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The Long and the Short of It: Dilemmas for U.S. Growth

Alan Blinder at a recent LEAD Conference at Georgetown University said that the U.S. report card should be marked, "needs improvement," next to both "growth" and "sharing of income gains." In what he calls "a horribly muddled debate," Blinder reminds us that growth is demand-driven in the short run and supply-driven in the long run. This is an important dichotomy to keep in mind, although how government produces short-term rebounds through counter-cyclical policy normally worsens the fiscal picture unless matched by enlightened supply-side inducements. Since the U.S. economy will remain below its potential growth rate for many years, the combination of short-run demand stimulus and long-term supply-side policies that can accompany a 10-year deficit reduction plan is in Blinder's view our best bet. But the challenge is how to raise growth. Given that the U.S. has averaged 2 percent real growth over the past 100 years, a rise to 2.2 percent on a sustainable basis would be quite an achievement.

The challenge, of course, is how to create more growth, and ensure greater equality in the sharing of that growth. This latter concern was less troubling in the 1960s and 1970s, when the top 1 percent commanded less than 8 percent of national income, than in 2007, when the top tier gained 23.5 percent, according to Piketty and Saez.

On the growth imperative, one can imagine the workforce as being fairly stable, except for immigration, and the capital stock increasing slowly – if at all – due to the net impact of new investment minus depreciation. Most efforts to increase private investment focus on either interest rates or tax incentives, but neither works well in times of uncertainty. In uncertain times, only the government can act, but this uses up precious fiscal space in the immediate time horizon.

In light of these dual objectives of short-term demand management and long-term supply creation, increased infrastructure spending may well be the answer, especially since public spending can draw in complementary private investment spending. That said, the notion of a National Infrastructure Bank has never gained traction in Congress, even before the mortgage crisis cast a pall on public-led borrowing for private sector projects. Increasing investment, however, can have three merits: it can create jobs; it can improve efficiency; and it can improve productivity. High-speed rail investments score better than painting bridges on these criteria.

Other drivers of better productivity rely on educational improvements. The U.S. now lags in educational outcomes, although we still do well in innovations due to the quality of higher education, vibrant competition in most sectors and low barriers to entry and – until recently – flush markets for venture capital. With services dominating GDP, a more capable work force combined with smart IT can improve productivity.

Long-term budget management rests with a restoration of growth and a better revenue path along with reductions in mandatory expenditures, largely in health care. But where to begin is the question? Stimulating more economic growth may well be the easiest path, preferable in the near term at least to fixing the tax code. While reducing loopholes and privileges would help long-term fiscal sustainability and improve resources allocation, it would reduce aggregate demand in the short term and propel lobbying to a new level of frenzy. Reducing health-care expenditures, also highly desirable for fiscal sustainability, is however complicated, and difficult to do in times of high unemployment and uncertainty.

So where do we come out? We know that there are basic trade-offs between the short- and long-run. Unfortunately, however, the lack of long-term supply-side solutions on infrastructure, educational attainment, and budget sustainability reduces the impact of demand management efforts. Even non-Ricardians are rational and want to see a viable fiscal path. And while the Congress dithers with debt limits and sequestration that don't solve the short-term problem of low growth, the long-term problem of low growth continues to go unattended.