PROSPECTS FOR ECONOMIC GROWTH IN THE UNITED STATES

Although economic growth has historically been an engine of prosperity in the United States, recent trends have generated uncertainty regarding the prospects for sustaining such growth. Economists disagree about the relative importance of many factors affecting future growth, including rapid technological advances, immigration, the growth of the financial sector, problems with the educational system, increasing income inequality, an aging population, and large fiscal imbalances that have not been addressed by the political system. This collection of chapters, authored by many of today's leading economists, addresses the prospects for economic growth in the United States over the next few decades. During a time of great economic uncertainty, this book engages with both sides in the debate over economic growth, focusing on policy options that increase the prospects for vigorous economic growth in the future.

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Prospects for Economic Growth in the United States

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To Martin Feldstein, whose pathbreaking contributions and profound insights into the theory and practice of public finance established the standard for the profession and inspired a generation of scholars

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the National Association of Business Economics. He was a trustee of the Council on Foreign Relations and a member of the Trilateral Commission, the Group of 30, the American Academy of Arts and Sciences, and the Council of Academic Advisors of the American Enterprise Institute. Feldstein received honorary doctorates from several universities and was an honorary fellow of Nuffield College, Oxford. In 1977, he received the John Bates Clark Medal of the American Economic Association, a prize awarded every two years to the economist under the age of forty who is judged to have made the greatest contribution to economic science. He was the author of more than 300 research articles on economics. Feldstein was a director of several public corporations and an economic adviser to several businesses and government organizations in the United States and abroad. He was a regular contributor to *The Wall Street Journal* and other publications. Feldstein was a graduate of Harvard College and Oxford University.

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Stephen J. Turnovsky received his PhD from Harvard University in 1968 and currently holds the Van Voorhis Professorship of Economics at the University of Washington. He was previously a member of the faculties of the University of Pennsylvania, the University of Toronto, the Australian National University, and the University of Illinois at Urbana-Champaign, where he was IBE Distinguished Professor of Economics. In 2005, he received a Doctorat honoris causa from the University of Aix-Marseille, France, and in 2009, he was awarded an honorary Doctor of Literature from Victoria University of Wellington, New Zealand. He was elected fellow of the Econometric Society in 1981 and was president of the Society of Economic Dynamics and Control from 1982 to 1984 and of the Society for Computational Economics from 2004 to 2006. He was co-chair of the Program Committee of the Eighth World Congress of the Econometric Society in 2000. He served on several editorial boards including the *Journal of Economic Dynamics and Control* (editor, 1981–7, 1995–2001; advisory editor (2002–), the *Journal of Money, Credit, and Banking* (1977–2010), the *Journal of Public Economic Theory* (2000–), *Macroeconomic Dynamics* (2001–), the *Journal of Human Capital* (2006–), the *International Economic Review* (1972–93), the *Journal of Public Economics* (1982–7), and the *Journal of International Economics* (1995–8). His main area of research is in the general area of macroeconomic dynamics and growth. Within this area, his interests are quite far-ranging, with particular focus on fiscal policy issues and optimal policy, extending to both closed and open economies.

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Foreword

James A. Baker III

President Ronald Reagan understood the importance of economic growth in creating prosperity and a higher standard of living for successive generations. At the time he took office in 1981, however, the prospects for economic growth in the United States were uncertain. The country faced a number of critical challenges, including rapid inflation, high unemployment, stagnant income growth, and increasing trade conflicts, not to mention military threats from abroad. As President Reagan's White House Chief of Staff in the early 1980s and his Secretary of the Treasury starting in 1985, I was deeply involved in the administration's efforts to enact sweeping economic reforms, including major reform of individual and corporate income tax policy, market deregulation, and working with the monetary authorities to create sound monetary policies to contain inflation. As is well known, Reagan's policies resulted in one of the longest uninterrupted non-inflationary economic expansions in American history.

Today, the level of uncertainty and the challenges facing the US economy are similar. But the nature of the problems we face are very different. In particular, the challenges that confront us today include rapid technological change, slow economic growth, an aging and slowly growing population, unsustainable fiscal policies, increasing inequality, and low interest rates that leave little room for effective monetary policy. Given the considerable level of uncertainty facing the US economy, it is essential to enact sound economic policies that allow economic growth to continue to provide prosperity to future generations.

This volume lays out in detail the economic issues that are fundamental to understanding how to maintain vigorous economic growth of the US economy. The various chapters discuss a range of subjects – including issues related to demographics, social insurance programs, technological progress, human capital accumulation, immigration, income inequality, the importance of financial institutions, and fiscal policy – that are critical inputs in determining the future level of economic growth in the United States. The contributors to the volume represent a "who's who" of renowned economists in the United States.

Baker Institute fellows John Diamond and George Zodrow deserve great credit for organizing both this volume and the conference at which these chapters were originally presented as papers. I am delighted that they dedicated this book to the memory of Martin Feldstein. Marty had a huge impact on public policy and his profound insights and wise council will be sorely missed. Their conference, which was entitled "Prospects for Economic Growth in the United States," was one of a series of events celebrating the twenty-fifth anniversary of Rice University's Baker Institute for Public Policy. Their understanding and exploration of the country's complex economic challenges play a critical role in keeping our nation the strong one that President Reagan desired, promoted, and achieved.

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Preface

Robust economic growth has long been the engine of prosperity in the United States, and has resulted in a sustained increase in living standards that has made the US economy the envy of much of the modern world. Prospects for future economic growth in the United States, however, are uncertain. For example, some researchers argue that technological advances, especially in the area of artificial intelligence, are likely to result in rapid automation-related increases in future growth – indeed, to the point that serious shortages in labor demand may result. In marked contrast, other observers believe that recent economic, demographic, and political trends, including an educational system that is ineffective in many dimensions, increasing income inequality, an aging population coupled with a lower labor force participation rate, and the absence of the political will to address large-scale fiscal imbalances, have created pervasive headwinds that will seriously limit future US economic growth.

This volume brings together a distinguished group of world-renowned economists to explore the challenges of maintaining vigorous economic growth in the United States, including issues related to demographics, social insurance programs, technological progress, human capital accumulation, immigration, income inequality, financial institutions, and fiscal policy. The volume consists of a set of chapters that were presented as papers at a conference on "Prospects for Economic Growth in the United States," which was one of a series of events celebrating the twenty-fifth anniversary of Rice University's Baker Institute for Public Policy. The conference was sponsored by the Baker Institute's Center for Public Finance and held at Rice on December 6–7, 2018.

Given the timing of the conference and the subsequent paper revisions, the chapters in this volume were essentially complete before the onset of the COVID-19 pandemic. As a result, none of the papers discuss the implications of the pandemic for the prospects for economic growth in the United States. Although this is clearly a subject that could be adequately treated only with a second book, we offer several brief observations as follows.

There is no question that the short run implications of the pandemic have been dire with large declines in output and employment. For example, in July 2020, the Congressional Budget Office (CBO)[1] estimated that over the period 2020–2030 annual real GDP will on average be 3.4 percent lower than it projected in January 2020, and that the unemployment rate will average 6.1 percent relative to an earlier prediction of 4.2 percent. We note that the accuracy of these economic projections will naturally depend on the course of pandemic – especially the extent to which the development of vaccines and more effective treatments is successful, and the extent to which the prospects for the success of efforts to continue reopening the economy are enhanced by effective procedures to ensure the wearing of masks, the maintenance of social distancing, widespread cleaning and disinfecting, and effective protocols for testing and health monitoring, contact tracing, and quarantining of those infected with or exposed to COVID-19.

From a medium run and longer run perspective, it is clear that the pandemic has the potential to accentuate all four of the "pervasive headwinds that will seriously limit future U.S. economic growth" noted above. First, from an educational standpoint, the learning lost due to school shutdowns and difficulties with remote learning will have a negative impact on the affected students. For example, Hanushek and Woessmann (2020)[2] estimate students in grades in 1–12 might suffer a decline of 3 percent in their lifetime incomes and annual GDP might be an average of 1.5 percent lower for the rest of the century as a result of the pandemic. They note that these effects can be ameliorated only with more effective instruction going forward, perhaps with more individualized instruction and if new and effective pedagogical techniques learned by coping with the pandemic, especially in the areas of remote teaching and technological innovation in teaching, are successfully implemented.

Second, the pandemic is likely to increase income inequality. Hanushek and Woessmann stress that educational losses will be concentrated among

1 Congressional Budget Office, July 2020, "An Update to the Budget Outlook: 2020–2030," Congressional Budget Office, Washington, DC.
2 Hanushek, Eric A., and Ludger Woessmann, 2020, "The Economic Impacts of Learning Losses," OECD, Paris.

disadvantaged students. More generally, numerous commentators have described the likelihood of a "K-shaped" recovery under which the poor bear a disproportionate share of the burden of the costs of the pandemic due to the collapse of the labor market, especially for relatively low paying jobs that cannot be done remotely, and reductions in pandemic relief packages, while higher income individuals are largely insulated from the effects of the pandemic, especially to the extent that the recovery in the nation's financial assets continues.

Third, declines in the labor force participation rate may be accelerated as individuals, especially those in the later stages of their life cycles, lose their jobs and have difficulty finding re-employment even as the pandemic subsides, especially in light of the increase in unemployment predicted by CBO. In addition, from a longer run perspective, Spence (2020)[3] notes that the pandemic has accelerated trends toward the increasing economic importance of relatively low labor-intensity firms with high levels of intangible assets per employee, partly due to increased adoption of digital technologies during the pandemic and partly because economic difficulties have been concentrated among relatively labor-intensive business sectors.

Finally, although the massive fiscal and monetary responses of governments in the United States and around the world are appropriate in light of the economic threat posed by the worldwide spread of COVID-19, there is no question that the fiscal situation of the United States has deteriorated as a result of the pandemic. For example, in September 2020, the CBO (2020)[4] projected a federal budget deficit of $3.3 trillion in 2020, more than three times the 2019 deficit, and that privately held federal debt will increase to a historical record of 109 percent of GDP by 2030, relative to its January 2020 projection of a debt of 98 percent of GDP. However, we should note that historically low interest rates – and the prospect that they may continue for an extended period of time, especially if Federal Reserve policy continues to be accommodating, global savings continue to be large relative to investment needs (the "savings glut"), and debt issued by the U.S. Treasury continues to be perceived to be an international investment safe haven – are of course one reason that high levels of debt may have less of an impact on future economic growth rates than they otherwise might.

[3] Spence, Michael, 2020, "Winners and Losers of the Pandemic Economy," Project Syndicate, Prague.

[4] Congressional Budget Office, September 2020, "An Update to the Budget Outlook: 2020–2030," Congressional Budget Office, Washington, DC; Congressional Budget Office, January 2020, "The Budget and Economic Outlook: 2020–2030," Congressional Budget Office, Washington, DC.

Despite concerns about such increases in these four headwinds facing future economic growth, we close on a more optimistic note. The effects of the pandemic on the four headwinds are largely medium term rather than long term factors. Indeed, it may be true, as suggested by former Federal Reserve Board Chair Ben Bernanke, that – as long as public health efforts to contain the pandemic are successful – the effect of the coronavirus pandemic on the economy will be akin to an extended "major snowstorm" that will have relatively little impact on long run growth. Moreover, the acceleration of trends toward increasing digitization noted above may have a positive effect on growth, along the lines suggested by those who are optimistic about the long run growth effects of ongoing advances in technology and artificial intelligence. Finally, some of the trends forced by the COVID-19 pandemic may have positive effects on long run productivity and thus long run growth, including increased use of telemedicine and greater business flexibility in allowing remote work when effective and the resulting reduction in congestion. Given all of these uncertainties, the net effect of the pandemic on long run growth is far from clear.

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