

CHAPTER 2: MACROECONOMIC OUTLOOK

- The *Report* estimates moderate output growth and a strengthening labor market in the near-term.
- However, CBO’s current estimate of real potential GDP for 2017 is \$2.1 trillion lower than its estimate from ten years ago.
- Growth-inhibiting policies imposed during the Obama era have constrained the economy’s potential.
- The Obama Administration failed to address the unsustainable mandatory spending trajectory that crowds out other spending and pushes the debt-to-GDP ratio ever higher.
- Pro-growth tax, spending, deficit, and regulatory reform can help restore fiscal sustainability and accelerate growth.

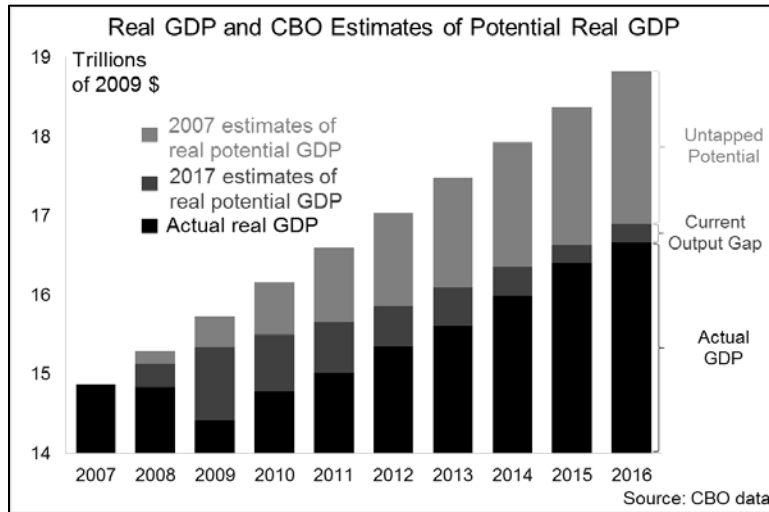
NEAR-TERM OUTLOOK

The *Report* broadly estimates that the economy is closing the output gap—the difference between what the economy could produce and what it is actually producing. However, key determinants of long-run economic growth—labor, investment, and productivity—indicate the presence of a growing untapped potential, which the Committee Majority believes results from policy constraints. Certainly, appropriate fiscal and regulatory reforms would allow the economy to grow faster in both the short and long run.

Potential GDP

CBO defines potential GDP as “the maximum sustainable amount of real (inflation-adjusted) output that the economy can produce.”ⁱ Since 2007, CBO has consistently revised estimates of potential GDP downward. The most recent CBO estimateⁱⁱ of real potential GDP in 2017 is 11 percent lower, or \$2.1 trillion (in 2009 dollars) lower, than its 2007 projection for 2017.

Figure 2-1



The *Report* focuses on how the output gap is shrinking. However, earlier expectations of potential GDP were much higher than estimates that are more recent. Figure 2-1 summarizes the difference between the *Report* and CBO’s 2007 estimates of potential real GDP.ⁱⁱⁱ In the Committee Majority’s view, the reason is Obama Administration policies have restrained economic growth and left untapped an increasing production potential. The *Response* uses CBO’s 2007 estimates of potential real GDP as a reference for what the economy’s full potential could be.

The Committee Majority regards CBO’s progressive downward revisions of its potential GDP estimates each year for the last ten years as reflecting the progressive growth-inhibiting policy constraints imposed on the economy by the last Administration. Potential GDP is a stable, long-term concept and would not change from year to year, absent a major unforeseen event, such as a new war, unless the government changes how the economy is permitted to function.

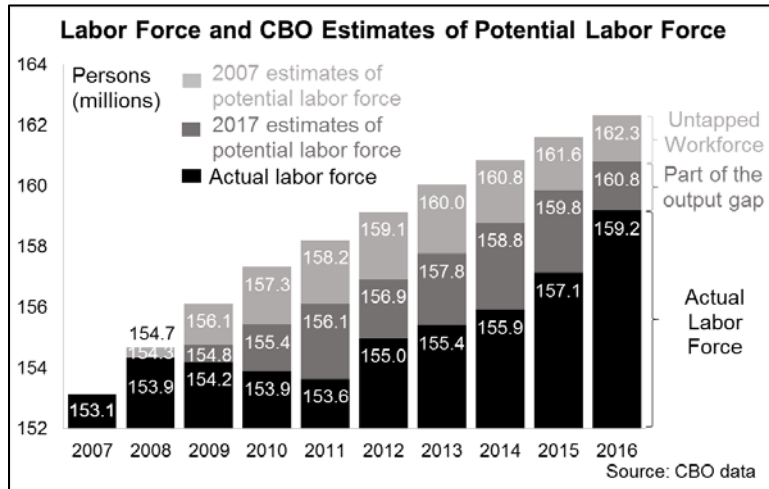
In February 2014, CBO released a report^{iv} analyzing the differences between its 2007 and 2014 estimates of 2017 real potential GDP.^v Between 2007 and 2014, this estimate had been revised downward by 7.3 percent. In other words, the economy’s estimated ability to produce goods and services in 2017 had been revised down by \$1.4 trillion in constant dollar terms.^{vi}

CBO’s estimates of potential real GDP depend primarily on projections of labor force growth, capital accumulation, and productivity growth. The report attributes 40 percent of the downward revision of potential GDP to lower workforce growth, 33 percent to reduced capital intensity, and 19 percent to productivity.^{vii} The next three sections analyze these three key determinants of economic growth and provide evidence of untapped potential.

The Labor Market

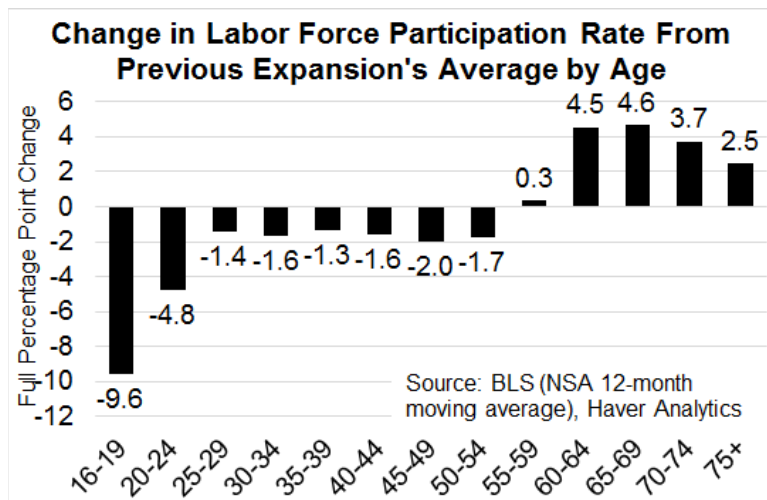
CBO’s estimates of labor force size in a fully recovered economy have fallen by 1.5 million since 2007, from 162.3 million to 160.8 million, as shown in Figure 2-2. The drop in CBO’s labor force estimate of 1.5 million accounts for 40 percent of the untapped potential in Figure 2-1.

Figure 2-2



It is conceivable that an aging population is retiring from the workforce faster than initially anticipated; however, labor force participation rates across age groups indicate that only workers under the age of fifty-five have lower labor force participation rates than the averages of the prior expansion (Figure 2-3).

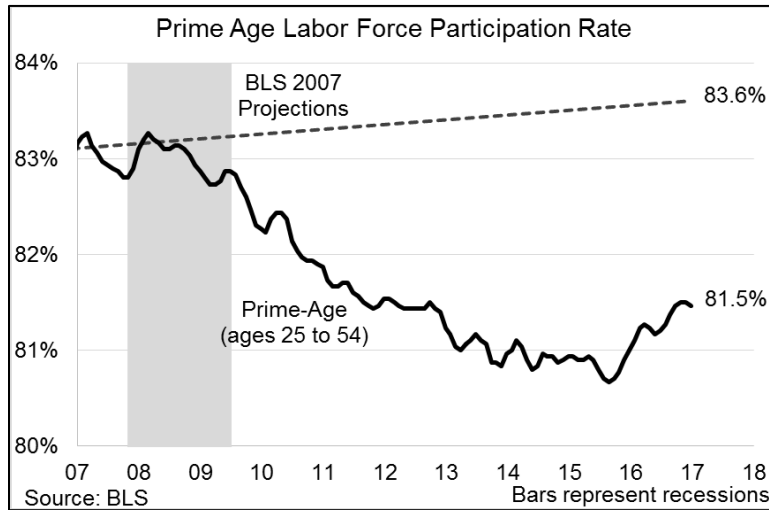
Figure 2-3



Comparing the 2007 BLS forecast of the prime-age labor force participation rate for 2016 of 83.6 percent with the current rate of 81.5 percent (see Figure 2-4) implies that over 2.6 million potential workers between the ages of 25 and 54 remain on the economy’s sidelines (more than the 1.5

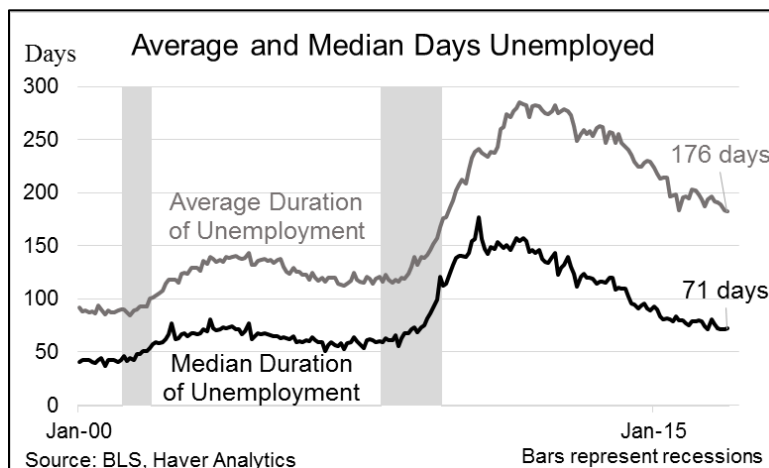
million derived from CBO data). Neither the baby boomer generation reaching retirement age, nor increased numbers of young people going to school or college full time—who are mostly 16-to-24 years old—can account for this decline.

Figure 2-4



The duration of unemployment remains elevated (Figure 2-5). During the previous expansion,^{viii} the mean and median duration of unemployment averaged 125 and 64 days, respectively, whereas at this point in the expansion, the mean and median duration were 176 and 71 days, respectively.^{ix} The higher mean unemployment duration implies that a large number of workers remains on the margins of the workforce, which means that there is room for the economy to grow more if these workers find employment.

Figure 2-5



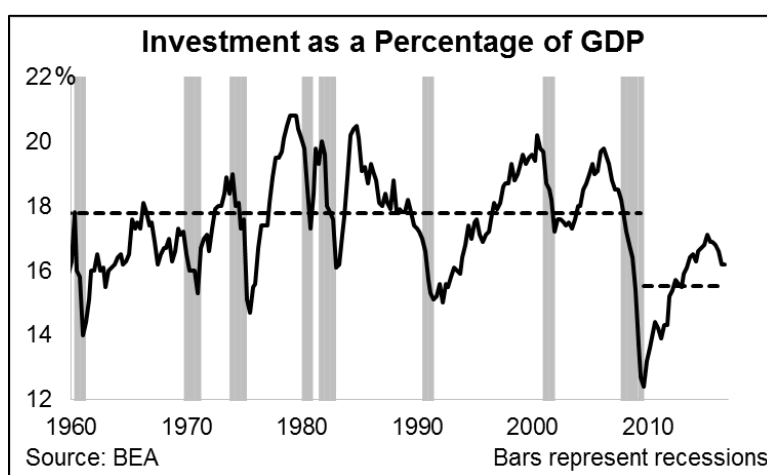
The *Report* states the “labor market continued to improve in 2016, with many measures of labor-market performance having recovered to, or near to, their pre-recession levels,”^x and notes that the

improvement “was apparent in the continued decline in the unemployment rate.”^{xi} The unemployment rate approaching full employment used to imply that the output gap was closing and actual GDP was returning to potential. However, the reliability of the unemployment rate as an indicator of economic performance has greatly diminished. The headline unemployment rate^{xii} only accounts for individuals who have actively sought work in the last four weeks. It does not measure how many individuals are potentially available to work.^{xiii}

Investment

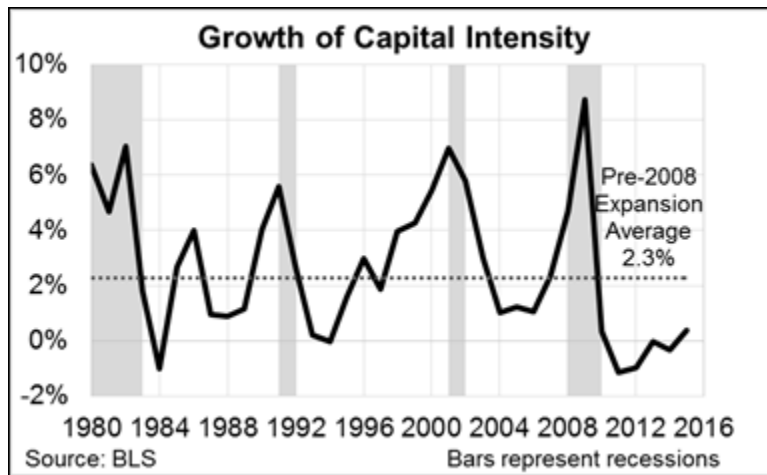
The average share of private investment-to-GDP during the post-1960 expansion period was 17.8 percent. During the current expansion, it has averaged only 15.5 percent (see Figure 2-6).

Figure 2-6



Investment drives capital accumulation, which in turn helps drive output and income growth. The data presented in Figure 2-7 shows capital intensity from 1980 to 2015. Capital intensity measures the ratio of capital—machines, tools, and equipment used to produce goods and services—relative to the number of hours worked by individuals. During the previous expansion, it averaged 2.4 percent growth per year—that is to say, investment in new capital was increasing relative to the workforce. In the current expansion, this measure has averaged -0.3 percent. There is not enough investment in new capital to offset the growth of the workforce.

Figure 2-7

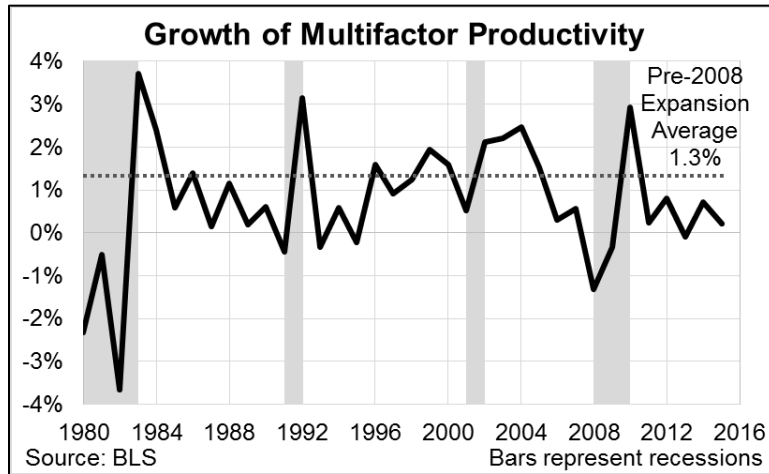


According to CBO estimates, lackluster business investment accounts for 33 percent of America's untapped potential.^{xiv}

Productivity

Workforce growth and capital accumulation can help produce economic growth, but eventually, diminishing returns set in. Even if both factors are increased and total output continues to grow, per capita output cannot increase unless people discover ways to use capital and labor more productively. Each year, BLS produces its statistics of multifactor productivity. This measures what economists often call the stock of technological knowledge. The *Report's* general focus is on labor productivity, which measures the ratio of output to labor input. The Committee Majority prefers multifactor productivity because it measures how well we are learning new ways of producing goods and services with a similar amount of inputs.

Figure 2-8

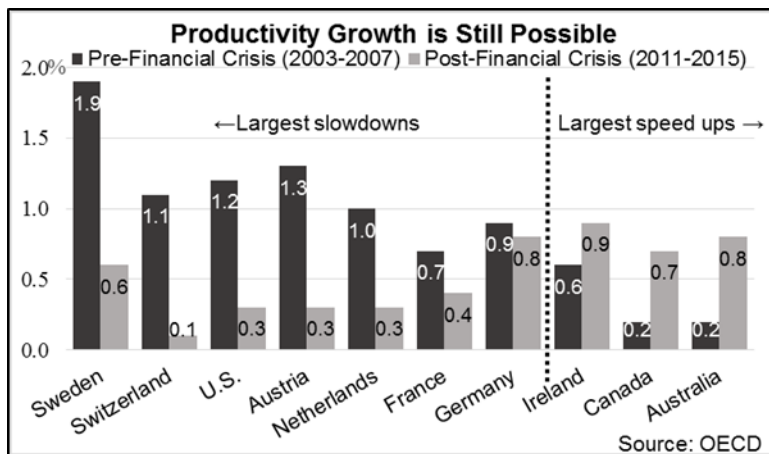


In its most recent annual report, BLS reported that multifactor productivity for the private nonfarm business sector grew 0.2 percent in 2015.^{xv} Between 1996 and 2005, multifactor productivity increased at an average of 1.6 percent per year. However, in the last decade for which data is available (2006-2015), multifactor productivity has grown by only 0.4 percent on average per year.

During expansion periods between 1980 and 2007, multifactor productivity growth averaged 1.3 percent annually as seen in Figure 2-8. From 2010 to 2015 it averaged only 0.8 percent per year. The year 2010 is an outlier; if excluded, the average from 2011 to 2015 is only 0.4 percent per year.

The Organization for Economic Cooperation and Development (OECD) data for multifactor productivity in the ten wealthiest member nations indicate that some developed nations are doing at least as well, if not better, in this respect than before the 2007-2009 recession.

Figure 2-9



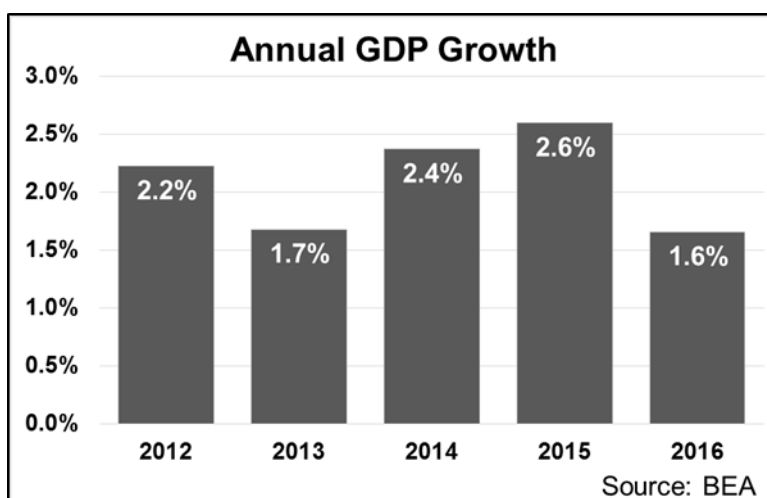
In Figure 2-9, the left-side bar for each nation shows the average multifactor productivity growth during the four years preceding the financial crisis, while the right-side bar shows the average

multifactor productivity in the most recent four years. The nations are ordered from left to right based on which nation had the largest absolute decrease in multifactor productivity growth in the aftermath of the most recent recession. The United States experienced the third largest drop. By comparison, Germany experienced only a slight decrease. Notably, Ireland, Canada, and Australia saw increases in their multifactor productivity growth. Therefore, the Committee Majority believes that it is possible to get productivity growth going again, and based on CBO estimates, regain as much as 19 percent^{xvi} of America's untapped potential.

Output

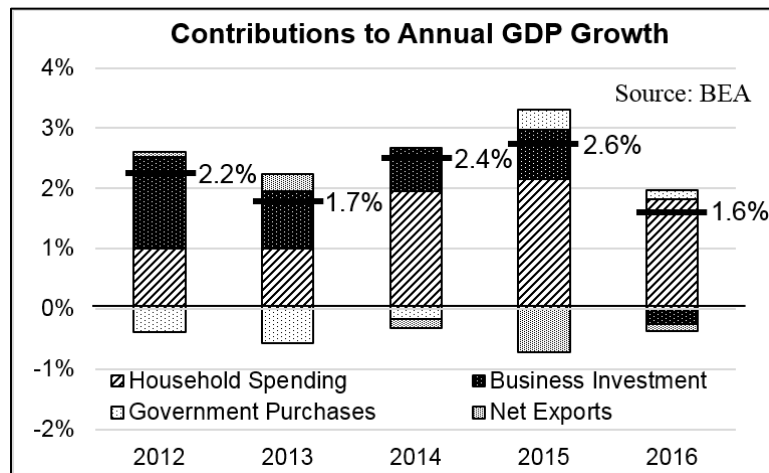
As shown in Figure 2-10, in 2016, economic activity decelerated as measured by real gross domestic product (real GDP)—the inflation-adjusted value of all final goods and services produced within the United States in a given year.

Figure 2-10



In 2014 and 2015, real GDP increased 2.4 and 2.6 percent, respectively, and then slowed 1.6 percent in 2016,^{xvii} falling well short of projections. In early 2016, the Office of Management and Budget (OMB) forecast real GDP growth of 2.6 percent for calendar year 2016,^{xviii} and CBO and the *Wall Street Journal's* December 2015 Economic Survey^{xix} each anticipated 2.5 percent growth for the calendar year of 2016.^{xx}

Figure 2-11



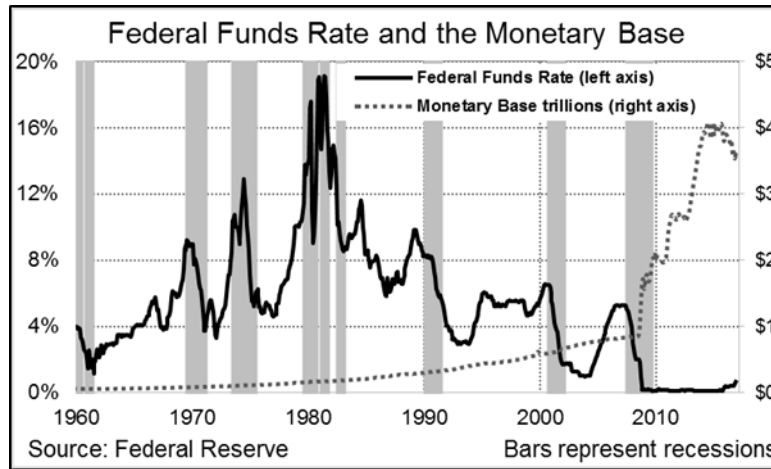
In 2016, for the first time during the recovery, lower investment was a drag on economic growth, as shown in Figure 2-11. Business investment in equipment used in the production of other goods and services as well as business investment in inventories were the largest drags on GDP growth in 2016.

Monetary Policy

Since the Federal Reserve is an independent agency, the CEA does not discuss monetary policy at length but confines itself essentially to giving a status report. The most pertinent observation is that the central bank kept the Federal funds rate near zero through 2016 despite having signaled four increases at the beginning of the year. Only in December did it raise the Federal funds rate and only by a quarter point. In the seventh year since the recession had ended, the economic recovery remained so fragile that the Federal Reserve refrained from moving toward normalizing interest rates.

To mitigate recessions, the Federal Reserve lowers the interest cost of borrowing for consumers and businesses with the aim of supporting spending and investment, which in turn support the demand for workers. As the economy recovers and closes the output gap, the Federal Reserve must gradually withdraw monetary accommodation to avoid inflation and asset price bubbles.

Figure 2-12



Traditionally, the unemployment rate was a more reliable indicator of the output gap and more help in guiding monetary policy.^{xxi} However, that was when the labor force participation rate was not shrinking. Now the Federal Reserve calibrates its policies based on what it believes potential employment and potential output might be, and that introduces it into doing more than merely mitigating a cyclical downturn or supporting an ensuing cyclical recovery. It is now drawn into a grey area of also offsetting other forces and hindrances acting on the market economy, for which monetary policy tools are not ideally suited, if at all. Monetary policy cannot remove constraints on market function and boost the economy's potential. That requires appropriate fiscal and regulatory reforms that motivate investment, hiring, work, and innovation.

Since the Obama Administration is not directly responsible for monetary policy and the *Report* discusses the topic only briefly, this *Response* also will not go into greater depth. Suffice it to say that the extremely low interest rate policy, to which the Federal Reserve has adhered to for so long, is not a sign of good economic health.

The CEA invokes long-term trends ostensibly outside the Obama Administration's control to excuse the slowness of the recovery. But the most plausible, straightforward explanation for the weak recovery is that from the beginning, many of the Obama Administration's policies have stood in the way of normalization. Significant amounts of capital and labor have been sitting on the sidelines that could expand the economy if they were put to use. Removing the obstacles to these sources of economic growth will allow the economy to grow faster.

LONG-TERM OUTLOOK

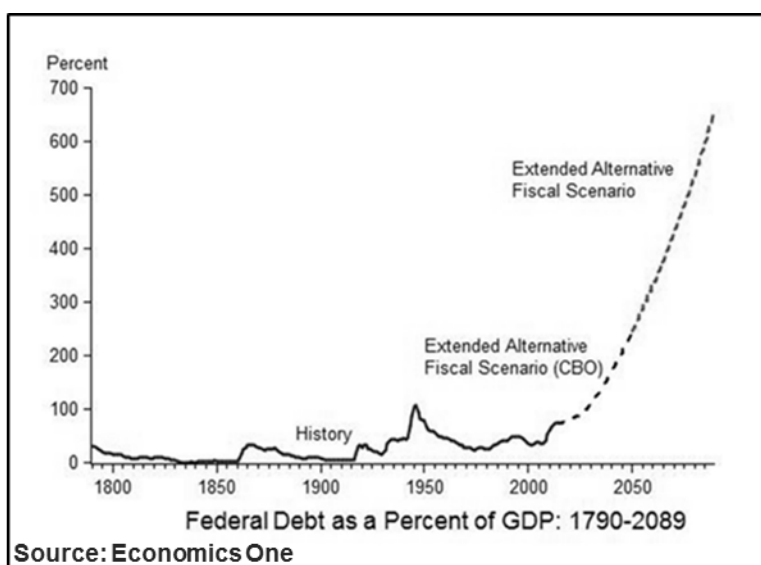
Federal Borrowing and Mandatory Spending

The United States has an extraordinary capacity to borrow,^{xxii} because it is the largest free market economy in the world, which traditionally has offered ample opportunities for entrepreneurship, innovation, investment, and employment, leading to faster growth than other advanced economies. Further, the U.S. dollar is the world's primary reserve currency.

But the United States has been borrowing at a voracious pace; policy constraints have hemmed in the market economy; and U.S. economic growth has slowed to a crawl. Last year, business investment declined. Millions of individuals age 16 and above remain outside the labor market, and the percentage of that population employed has not been below 60 percent in decades.

On top of that, the Federal Government currently faces obligations to pay retirement income (Social Security) and for health care services (Medicare, Medicaid, and ACA premium subsidies) under parameters that become fiscally and indeed economically unworkable (see Figure 2-13). The economy cannot support them. Investors who lend the government money know this, but expect the government will fix the programs.

Figure 2-13



The programs are fixable. The beneficiaries are American nationals, not foreign nationals. The Federal Government can change program parameters in ways that continue to assist Americans in their retirement and help them with medical expenses, while adjusting these programs in ways that make their costs manageable. There is bipartisan agreement that Social Security can be reformed relatively easily. At a JEC hearing in the 114th Congress on the Federal debt, Alice M. Rivlin, a former CBO director, and witness for the Committee Minority stated:

Personally, I think we need to do everything, but if I had to do one thing up front and get it out of the way, it would be Social Security. It's not hard. It's not conceptually difficult. Tip O'Neill and Ronald Reagan did it. We can do it. It's a bipartisan conversation about known quantities.^{xxiii}

It is important to recognize that the current leading Social Security reform proposals would affect individuals who still have time to adapt to changing program parameters while exempting those already in or near retirement. However, the more that time passes, the greater the challenge to keep program changes modest.

Reforming the health care sector proves more difficult, and Chapter 4 of this *Response* discusses the subject at greater length. The highly inefficient institutional settings created by government for health insurance and health care markets lead, in part, to escalating health care costs. What the government creates within our borders, the government can correct and one must expect that the political process will make course corrections that avert moving further up the curve in Figure 2-13.

However, while the Federal Government’s creditors have been patient with respect to the mandatory spending problem, it is unclear when unease will rise at seeing no progress toward a resolution. Where are they to look for reassurance? Certainly not at the *current* rate of U.S. economic growth. Increasing the GDP growth rate is important; it will help allay concern over the size of existing Federal debt. However, any realistic acceleration of growth can only buy some time. A glance at the Figure 2-13 makes clear that GDP growth alone cannot solve the entire problem. Even if the government puts the money to productive uses, borrowing more money, even when interest rates are low, cannot grow the economy enough to contain the rise of the debt-to-GDP ratio.

For the United States to maintain its extraordinary borrowing capacity, there must be visible progress toward containing its mandatory spending obligations.

Rising interest on the debt compounds the urgency of spending containment. Net interest expense is a growing share of the Federal budget, and in CBO’s baseline scenario, overtakes nondefense spending in 2025 and defense spending in 2027 (see Figure 2-14).^{xxiv} If nothing changes, the United States would spend \$768 billion on annual net interest by 2027.^{xxv}

Figure 2-14

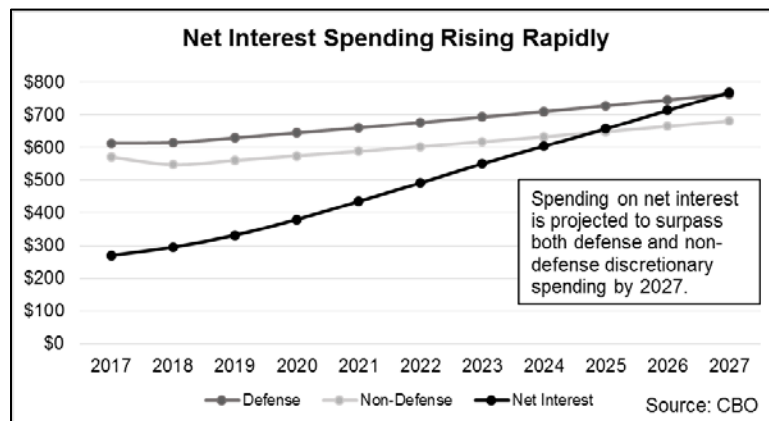
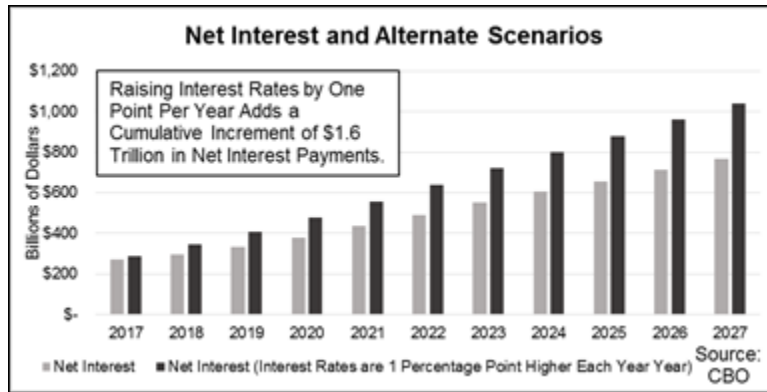


Figure 2-15 shows by how much Federal interest expense would increase if the interest rates CBO assumes for its forecast were one percentage point higher. If future interest rates were to shift up by one percentage point from what CBO assumes, the Treasury would owe in excess of \$1.6 trillion more in net interest expense over the next ten years. Much Treasury debt is issued for relatively short terms and must be rolled over continuously, which exposes it to interest rate risk.

Figure 2-15



The looming obligations from mandatory spending and interest expense have been pressuring ongoing Federal spending priorities already, even those that are well-established and important right now, such as national defense. *The Coalition for Fiscal and National Security*^{xxvi} has warned that the long-term debt is the single greatest threat to our national security, explaining that:

This debt burden would slow economic growth, reduce income levels, and harm our national security posture ...It would inevitably constrain funding for a strong military and effective diplomacy, and draw resources away from the investments that are essential for our economic strength and leading role among nations.^{xxvii}

The warning resonates particularly in the context of another possible crisis, economic or military, that would put further stress on the Federal budget.

A Distressing Legacy

During past Federal debt ceiling debates, the Obama Administration seemed to presume that the country's economic strength supports boundless Federal borrowing and argued that U.S. creditors show no sign of concern over America's economic ability to repay them. Warnings that the debt-to-GDP ratio approached levels that marked economic slowdowns in other countries were contested, but the Obama Administration offered no "caution zone" of its own for the debt ratio. The need to raise the debt ceiling was the only lever available to the opposition at the time to slow deficit spending, and the resulting budget sequestration in 2013 represented some progress. However, the Obama Administration took no steps to address the skyrocketing future mandatory spending expenditures that will force the government to borrow ever more (Figure 2-13). Both the mandatory spending problem and the larger debt are significant parts of the Obama Administration's economic legacy, with which the nation must now contend.

A Sustainable Way Forward

Releasing the economy from the artificial policy constraints that the Obama Administration imposed on the potential rate of output would allow an acceleration of the GDP growth rate in short order, as discussed earlier in this chapter, in addition to taking steps that push out and bend

down the mandatory spending curve. The more progress that is made in both of these respects, the less the current debt-to-GDP ratio may concern investors and creditors because, if they see progress, the U.S. economy's inherent strengths will continue to reassure them. While current long-term interest rates remain relatively low, there also may be an opportunity to lessen future interest rate risk somewhat by rolling some maturing debt over to longer terms.

Managing the two challenges that require immediate attention—the artificial constraints on the economy's potential and the burning fuse to a spending-driven debt explosion—should not distract from planting the seeds for higher long-term economic potential, increased workforce participation, and increased real GDP growth. Normalized monetary policy; financial reform; greater emphasis on education and training as an investment over consumption; inner city and rural area economic rejuvenation; more effective and efficient health care; climate and environment policy that draws on, rather than chokes, our economic strengths; and much more should be on the agenda. There is much to do.

CONCLUSION

Much of the current commentary on the economic policies of the new Administration and Congress uses the fact that the unemployment rate is below five percent (taken to mean close to full employment) to suggest that the economy has recovered. The implication would be that production and output cannot increase very much, unless there is a leap in total factor productivity. The CEA also suggests this and advocates policies that further its preferred technologies or are mixed with social objectives it favors,^{xxviii} to raise the otherwise supposedly inevitable “new normal” of meager growth rates resulting from demographic and other forces outside the Obama Administration's responsibility and control.

But low unemployment only means a small excess labor supply at current wage rates. The low employment-to-population ratio of less than 60 percent reveals that many more people could be working. We also know that the rate of business investment is not back to normal and could be much higher. Finally, we know that CBO lowered its estimate of potential GDP each year since the recession. Hence, we know that labor and capital are available, and if policy takes the right course to attract them back into the market economy, workers can increase output.

Recommendations

- With pro-growth tax and regulatory reforms:
 - Accelerate near-term private investment;
 - Raise the economy's output potential back up;
- Contain, if not reduce, Federal debt;
- Start mandatory spending reform (particularly Social Security).

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- ⁱ “Revisions to CBO’s Projection of Potential Output Since 2007,” Congressional Budget Office, p.1, February 2014. <https://www.cbo.gov/publication/45150>
- ⁱⁱ “The Budget and Economic Outlook: 2017 to 2027,” Congressional Budget Office, January 24, 2017. <https://www.cbo.gov/publication/52370>
- ⁱⁱⁱ CBO estimates real potential GDP based on long-run labor force, capital, and productivity trends. Business cycle fluctuations therefore should not affect potential GDP, yet CBO progressively lowered its projection each year from 2007 to 2016. CBO’s projection in 2007 of real potential annual GDP through 2017 provides a benchmark for the economy’s untapped potential while the reduced estimates provide a measure of the output gap.
- ^{iv} “Revisions to CBO’s Projection of Potential Output Since 2007,” Congressional Budget Office, February 7, 2014. <https://www.cbo.gov/publication/45150>
- ^v 2017 was the last year both CBO’s Economic Outlook releases held in common.
- ^{vi} 2009 dollars.
- ^{vii} The remaining 8 percent comes to changes in “other sectors” of the economy. The aforementioned estimates occurred in the nonfarm business sector of the economy.
- ^{viii} References to the previous expansion’s average in this chapter of the *Response* refer to the period of December 2001 to November 2007.
- ^{ix} References to the current expansion’s average in this chapter of the *Response* refer to the period of July 2009 to the most recent available data.
- ^x ERP 2017, p. 76
- ^{xi} ERP 2017, p. 76
- ^{xii} Measured by the Bureau of Labor Statistics U-3 series. It is frequently referred to as the headline unemployment rate.
- ^{xiii} “Is the ‘Full Employment’ Glass Half Full?” February 10, 2016.
- ^{xiv} “Revisions to CBO’s Projection of Potential Output Since 2007,” CBO.
- ^{xv} “Multifactor Productivity Trends, 2015,” Bureau of Labor Statistics, May 5, 2016. <https://www.bls.gov/news.release/prod3.nr0.htm>
- ^{xvi} “Revisions to CBO’s Projection of Potential Output Since 2007,” CBO.
- ^{xvii} Measured from the BEA’s annual GDP (billions of chained 2009 dollars) series. The same calculation is applied for 2016. At the time of publication, only the advance estimate of GDP was available.
- ^{xviii} “Budget FY 2017 – Economic Assumptions FY 1976 – FY 2017,” Office of Management and Budget, Row 12, Sheet AT, February 2016. <https://www.govinfo.gov/content/pkg/BUDGET-2017-EA/xls/BUDGET-2017-EA.xls>
- ^{xix} “Wall Street Journal January 2015 Economic Survey,” *The Wall Street Journal*, December 2015. <http://online.wsj.com/public/resources/documents/wsjecon1215.xls>
- ^{xx} “10-Year Economic Projections,” Congressional Budget Office, January 2016. <https://www.cbo.gov/sites/default/files/recurringdata/51135-2016-01-economic-projections.xlsx>
- ^{xxi} Bullard, James, “The Rise and Fall of Labor Force Participation in the United States,” Federal Reserve Bank of St. Louis Review, p. 2-3, Q1 2014.
- ^{xxii} We do not know what that capacity is exactly. We do know that we are already in an uncomfortable range when one considers the possibility of another crisis that may cause still larger deficits.
- ^{xxiii} “Federal Debt: Direction, Drivers and Dangers,” September 8, 2016, United States Congress, Joint Economic Committee, Washington, D.C. <https://www.jec.senate.gov/public/index.cfm/2016/9/federal-debt-direction-drivers-and-dangers>
- ^{xxiv} Net interest consists of the government’s interest payments on the debt held by the public minus interest income the government receives.
- ^{xxv} “The Budget and Economic Outlook: 2017 – 2027,” CBO, p. 92.
- ^{xxvi} The Coalition for Fiscal and National Security is chaired by retired Navy Adm. Mike Mullen, former Chairman of the Joint Chiefs of Staff, and includes former Secretaries of State Madeleine Albright and Henry Kissinger, former Defense Secretaries Robert Gates and Leon Panetta, and former National Security Advisers Zbigniew Brzezinski and Brent Scowcroft.

^{xxvii} Wong, Kristina, “National security experts sound alarm on long-term debt,” *The Hill*, May 10, 2016.
<http://thehill.com/policy/defense/279320-prominent-group-says-long-term-debt-the-single-greatest-threat-to-us-national>.

^{xxviii} ERP 2017, p.145