THE MPACT REPORT

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Can the American Economy Break Out of its Growth Slump?

By W. Michael Cox and Richard Alm

Economies grow through activities that increase the output of goods and services. These include working smarter or longer, saving and investing, innovating and starting new businesses, improving skills and learning, buying and selling. In a free-enterprise system, higher pay and profits reward those who undertake these productive activities.

Add up the microeconomic output additions for three months or a year, and we get the macroeconomic number that makes headlines and moves markets—growth in gross domestic product (GDP), the broadest measure of our economy's health.

At times, GDP growth soars, taking stocks on a giddy upward ride. At other times, the economy sinks into the gloom of recession, pummeling investors. And, somewhere in between, there are periods of sluggish growth, the most recent being the 10 years since the Great Recession.

GDP increased by an annual average of 1.4 percent from 2008 to 2017. The projection for the decade that just started isn't much better—less than 2 percent. These GDP readings look anemic in historical perspective. Growth averaged around 4 percent from 1948 to 1967, followed by more than 3 percent from 1968 to 2007 (*see chart below, black bars*).

Breaking down the aggregate data shows that productivity growth *(green bars)* and working-age population growth *(blue bars)* have been the leading factors in pushing the economy forward since 1948. Changes in labor force participation *(red bars)* and the unemployment rate *(yellow bars)* made smaller contributions. At times, they've been drags on growth, notably labor force participation since 1998. Declining hours of work have lowered growth in every decade *(purple bars).*

This issue of *The MPACT Report* looks at America's growth slump, seeking its roots and asking how it might be reversed. Few issues are more important. For most of its history, the United States has seen faster growth as key to good jobs and higher living standards—that is, the American Dream of a better life. The government's fiscal policy rests squarely on an assumption of continued strong growth to pay debt and keep the promises made to ordinary Americans, such as Social Security.

Investors count on growth, too. Stock prices reflect interest rates, personal and corporate tax rates and expectations for future earnings. The latter benefits from faster economic growth, which raises companies' revenues, pumps up earnings and supports higher share prices.

Two ratios verify the links from economic growth to earnings and from earnings to stock prices. First, earnings have tracked GDP since 1947—at a relatively stable 6 percent to 11 percent before taxes and 4 percent to 7 percent after taxes. Second, the well-known P/E ratio, adjusted for the business cycle's ups and downs, shows prices averaging 15 to 20 times after-tax earnings since the early 1880s.

Households, politicians, investors—they all have good reason to want faster growth. President Trump has vowed to deliver it by lowering taxes and cutting regulatory burdens. However, faster growth is easier said than done. Obstacles stand in the way, some demographic, some the side-effects of policy. At the

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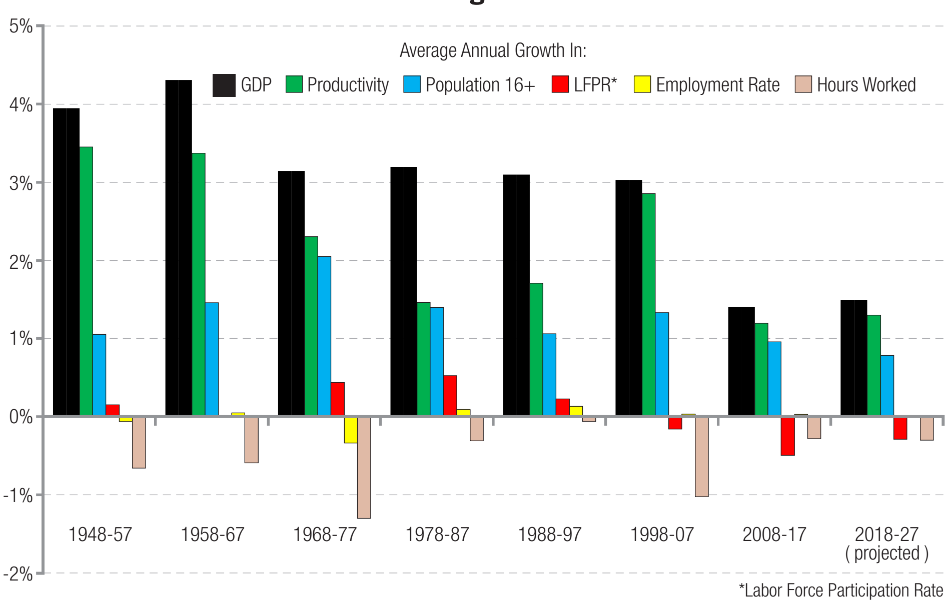
Not What It Used to Be—Declining U.S. Growth Over 8 Decades



same time, the arrival of the digital era raises concerns about how well traditional GDP measures economic growth.

PRODUCTIVITY'S CONTRIBUTION

From 1948 to 1967, when economic growth was its most robust, surging output per hour accounted for about 3.5 percentage points of America's economic growth. In the decades that followed, the country approached this productivity performance only once—in 1998-2007. After that, productivity added just 1.2 percentage points to growth, its lowest rate in seven decades. The outlook for the next 10 years shows only a slight improvement.

Productivity gains come from companies investing in whatever makes them more efficient—structures, machinery, information technology, business practices (i.e., supply chains). In the past decade, investment as a share of GDP was roughly half what it was in the highest-growth years *(see chart right)*. Spending on structures continued to dwindle, while outlays for equipment have picked up a bit.

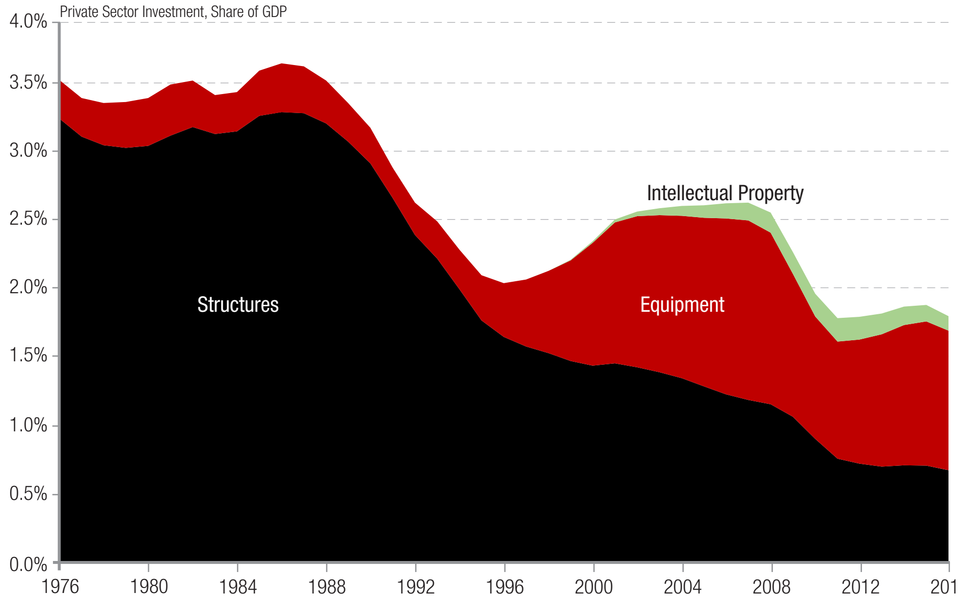
To achieve faster growth, the economy needs a lot more investment. Money doesn't seem to be a major issue. Corporate profits are high. Interest rates are low. Apple and other companies sit on piles of cash. What's holding corporate America back?

A decade of slow growth is part of it. Investment decisions hinge on rates of return, and companies find it hard to justify spending to increase output when the economy remains soft. With stock prices soaring, there's a surer return in buying back company stock.

Taxes and regulations are both drags on productivity growth. Spurring investment lies behind December's law to reduce the federal government's top corporate tax rate from 35 percent, one of the highest in the world, to 21 percent, more in line with the global average.

Lower rates tend to boost after-tax earnings, and the hope is that companies will use their tax savings to increase their investment budgets. Forecasts on the size of the tax bill's investment dividend differ —but it's not likely to bring productivity all the way back.

U.S. Investment on a Downward Trend in Recent Decades



Regulations raise costs and divert investment dollars from productivity to meeting bureaucratic dictates. Changing rules already in place involves lengthy procedures, so any productivity payoff may take a long time. For the short term, at least new regulatory burdens are less likely.

Better educated and higher skilled workers are more productive, so improving workforce quality is also important to faster economic growth. More elementary and high school students need to learn basic math and reading skills. More college students need to choose majors like engineering that prepare them for highly productive jobs.

Big obstacles stand in the way. Public education caters to unions and spends more on administration than on teaching. School choice has spread in recent years, which promises to help at least in some places. Even if education could be improved starting today, it would take a decade or more to make an impact on productivity and growth.

LABOR'S CONTRIBUTION

The more Americans work, the faster the economy will ramp up production. Key metrics are the size of the working-age population, the share of that population available for work, how many of them find jobs and the hours they work.

Working-age population. America has been getting older—and that's not good for growth. In 2016, those over age 65 made up the largest segment of the population—19.4 percent (*see next page*). The cohort's share is likely to rise in the next decade as rest of the Baby Boom generation ages. In the past 20 years, people aged 55 to 64 have been the fastest-growing segment of the population.

Younger cohorts have been declining as a share of population for decades, with the youngest (16-24 years old) at its lowest point in 2017. New workers will turn 16 and join the working-age population over the next decade, but not fast enough to alter the country's basic demographic trends.

Over the next 10 years, projections call for an annual increase of 0.8 percentage point in the working-age population—the slowest rate in seven decades. Because everyone who will enter the workforce in the next decade has already been born, population growth isn't likely to lead a revival of economic growth.

Admitting several million working-age immigrants could quickly expand the U.S. population. However, the political climate isn't favorable for an opening to foreign-born workers. Just the opposite, recent Trump administration proposals seek sweeping reductions of *legal* immigration.

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Labor-force participation. Not all adults are working or seeking employment. Some stay home to raise children, others receive disability checks and still others remain idle because of discouraging job prospects.

The share of the population over age 16 available for work rose from the early 1960s through 2000, largely because of women entering the job market *(see chart below, black line)*. In the past 17 years, the labor-force participation rate has declined from 67.1 percent to 62.9 percent. Aging and other demographic changes are a large part of the story *(blue line)*.

In the past two years, a healthy economy with more jobs and rising wages has drawn people into the labor force, bringing an uptick in the participation rate. The key to additional gains is making work more worthwhile. Lower income and payroll taxes increase take-home pay and boost incentives to work—so the recently enacted individual tax cuts are at least a small step in the right direction.

Other policies discourage labor force participation—from disability payments to Social Security. Political realities make it unlikely that Congress will pursue meaningful changes that may favor work but alienate many voters.

Getting larger numbers of Americans into the workforce will be difficult.

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Declining labor-force participation has been a drag on the economy since 1998, and it's likely to reduce the average annual growth rate by a projected 0.3 percentage point in the next decade.

Employment rate. Working-age population and labor-force participation define the pool of potential employees; the employment rate tells how well the economy puts them to work. An economy with a low unemployment rate is doing a better job of using its labor resource to support growth.

Over the past seven decades, the employment rate has been a minor factor in average annual growth rates. That's not likely to change with the U.S. unemployment rate already below 5 percent. In projections for 2018-27, the employment rate shows no impact at all on growth.

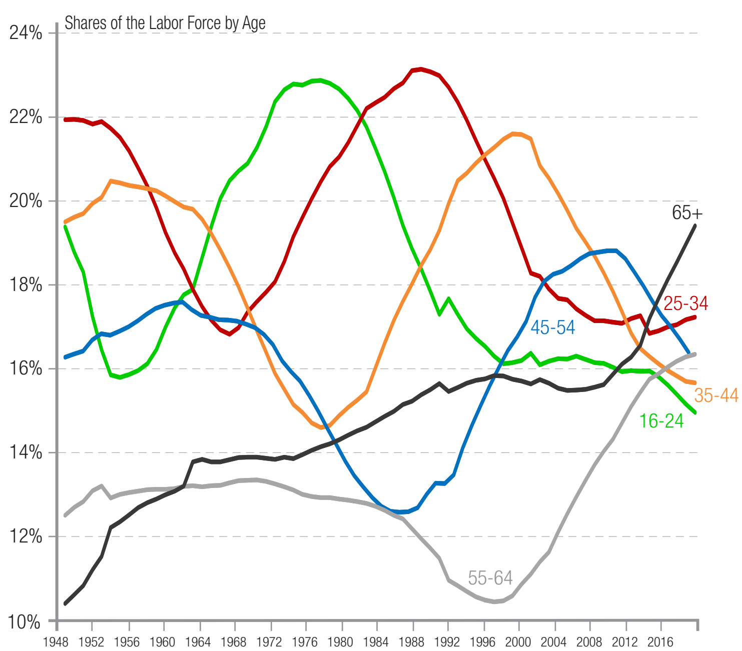
Hours of work. Anecdotal stories of overworked Americans run counter to data that show the average work week has been shrinking for a century or more. In effect, workers have chosen additional leisure time over higher incomes from more hours of work.

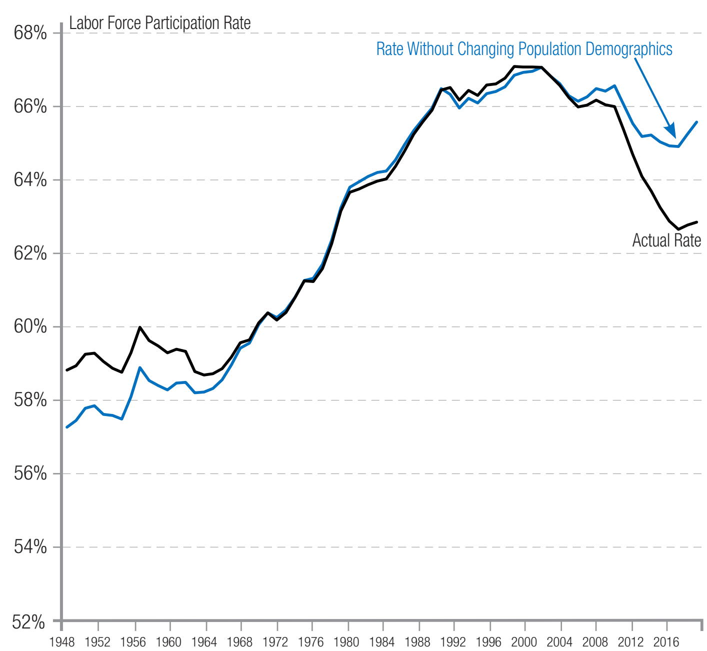
This long-term preference—a hallmark of a wealthier society—isn't going to suddenly reverse itself. According to the projections, hours of work will diminish GDP growth by 0.3 percentage point in the next decade.

THE GDP CONUNDRUM

Higher productivity gives the economy its best shot at faster growth, especially if lower corporate tax rates and deregulation remain in place and deliver as promised. Even in the best scenario, however, getting back to the productivity gains of four decades ago will be a long shot. Productivity won't get much help from demographic and labor-force trends,

It's Not Working: Population Getting Older (Left), More Adults Opting Out of the Labor Force (Right)





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which are likely to continue as drags on economic growth.

That sounds gloomy, but we'll end on a more upbeat note. The way the Commerce Department measures GDP is a relic of the industrial era, when the economy largely produced physical goods that are relatively easy to count and value—like automobiles and tons of steel.

In today's economy, physical goods are a smaller share of GDP and intangibles account for a larger and growing share. How do we value Google maps, You Tube videos, the Internet and free apps for digital devices? They're worth a lot more than we pay for them.

The rise of the digital economy makes GDP harder to measure accurately—at least with the accounting methods used since the World War II era. Capturing the full value of digital output would increase U.S. GDP in the past decade and the one to come, probably by a large margin. If GDP were measured at its true value, then economic growth would be faster.

America would still benefit from the improving incentives for microeconomic activities that increase the output of goods and services. Productivity and work still matter, but the economy may be doing better than what we've seen in the measured GDP numbers.

Intrigued? We'll examine the rise of intangible output more fully in the next issue of *The MPACT Report.*

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CHARTING THE ECONOMY

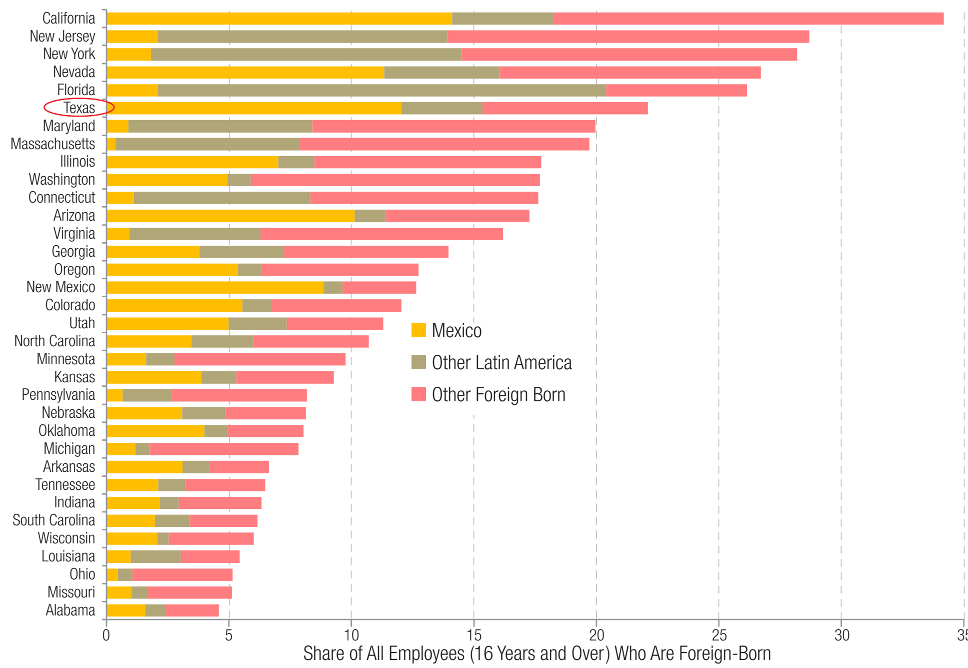
Different Views on National Issue: States Vary in Size of Foreign-Born Workforces

Immigrants accounted for 16.7 percent of the U.S. workforce in 2016, up from 8.9 percent two decades earlier. These workers weren't distributed evenly across the country.

At 34.3 percent, California had the highest share of foreign-born workers (*see chart*). Other states with a high reliance on foreign-born workers were New Jersey, New York, Nevada and Florida—all above 25 percent. Texas comes next at 23 percent.

The workers' origins show differing patterns. For California, Texas and Nevada, the largest share of immigrant labor came from Mexico. New York, New Jersey and Florida also had heavily Hispanic foreign-born workforces, but they received small inflows from Mexico and large ones from the rest of Latin America.

Coastal and border states employ the largest shares of foreign-born labor. Most states in the single digits lie inland. Even where immigrant penetration is low, the largest shares come from Mexico and Latin America—with the notable exceptions of Ohio and Michigan.



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