How to Achieve Stronger U.S. Growth

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The United States faces two distinct challenges in raising our rate of economic growth. The first is to overcome the tepid pace of cyclical expansion since the current recovery began in the summer of 2009. The second is to raise the long-term potential growth of GDP.

I am convinced that there are a large number of policies that could make important contributions to growth in both the near term and the more distant future.

Stimulating Short-term Demand

The rise in GDP and employment since the recovery began in 2009 never reached the pace that was common in previous economic upturns. Real GDP at the end of each year has been less than two percent higher than a year earlier and employment has grown more slowly than population.

This very sub-par recovery occurred because the 2007 recession was itself very different from earlier downturns. Previous post-war recessions were caused by the Federal Reserve raising interest rates to deal with inflation. When the Fed achieved what it wanted, it lowered the interest rate and the economy bounced back. In contrast, the 2007 downturn was caused by a general mispricing of risks, including grossly overpriced houses supported by very high loan-to-value mortgages.

House prices started to fall and mortgage borrowers began to default in 2006. Other overpriced assets also lost value. The falling prices of financial assets led to a dysfunctional financial market in which financial institutions were unwilling to lend to each other. Credit dried up.

In this condition, lower Federal Reserve interest rates could not generate a sharp recovery. Housing in particular was declining and not responding to lower interest rates.

The 2009 fiscal stimulus package was less than the GDP gap and so poorly designed that it added more to the national debt than it did to GDP.

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The Federal Reserve's unconventional monetary policy lowered long-term rates but house prices continued to fall until 2012 and the stock market did not rise faster than corporate earnings until 2013.

The Federal Reserve's unconventional monetary policy has been the only policy stimulus in recent years but is no longer able to provide a substantial boost to growth. The near-zero interest rate policy and aggressive quantitative easing also create dangerous risks to future stability. The Fed is now cutting back on its bond buying and long-term interest rates are up significantly.

So fiscal policy is the best way to stimulate faster short-term growth. But while the <u>direct</u> effect of a large fiscal stimulus would be to raise GDP, the resulting increase in the national debt would be a drag on the economy as businesses and entrepreneurs cut back because they fear higher future tax rates and a sharp rise in future interest rates.

A feasible strategy for raising GDP and employment more rapidly in the remainder of this decade would therefore be to combine substantial reductions in the relative size of the <u>future</u> national debt with <u>immediate</u> permanent tax-rate cuts and a multiyear program of infrastructure spending.

The size of the five-year infrastructure program would have to exceed $1 trillion to achieve the needed rise in the economic growth rate. The lack of "shovel ready" projects is not an excuse for not pursuing this strategy or for diverting the funds into low-impact spending of the kind that made the 2009 stimulus so ineffective. It would be better to spend a year or two preparing for the right kind of spending.

But the short run fiscal stimulus will only increase GDP if it is combined with policies to reduce future government spending by enough to make the ratio of debt to GDP lower a decade from now than it is today. That can only be achieved by slowing the growth of Social Security and Medicare and limiting the tax deductions and exclusions that are really hidden forms of government spending. (Feldstein, 2013a)

That is a politically tough prescription but the combination of the positive and negative tax and spending components could in principle achieve bi-partisan support. Without such a plan, we are likely to continue to have sub-par growth and employment.

<u>Raising Long-Term Growth</u>

I turn now from stimulating demand in the current decade to policies that could raise real GDP in the longer term.[1] I divide these potential policies into three groups: increasing the labor force; improving the quality of the labor force; and

[1] I discuss these and other ideas in <u>America's Challenge</u> (Feldstein, 2011)

increasing the rate and quality of capital accumulation. These policies would also accelerate technical progress through a more technically competent labor force and more capital accumulation. If there were more time, I would discuss policies aimed more specifically at increasing technical change.

I recognize that many of these policies would raise the level of future GDP and not the permanent growth rate. But the effects of these policies would, if adopted, be phased in over long periods of time so that the effective impact would be to raise the growth rate of GDP over many years.

Because my time is very limited, I will state only three potential policies in each group and will not develop them in any detail. They indicate though that much could be done to increase our future potential GDP.

Increasing Employment

(1) Employment among seniors: The labor force participation rate now declines from 64 percent among 60 year olds to only 32 percent among individuals age 65 through 69. Congress in 1983 raised the age for full Social Security benefits from 65 to 67, with a delay and gradual phase-in. In the past twenty years, the labor force participation rate among those aged 65 to 69 has increased from 21 percent to 32 percent.

Life expectancy at age 67 has increased by three years since Congress last raised the age for full Social Security benefits. Raising the benefit age again in line with the increased life expectancy would expand the labor force and raise real GDP.

(2) Employment among women. Tax and Social Security rules now penalize married women who tend to be the lower earners in two-earner households. The federal government taxes a wife's first dollar of earnings at the same marginal rate as her husband's last dollar of earnings. Other countries tax each individual on their own earnings, giving married women a greater incentive to work and to work at higher wages.

Social Security now taxes a woman on her full earnings but provides an incremental benefit in return only if the potential benefit based on her own earnings exceeds 50 percent of her husband's benefit while he is alive and 100 percent after he dies. Reforming these rules would increase female labor force participation and GDP.

(3) Employment among low-skilled individuals. The minimum wage law prevents individuals with low skills from obtaining employment. Integrating existing welfare payments with the minimum wage -- by allowing individuals to treat a fraction of their welfare payment as an offset to the required minimum wage -- would permit some of today's poor and unskilled to get onto the job ladder where they would gain the skills and experience needed to rise above the minimum wage. (Feldstein, 2013b)

Improving the Quality of the Labor Force

(1) Better teachers for better outcomes. My Harvard colleague, Raj Chetty, and his coauthors (Chetty, et. al., 2012) have shown how school teachers who increase students' academic performance can be identified statistically and that the students' improved academic performance leads to higher real incomes in adult life. Policies that make the teaching profession more attractive and that allow schools to weed out poor performing teachers could therefore lead to higher incomes in the future. Many experts believe that the current role of teachers' unions prevents such reforms.

(2) Occupationally relevant high school curriculums. More than a million high school students drop out annually. In Chicago, one third of students who enter high school as freshman do not graduate within the next five years. An important contribution to this behavior is the sense among those students that the classes are not relevant for the kinds of jobs that they might obtain but are focused on "irrelevant" academic material. Career oriented classes and apprentice programs in other countries might provide models that will help those who now drop out to finish high school with relevant skills.

(3) College courses with market value. A general liberal education is a worthwhile college goal for many students but not for all. Many employers are now complaining that a college degree leaves many students without the skills needed for useful employment. Many college graduates complain that the jobs that they obtain do not require a college education. Federal dollars that support college students through grants and loans might be restricted to academic majors that lead to productive careers.

Increasing Capital Investment

More capital investment increases productivity and output directly and by introducing new technology. Better policies could increase the volume of capital and the way that it is deployed.

(1) Raising the household saving rate. Household saving as a percentage of disposable income fell from 9 percent in the 25 years from 1960 through 1985 to about one third of that rate in recent years.[2] A variety of public policies contribute to the low rate of saving and high rates of dissaving. These include the level of unfunded Social Security benefits and the tax subsidy of borrowing implied by the deductibility of mortgage interest and interest on home equity loans. Automatic enrollment IRA plans and a shift of Social Security to a mixed system with

[2] The current household saving rate of about 4.5 percent reflects a change in definition that raises the level by about 1.5 percent relative to the old definition.

investment-based personal retirement accounts would increase national saving and therefore productivity-raising business investment.

(2) Encouraging corporate investment. The high U.S. corporate income tax rate (the highest among OECD countries) drives capital into housing and other uses that contribute less to GDP than investments in business plant and equipment. The high corporate tax rate also induces American firms to invest more abroad and foreign firms to avoid investing in the United States.

(3) Rebalancing international capital investment. Almost all industrial countries use a "territorial" tax system that does not subject repatriated profits to the country's own tax rate. Because the United States does not do that, American firms are incented to leave profits abroad and to expand foreign activities. This raises the productivity and growth in those other countries at the expense of the United States.

Conclusion

The United States fortunately does not have the kinds of labor and product market barriers that impede growth and employment in Europe. The U.S. can therefore return to full employment and higher real incomes over the next decade even if no short run stimulus is adopted. But that return will be slower than necessary and than would occur with a combination of long-term debt reduction and short-term stimulus.

Without policy changes, the slower growth of the U.S. labor force in future decades will reduce the growth of real GDP. But as I have indicated, there is much that can be done to increase the size and quality of the labor force and the amount of capital in American firms.

In short, there is no reason for pessimism about our economic future if we adopt appropriate policies.

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