From 1992 to 2012, the 10-year average annual growth equaled or exceeded 2.3 percent 65 percent of the time. Each of these periods contains at least one recession and includes periods, such as the 1970s, when economic policies were decidedly growth-defeating.

Attaining 3 percent GDP growth also requires that the U.S. labor force increase by 1 percent per year. Over the next decade, the civilian population age 16 and older is projected to increase by that amount.[5] But because the population is aging and older workers have lower labor force participation rates than prime-age workers, the labor force is not expected to increase as rapidly.

According to our estimates and those of the Obama Administration's CEA, if age-specific labor force participation rates remain at their current levels, the aging population would cause the overall U.S. labor force participation rate to decline on average by 0.4 percent per year over the next decade. Therefore, to offset this decline and attain a 1 percent growth in the size of the overall U.S, labor force, age-specific labor force participation rates must rise by 0.4 percent per year, or 4 percent over 10 years.

We believe that the aforementioned policy package, if implemented, would enable this increase to occur. In 2006, the Bureau of Labor Statistics predicted that the U.S. labor force participation rate would decline from 66.2 to 65.5 from 2006 to 2016 based on its assessment of demographic changes and trends in age-specific labor force participation rates. The actual participation rate actually declined to 62.8 during this period. The reduction over and above the BLS forecast is, in our judgement, largely a consequence of anti- growth economic policies. We judge that this policy-driven decline of 4 percent ((62.8-65.5)/65.5) can be reversed over the next decade by the passage and implementation of the pro-growth policies described above.

[4] The measure of productivity is business sector output per hour (BLS.gov, series PRS84006092). From 1948 to 2012, there are 54 10-year periods for which productivity data are available. In 34 of those periods, productivity averaged at least 2.3 percent. During twenty 10-year periods ending between 1992 and 2012, productivity growth equaled or exceeded 2.3 percent 13 times.
[5] 2017 Economic Report of the President, Table 2.2

In comparing our economic growth estimate to the CBOs current projection, it is important to keep in mind that attaining 3 percent annual GDP growth rate is based upon enactment and implementation of a package containing significant tax reform, regulatory reform, budget reform and monetary reform. In contrast, the CBO’s economic growth projection of 1.8 percent per year is based on a continuation of status quo policies in which tax rates remain high and the tax code remains unreformed, the large regulatory burden persists, and the growth in federal spending and the national debt outpace the growth in GDP.

With this distinction in mind, the accounting differences between our economic growth estimates and CBO’s are as follows: 0.7 percentage points of the difference is due to our judgment that labor productivity will generate a 2.0 percent per year increase in GDP compared to CBO’s assumption of 1.3 percent per year. As recently as 2012, CBO assumed that productivity growth under the previous non-growth policy environment would generate a 2.0 percent per year growth in GDP. The remaining 0.5 percentage points of the difference is due to our judgment that the labor force participation rate will remain constant compared to CBOs assumption that the labor force participate rate will decline.

Taken together, these policy changes will help reset household and business expectations toward faster growth. Failure to enact these policies would lead to lower incomes and smaller improvements in the standard of living and would leave the economy closer to recession than resurgence. Moreover, it would leave our country considerably less capable of an economic upturn when the next recession or shock hits.