

Prepared Testimony for the Hearing “The Economic and Fiscal Benefits of Pro-Growth Policies”

Jason Furman
Senior Fellow, Peterson Institute for International Economics

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Committee on the Budget

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Chair Black, Ranking Member Yarmuth, and Members of the Committee:

Thank you for the opportunity to testify on the important topic of the economic and fiscal benefits of pro-growth policies. In my testimony today I would like to make five points:

1. The growth rate has been slower over the last decade primarily because of demographic factors. The baby boom generation contributed to growth from the 1970s up until about a decade ago, but now the generation is beginning a retirement boom that is subtracting from growth. In addition, women’s entry into the workforce from the end of World War II to about 2000 was another engine of growth that cannot be repeated on the same scale a second time.
2. Additional economic growth would be welcome and would help both increase household incomes and improve the long-run fiscal outlook.
3. Additional demand could help strengthen the economy in the short run, but with the cyclical recovery largely complete, faster growth will require a combination of faster productivity growth and an expanded labor force.
4. A number of budgetary policies would contribute to these goals. Productivity growth could be enhanced by well-crafted, revenue-neutral business tax reform and increased investments in public infrastructure and research. The labor force could be expanded through active labor market policies and efforts to make workplaces more flexible for workers. Finally, immigration reform and expanded educational opportunity would boost both productivity growth and the labor force.
5. A number of fiscal policies advanced by President Trump would worsen economic growth. These include unpaid-for tax cuts, reductions to infrastructure and research investments, and reductions to safety net programs that foster mobility. Other policies, like restrictions on immigration and restrictions on trade, would also worsen economic growth. While some policies could have a very small positive impact on measured economic output, these effects would not be sufficient to overcome their other drawbacks.

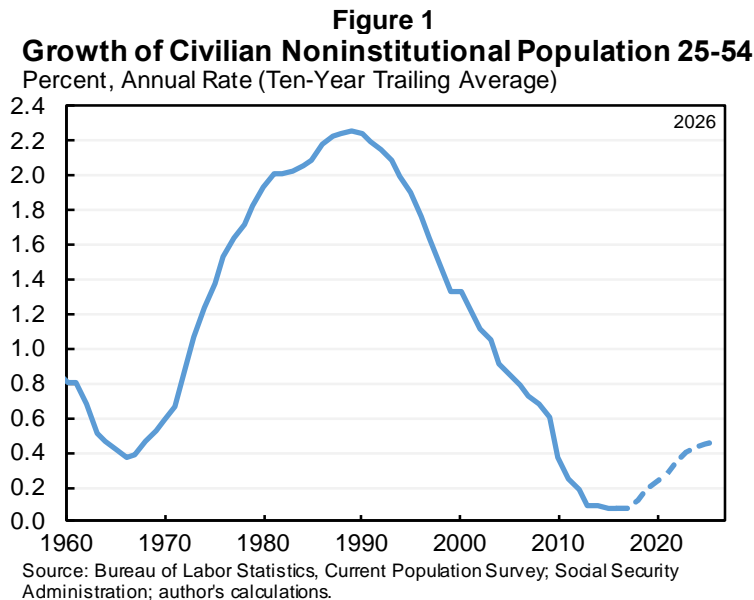
Let me now elaborate on these five points.

Point #1: The Growth Rate Has Been Lower Primarily Because of Demographic Factors

During the Reagan era, the economy grew 3.1 percent a year, with some arguing that this growth was spurred by tax cuts and regulatory reforms. A closer look, however, shows that the 1980s are not an argument for optimism—precisely the opposite.

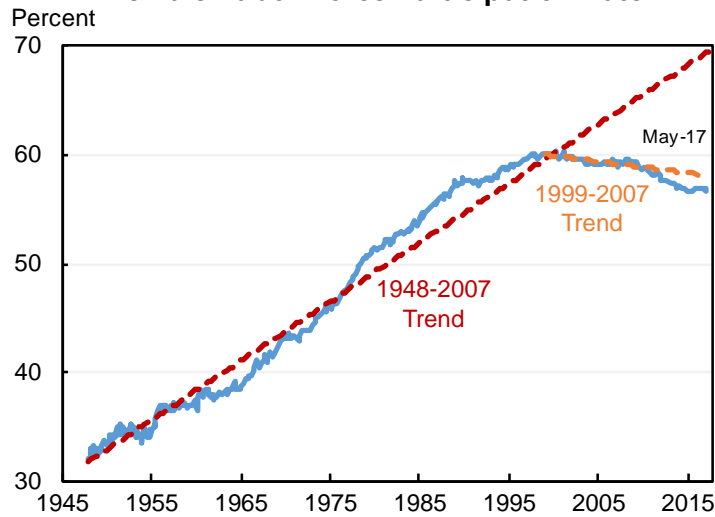
There are two components to economic growth: adding more workers and increasing their productivity. Faster growth in the 1980s was the result of the former, an expanding workforce driven by two irreproducible demographic factors: the baby boomers’ entering their prime working years, and women’s continuing influx into the workforce. From 1980 to 1990, labor productivity—the amount of goods and services the average worker can produce in an hour—grew only 1.6 percent a year, below the figure marked since 2001.

Today, the baby boomers are hitting retirement. As a result, Reagan-era productivity gains of 1.6 percent a year would now generate economic growth of only 1.7 percent. The dramatic change in the demographic outlook can be seen clearly in Figure 1, which shows that in the 1980s the prime-age (25-54) population was growing at over 2 percent a year, while it has barely increased over the last.



In addition, as Federal Reserve Chair Janet Yellen (2017) has said, “women’s incorporation into the economy contributed importantly to the rapid rise in economic output and well-being over the 20th century”. This can be seen in Figure 2, which shows how the share of U.S. women either employed or looking for work—known as the labor force participation rate—rose from 33 percent in 1948 to 60 percent in 1999 before it levelled off and started declining. As I will discuss later on, there is certainly room for further increases in women’s labor force participation, but nothing like the sustained upswing of the second half of the 20th century.

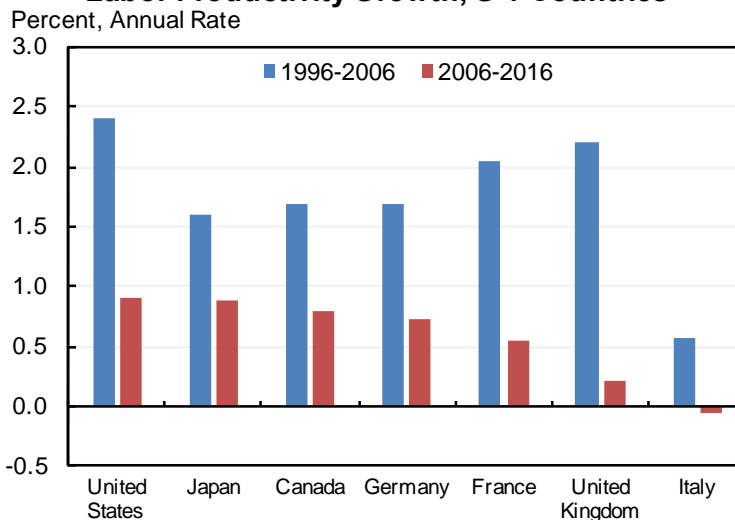
Figure 2
Female Labor Force Participation Rate



Source: Bureau of Labor Statistics, Current Population Survey; author's calculations.

Although demography has been the largest source of the slowdown in growth in the past decade, it is also the case that productivity growth has been disappointing. This has been a worldwide trend, as productivity growth has slowed in nearly all of the advanced. In fact, the United States has actually had faster productivity growth than the other G-7 economies, as Figure 3 shows. This strongly suggests that the major sources of the productivity growth slowdown are not U.S.-specific factors like the passage of the Affordable Care Act (ACA) or the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Figure 3
Labor Productivity Growth, G-7 Countries



Source: Conference Board, Total Economy Database; author's calculations.

The unfavorable demographic headwinds will continue over the next decade, but economic forecasters are generally expecting a rebound of productivity growth from 1.2 percent a year over the last decade to around 1¾ percent, which is the average over the last four decades.

Together with the known path of demographic trends, this would be sufficient to generate economic growth of about 1.9 percent a year—the same as expectation of the Congressional Budget Office (CBO) and close to the median expectation for long-run growth of Federal Open Market Committee (FOMC) participants. The Blue Chip consensus forecast is slightly higher at 2.0 percent, as shown in Table 1.

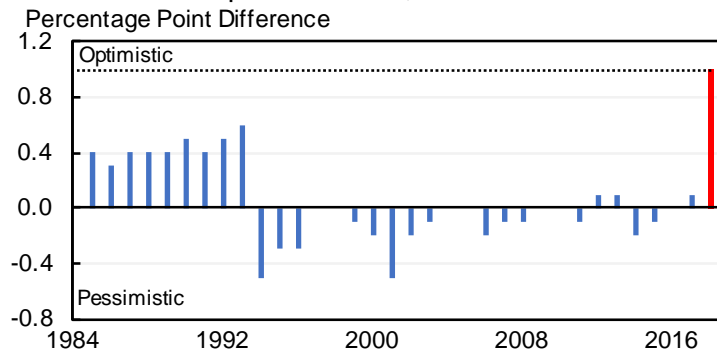
Table 1
Summary of Long-Run Economic Growth Projections

Forecaster	Long-Run Annual Real GDP Growth (Percent)
International Monetary Fund (IMF)	1.7
Federal Open Market Committee (Median)	1.8
Congressional Budget Office	1.9
World Bank	1.9
Blue Chip consensus forecast	2.0
Consensus Forecasts	2.1
Organisation for Economic Co-operation and Development (OECD)	2.4
Trump Administration	3.0

Source: Office of Management and Budget; Congressional Budget Office; Board of Governors of the Federal Reserve System; Blue Chip Economic Indicators; Consensus Economics Inc.; International Monetary Fund, *World Economic Outlook*; Organisation for Economic Co-operation and Development; World Bank; author's calculations.

The Trump Administration’s economic forecast of 3.0 percent long-run growth is a major outlier. In fact, as shown in Figure 4, the current Administration’s forecast is the largest outlier in an ultimate growth rate forecast in over three decades. Hitting this target would require productivity growth rates about as high as the United States has ever experienced. My own detailed simulations put the odds of hitting or exceeding this target at 4 percent (Furman 2017).

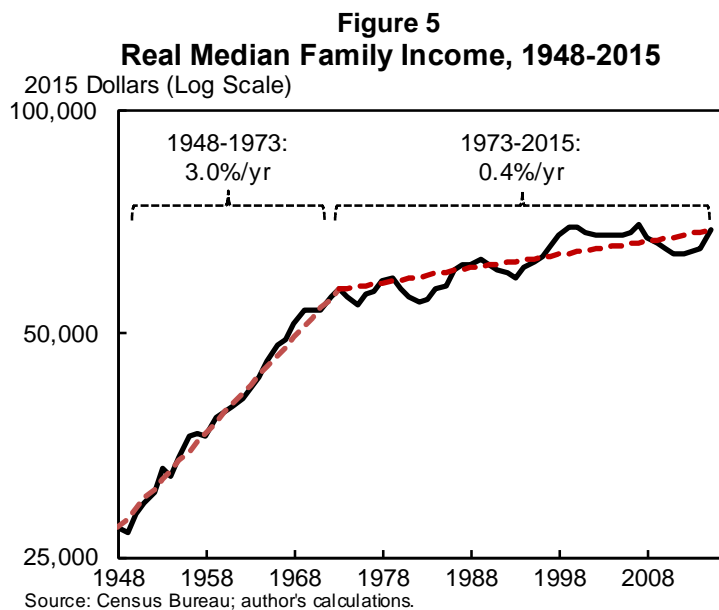
Figure 4
Trump Forecast More Optimistic Than Any Administration Since the 1980s:
Long-Run Real Output Growth Forecast, Administration vs. Blue Chip Consensus, FY 1985 - FY 2018



Note: Difference in annual growth rate in last year available for both sources. Forecast is for real GNP prior to FY 1993 and real GDP thereafter.
Source: Office of Management and Budget; Congressional Budget Office; Blue Chip Economic Indicators; Congressional Research Service; author's calculations.

Point #2: Additional Growth Would Be Welcome for Both Household Incomes and the Long-run Budget

From 1948 to 1973, the typical U.S. family saw its income rise 3.0 percent a year, as shown in Figure 5—a pace at which incomes double roughly every generation. Since 1973, however, median family income growth has slowed to only 0.4 percent a year—a pace at which it takes over a century for incomes to double. The largest factor in this slowdown has been slower economic growth, largely because the productivity growth rate fell from 2.8 percent a year in the first period to 1.8 percent a year in the second period. Another important factor in the slowdown in family income growth has been the increase in inequality: in 1973, the bottom 90 percent of households received 69 percent of income, but by 2015 that figure had fallen to 50 percent of U.S. income. This combination of a slower-growing pie and its increasingly uneven division has been very challenging for American families.



Faster economic growth would help support stronger income growth for U.S. households. Over the last four years, for example, real compensation has increased at a 1.2-percent annual rate—which exceeds the 0.8-percent annual growth rate of productivity. This is possible over a shorter period of time as the profit share has been compressed, but over the longer run the only sustainable basis for more rapid wage and income gains is faster economic growth.

Increased economic growth would not, however, guarantee faster income growth for middle-class households. If the gains from any increase in productivity growth were largely enjoyed by high-income households and if inequality were to increase as a result, then the typical household might still see slow income growth. This is why it is important that growth is both sustained *and* widely shared.

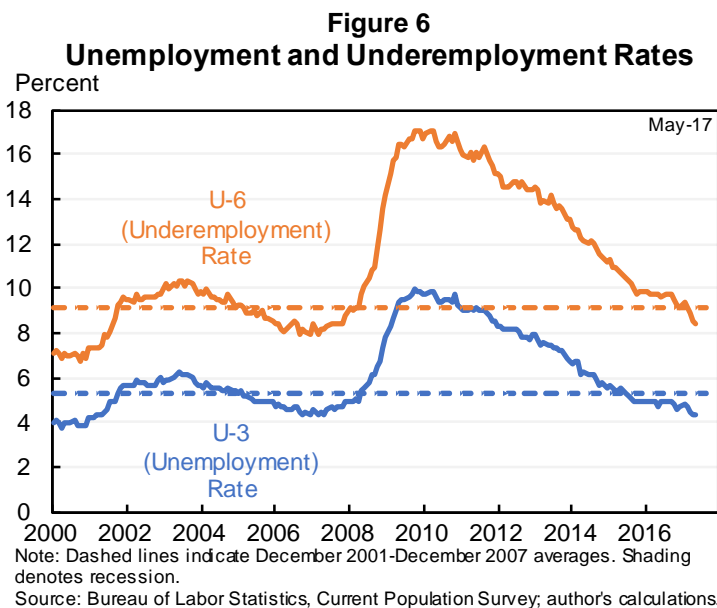
Additionally, faster economic growth would be favorable for the fiscal outlook—reducing the magnitude of spending cuts or tax increases needed for long-run fiscal sustainability. Based on CBO (2017), a one-quarter point increase in the annual growth rate of productivity would reduce

deficits by \$340 billion over the next decade—amounting to 0.5 percent of GDP in the tenth year of the budget window. These effects compound over time, so the impact on the long-range forecast is even more dramatic. The Office of Management and Budget (2016) estimated that this increase in productivity growth would reduce the 25-year fiscal gap by 0.8 percent of GDP, closing roughly half of the fiscal gap.

Point #3: Going Forward, the Main Source of Increased Growth Will Be Expansions in Supply, Although More Demand Could Also Help

Economists break growth into two sources: (i) cyclical and (ii) structural. Cyclical growth comes about as more underutilized resources are put back into production—notably, as the unemployment rate declines. Structural growth—also called potential growth—is dependent both on the underlying growth of the labor force and on its productivity.

The unemployment rate peaked at 10.0 percent in 2009. Since then, declining unemployment has helped to undergird the cyclical component of growth as more Americans have been put back to work. But, as shown in Figure 6, both the headline unemployment rate (U-3) and a broader concept that includes discouraged workers, marginally attached workers, and those working part-time for economic reasons (U-6) are now below their respective pre-crisis levels. There still may be some additional room for cyclical expansion as workers rejoin the labor force—helping to boost the age-adjusted participation rate—but likely not a substantial amount.



Going forward, sustained growth will require either faster growth in output per hour (productivity growth), faster population growth, or an increase in the fraction of the population in the workforce. Some increase in each of these is possible with the right policies, as I will discuss in my next point.

Point #4: Sound Policies Could Increase the Growth Rate

No single magic bullet would transform the outlook for U.S. growth. But a combination of policies could have a meaningful effect over time. The following is not a complete list, but it is indicative of some budget policies, or at least policies with major budgetary implications, that would increase the level of output and thus, over a given period, the growth rate:

Selected Policies That Would Primarily Increase Productivity

- **Revenue-neutral business tax reform.** The United States has high statutory tax rates but an uneven tax base that does not result in substantial revenue collection. In addition, our international system is broken. Tax reform that would cut the corporate rate to around 28 percent, shift to more of a cash-flow tax base, and pay for these changes by eliminating major tax expenditures and reforming the international system would have the potential to improve the quality of capital formation and thus boost economic growth.
- **Infrastructure and scientific research.** From 2010 to 2015, U.S. public investment averaged only 3.8 percent of GDP, a fraction that has fallen over time and puts us 16th among members of the Organisation for Economic Co-operation and Development (OECD). At the same time, public investment in research and development (R&D)—which focuses on higher-risk, more basic research than private R&D—has also fallen as a share of the economy since the 1960s and is now less than 1 percent of GDP. The economic evidence clearly shows that increased investment in these two areas would have high returns going forward.

Selected Policies That Would Primarily Boost the Workforce

- **Active labor market policies, including training, job search assistance, and subsidies for jobs.** The United States has among the lowest labor force participation rates for prime-age workers of any of the OECD economies. There is substantial scope to boost participation, which would help to offset some of the demographic challenges going forward. Part of the participation challenge we face is due to the fact that the United States invests only 0.1 percent of GDP in helping to train people for jobs, find people jobs, or, when necessary, subsidize those jobs, a level that puts us third from the bottom in the OECD. Expanding training in well-targeted, evidence-based ways, better integrating job search assistance into unemployment insurance, and subsidizing jobs in a range of circumstances—including expanding the Earned Income Tax Credit (EITC) for lower-income workers without children and establishing wage insurance for older workers who cannot find higher-paying jobs—would all be helpful.
- **Flexible workplaces.** U.S. workplaces are very flexible for employers but much less so for workers. The United States is one of two countries in the world without a national paid leave law and also lacks mandatory provision of sick leave for workers. Federal legislation to establish a public program for paid leave and to mandate employers to cover sick leave would make workplaces more flexible and help keep workers attached to jobs, increasing labor force participation—especially for women.

Selected Policies That Would Simultaneously Boost Productivity and the Workforce

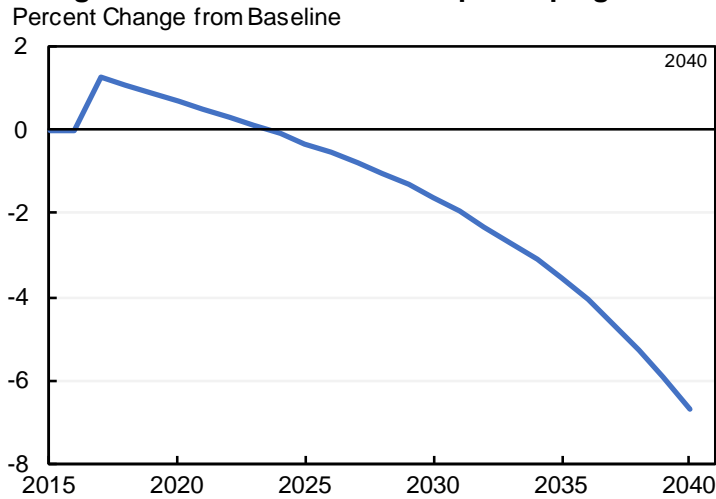
- **Immigration reform.** One of the biggest policy levers to increase growth would be to reform the U.S. immigration system. The bipartisan legislation passed by the Senate in 2013 would have strengthened border security, reformed the system for legal immigration, and provided a pathway to citizenship for undocumented immigrants. CBO (2013a) estimated that the Senate bill would add 5.4 percent to real GDP after two decades both by expanding the U.S. labor force and by attracting skilled immigrants and creating more certainty for the undocumented, boosting productivity and innovation. Additionally, this legislation would have reduced the deficit by \$843 billion over the following twenty years— even without counting its full dynamic benefits for the economy (CBO 2013b).
- **Education from pre-school through college.** Finally, additional investment in everything from pre-school—where the United States lags substantially—through college is a well-established way to increase skills, both boosting productivity growth and raising labor force participation by helping Americans connect with high-quality jobs.

Point #5: Unsound Policies—Including Many Advanced by the Trump Administration— Could Reduce the Growth Rate or Lead to Undesirable Tradeoffs

A number of policies pursued by the Trump Administration, however, have the potential to reduce longer-run growth. In my testimony I will discuss on three specific fiscal policies: unpaid-for tax cuts, reductions to infrastructure and scientific research, and cuts to the social safety net. It is important to note that while I will not discuss policies advanced by the Administration that are outside the fiscal area, including restrictions to immigration and trade, these efforts could also have a deleterious impact on economic growth.

- **Unpaid-for tax cuts.** Tax rate reductions can lead to increased work, savings and capital formation—increasing the level of output and, over a period of time, the growth rate. But increases in the deficit have the opposite effect. While they may help expand demand in the short run, over the medium and long run, increases in the deficit lower national savings, reducing capital formation and increasing foreign borrowing—both of which reduce national income and growth over time. The Tax Policy Center, in collaboration with the Penn-Wharton Budget Model, estimated that the tax cuts proposed by President Trump during the 2016 campaign would follow this pattern: they would increase output initially, but over time the costs of higher deficits would outweigh the benefits of tax cuts, leading to a reduction of 4 percent in output after twenty years, as shown in Figure 7 (Nunns et al. 2016). The tax principles put forward by the Administration in April are similar but somewhat smaller than the campaign plan, so one should adjust this analysis accordingly. CBO, the Joint Committee on Taxation (JCT), and the Bush Administration Treasury Department have all reached a similar conclusion that deficit-financed tax cuts can hurt the economy in the medium and long run (Dennis et al. 2004; JCT 2005; OTA 2006).

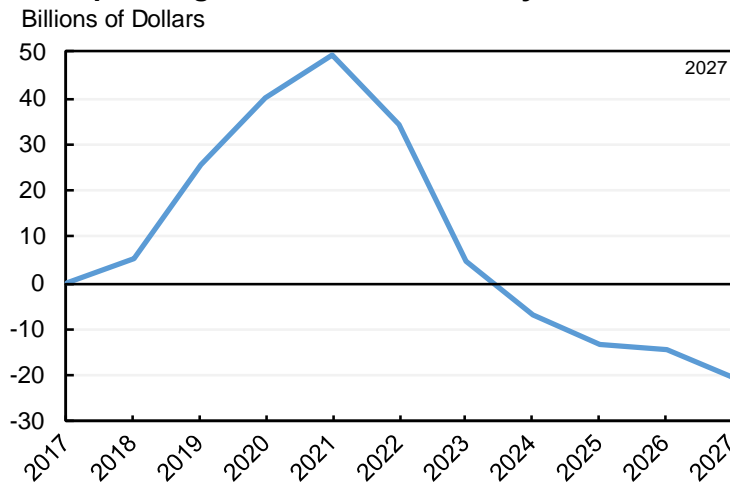
Figure 7
Change in Real GDP Under Trump Campaign Tax Plan



Note: Based on medium elasticities scenario.
 Source: Nunns et al. (2016); author's calculations.

- Reductions to infrastructure and science.** The President’s Budget also includes large, immediate reductions to scientific research and over time also reduces investments in surface transportation infrastructure. President Trump’s Budget proposes substantial cuts to investments in science in FY 201, including a 22 percent cut for the National Institutes of Health (NIH) and an 11 percent cut for the National Science Foundation (NSF). The Budget proposes an initial boost to infrastructure, but, beginning in 2021, proposes to limit highway spending to current levels of receipts without any proposal to boost receipts or bring in additional funding. As the *Analytical Perspectives* of the Budget notes, “Relative to baseline levels, this presentation shows a reduction in total HTF [Highway Trust Fund] outlays by \$95 billion over the 2021-2027 window” (OMB 2017). The result of this combination of a \$200 billion increase in infrastructure spending and eventual reductions to highway spending would be an initial modest boost to infrastructure followed by growing reductions, as shown in Figure 8.

Figure 8
President's FY 2018 Budget: Change in Infrastructure Spending Relative to Baseline by Fiscal Year



Source: OMB (2017).

- Cuts to safety net programs that benefit children, like Medicaid, nutrition assistance, and tax credits for low-income households.** The Budget also makes dramatic cuts to safety net programs, including (but not limited to) Medicaid, the Supplemental Nutrition Assistance Program (SNAP), the Children’s Health Insurance Program (CHIP), Temporary Assistance for Needy Families (TANF), unemployment insurance (UI), and the EITC—a total of \$2.5 trillion in cuts to programs for low- and moderate-income households. Economic researchers have not quantified the impact of these specific programs on aggregate macroeconomic performance, but there are three reasons to be concerned that these cuts could have a negative impact on the U.S. economy as a whole. First, there is substantial and credible microeconomic evidence that a wide range of programs that benefit children—such as Medicaid, SNAP, housing vouchers, and the EITC—have substantial long-run benefits for the children in households that receive them, including greater likelihood of graduating from college, higher lifetime incomes, and improved health; all of these outcomes would improve the performance of the U.S. economy in aggregate (Furman 2017a; Cohodes et al. 2016; Hoynes, Schanzenbach, and Almond 2015; Chetty, Hendren, and Katz 2016; Manoli and Turner 2014). Second, more speculatively, economists at the International Monetary Fund (IMF) and OECD have found evidence that suggests that programs that reduce aggregate inequality could boost aggregate growth (Ostry, Berg, and Tsangarides 2014; OECD 2015). Finally, many of the cuts proposed by the Trump Administration would shift costs to States—reducing growth to the degree that some States address declines in Federal contributions by redirecting funds from other, growth-enhancing areas of State expenditures like education and infrastructure.

Finally, it is important to emphasize that in some cases policies that would have a small positive impact on growth that would not be sufficient to justify the tradeoffs inherent in those policies. For example, suppose that raising taxes or cutting benefits by an average of \$10,000 a year on the bottom 90 percent of households to pay for an average tax cut of \$100,000 a year for the top 10 percent of households was shown to increase the average annual growth rate by 0.2

percentage point per year for the next decade. The typical household would see its income boosted by about \$1,000 by the higher growth but would lose \$10,000 in taxes or benefits—making them worse off on net. Moreover, to the degree that the \$1,000 in additional income was generated by additional work by members of the household, they would also lose valuable leisure or family time—making the net reduction in household welfare even worse (Furman 2016).

This example sounds hypothetical, but a number of proposed policy changes have this character. For example, CBO (2015) estimated that full repeal of the ACA without replacement would increase the average annual growth rate by less than 0.1 percentage point over the next decade. This estimate may miss some of the positive effects of the ACA on growth, like the positive effects of access to health insurance on workers' health and the increased flexibility that the ACA exchanges provide to workers who want to switch jobs. But assuming CBO's estimate is correct, this would boost the income of a household at the 20th percentile of the distribution by about \$200 after a decade—a tiny fraction of the thousands and in some cases tens of thousands of dollars the household could lose in tax credits and/or Medicaid benefits.

Similarly, regulatory reform—which I do not discuss in my testimony because it is outside the scope of the budgetary policy I have focused on—can in some cases be a sensible way to improve the efficiency of meeting existing goals. In other cases, however, regulatory reform may reduce costs for businesses and produce a small additional increment of growth at the expense of much more valuable goals like worker safety or environmental protection and conservation.

Conclusion

Much of the underlying cause of slower growth rates in the last decade—namely, demography—will not change. Policymakers need to realistically assess the prospects for future growth and make policy decisions based on conservative, plausible expectations for the coming years. At the same time, policymakers should actively push for the types of policies that increase economic growth while avoiding policies that either would reduce growth or would generate very small amounts of growth at the expense of broader goals.

Thank you, and I would be happy to take your questions.

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