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The U.S. Economy in a Global Context

Congress faces challenges in formulating policies to foster economic growth. The imbalance between federal spending and revenues will continue and grow in the long run if current policies are continued. This imbalance will lead to unsustainable growth in the federal debt. Nevertheless, deficit reduction that is too large can temporarily slow economic growth.

Near Term Outlook

The economy has recovered from the 2007-2009 recession with a historically low level of unemployment (3.7% in October 2018). The labor force participation rate of 62.8% is at its trend level. It has declined over time largely due to the aging of the population. The economy continues on a growth path at an average rate of 2.2% from 2010 through 2017. Growth in the first and second quarters of 2018 was 2.2% and 4.5 % with a preliminary estimate of 3.5% for the third quarter.

The Congressional Budget Office (CBO) estimates a growth rate of 3.1% in 2018, with the higher growth rate reflecting the increase in government spending, reductions in taxes, and faster growth in investment. The Blue Chip Forecast consensus is similar with a projected growth rate of 2.9%.

Longer-Term Issues

Economic Growth and the Debt

Growth is expected to slow to trend in the future, with recovery complete, transitory effects of the 2017 tax cuts (P.L. 115-97) fading, and various moderating forces including reductions in government spending, increases in interest rates, and uncertainties about trade and trade policy. CBO projects a growth rate of 2.4% in 2019, slowing to an average of around 1.6% to 1.7% from 2020 through 2028. CBO's projections are similar to those of private forecasters.

In the longer run, economic growth depends on the growth of the labor force, growth of human capital in the labor force (which depends in part on the age distribution given the importance of on-the-job training), growth of the capital stock, and the rate of technological change. Federal government policies have limited influence on the magnitude of most of these variables. Technological advance can be encouraged through grants and tax subsidies but probably cannot be significantly affected. Although tax cuts have often been aimed at encouraging savings and investment, the most direct effect on the capital stock may be through government dissaving (or increasing debt), which crowds out private investment. This crowding out effect is moderated by borrowing from abroad, but the returns to that investment must be paid to foreign investors.

A more fundamental issue with government debt is its unsustainability given projected deficits. During the recession and recovery, the debt grew from about 40% of GDP in FY2008 to 77% in FY2016 (the highest since World War II). Although the debt to GDP ratio stabilized in FY2017, it increased in FY2018 as revenues declined by 0.7% of GDP following the 2017 tax cut. Spending declined slightly by 0.2% of GDP for a net increase in the deficit of 0.5% of GDP. CBO projects the debt to reach 96% of GDP by FY2028, 118% by FY2038, and 152% by FY2048. This projection (which assumes spending reductions and the expiration of the individual tax cuts enacted in 2017) depicts an unsustainable path. The debt can grow without increasing the ratio of debt to GDP as long as it rises at a rate less than or equal to GDP growth. For example, if the debt is 80% of GDP and the economy is growing at 1.6%, a deficit of 1.28% of GDP (1.6% of 80%) will maintain the debt to GDP ratio. The 2018 deficit is 4% of GDP.

The debt is projected to grow in the future largely because spending grows faster than revenues, due to long-recognized issues, such as the aging population and increased health care costs. Over the 30-year period (up to FY2048), Social Security is projected to grow from 4.9% of GDP to 6.3% and health spending is projected to grow from 5.2% to 9.2%, an increase of four percentage points, with three-quarters of that increase due to Medicare. Moreover, the compounding debt also causes a rapid growth in interest payments, which rise from 1.6% of GDP to 6.3%, an increase of 4.7% of GDP. Other spending (including defense and nondefense discretionary spending) is projected to decline as a percentage of GDP, from 8.9% to 7.6%.

Revenues, after dropping to 16.6% of GDP in FY2018 due to the tax cut, are projected to grow over time, reaching 19.8% of GDP in FY2048. About a third of this increase is due to the expiration of the individual income tax cuts and the remainder largely due to real bracket creep in the individual income tax, as payroll taxes, corporate taxes, and other revenues remain relatively stable as a percentage of GDP.

This long-term outlook for the debt might be considered by some as optimistic given the difficulty of maintaining spending cuts and the possibility of making the individual tax cuts permanent. Moreover, were the economy to encounter a recession, the increase in deficits (through automatic stabilizers that reduce revenues and increase spending as well as potential discretionary fiscal policy stimulus) would add to the long-term debt.

The earlier measures are taken to address the debt, the less difficult such measures will be, because interest payments grow when the debt is not addressed thus requiring harsher measures to achieve a given fiscal outcome. Measures might require both spending cuts and revenue increases, although the two largest sources of spending increases, Social Security and Medicare, may prove difficult to alter, particularly in the short run.

CBO projects that to target debt at 41% of GDP (roughly the pre-recession level) by FY2048 would require a cut in noninterest spending, an increase in revenues, or both, by a total of 3% of GDP in FY2019. This change would involve a 15% cut in spending, a 17% increase in revenues, or some combination of both. If the target were the current debt level of 78% of GDP, the reduction would be 1.9% of GDP. Smaller short-run changes could be made but they would require larger longer-term ones.

Growing Inequality

There has been concern about the growing inequality in the economy. From 1979 to 2017, the income share of the bottom quintile of families fell from 5.3% to 3.5%, whereas the share of the top quintile rose from 41.9% to 50.1%. Shares also fell for the lower middle quintile (from 11.7% to 9.0%), the middle quintile (from 17.2% to 14.7%), and (slightly) for the upper middle quintile (from 23.8% to 22.7%). These effects occurred due to increasing inequality in the distribution of wages and a decline in labor compensation as a share of income.

Most economists view technological change as the major factor limiting the wage growth of workers without a college education. Trade appears to have little effect except for the very highest incomes where larger markets may have increased the incomes of "superstars." The decline in the real minimum wage may have played a small role in limiting wage growth at the lower end of the distribution. Given the limited ability of government policy to affect distribution arising from market factors such as technology, the main option for decreasing inequality is through the tax and transfer system. Another option is increasing the minimum wage, although that option might also increase unemployment of less educated workers.

The Global Economy

The United States is increasingly interconnected with the rest of the world through trade and financial flows. As a result, other countries affect the U.S. economy and U.S. policies affect or are constrained by other countries.

Growth and Investment in a Global Economy

Slower growth is projected for the world economy, which could limit demand for U.S. exports and be a contributing factor to slower short-term growth. The global economy is also a source of potential investment and some of the recent tax reforms were aimed at that objective, although their effectiveness is uncertain. The global economy also is a source of borrowing to finance the government debt. Capital inflows can increase the capital stock with small benefits for wages, but the investment earnings do not benefit Americans as they are paid to foreigners.

Foreign Holdings of Federal Debt

About half of debt held by the public is held by foreign investors including foreign governments. Concerns have been raised in the past about the large foreign holdings of U.S. debt, especially by China, and about the effects of a sudden sell-off. China holds about 9% of U.S. debt held by the public. However, these concerns may be overstated. China benefits from holding U.S. debt, and an abrupt withdrawal and accompanying fall in security prices would be costly to China. Moreover, any funds withdrawn from the United States would have to be invested elsewhere and restore overall worldwide demand for securities.

Trade Policy in a Global Economy

International trade (exports and imports) is equivalent to more than 20% of U.S. GDP. The President has placed increased emphasis on the trade deficit and bilateral trade flows and has proposed or imposed tariffs under the view that trading partners, particularly China, are engaging in unfair practices. Bilateral trade deficits are, however, not considered to be meaningful and given flexible exchange rates, the overall trade deficit is simply a consequence of net capital inflows, as incoming resources must be paid for. Imposing tariffs and other restrictions has the potential, however, to disrupt sectors of the economy and invite retaliatory policies from other countries.

There are important trade issues to address, including increasing market access to countries such as China and protecting intellectual property rights worldwide. These issues may be addressed in general trade agreements. However, the President has withdrawn from the Trans-Pacific Partnership that was addressing some of these issues (including issues with China) and has indicated an intention to negotiate bilateral agreements.

Although free trade is generally mutually beneficial for countries overall, it can affect the distribution of income. It can reduce jobs in import-sensitive industries, although it creates them in export-intensive industries. Concerns have been raised about the loss of manufacturing jobs. Most economists believe the major reason for this effect is not import competition but automation, as manufacturing output has steadily increased while jobs have declined. In the long run, trade will largely affect the mix of jobs in the United States and not the overall number.

Other Global Economy Issues

The interconnected global economy has led to focusing on a variety of other policy issues. The United States continues to negotiate with other countries on the adoption and implementation of financial regulatory standards. Global economy concerns, including base erosion and profit shifting, motivated some of the recent changes in the corporate income tax, including lowering the corporate tax rate and instituting international revisions. The effects of these proposed tax changes would likely be small relative to overall economic growth given the relatively small size of the corporate tax, which is less than 2% of GDP.

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