U.S.News & WORLD REPORT

Why You Should Be Pessimistic About Economic Growth

Economies on both sides of the Atlantic seem to be in for a long slog

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November 15, 2013

Western economies are not out of the woods yet, but many see reasons for optimism. In October, job growth in the United States was higher than expected, with 204,000 new jobs created. According to the U.K.'s National Institute of Economic and Social Research, the British economy will expand at 1.4 percent this year, with growth further accelerating to 2 percent in 2014. Even Greece is expected, according to the European Commission, to grow next year – albeit at a modest rate of 0.6 percent.

But how strong are the fundamentals of long-term economic growth on either side of the Atlantic? In a recent paper, Cato Institute scholar Brink Lindsey argues that the U.S. economy is unlikely to regain pre-crisis rates of economic growth. The reasons are straightforward. Economic growth can be understood as a combination of growth in the labor force and its quality, capital accumulation and technological innovation. On any of these fronts, large long-term improvements are unlikely.

Following decades of growth in labor participation in United States – driven largely by the rising numbers of working women – this measure plateaued in the aughts at rates close to 65 percent. At the same time, there has been a slowdown in the growth of educational attainment, resulting in slower improvements in the quality of labor force.

Similar trends can be expected to prevail in the EU where labor participation, though rising, is already above 70 percent. In the EU, pupils now spend 17 years on their education – only marginally more than in 2000. So unless Western societies can dramatically bring more people into the labor force – which is unlikely given that those who stay out today do so for good reasons – or find significantly better ways of educating children, future growth will not come from a rise in numbers and quality of workers.

[See a collection of political cartoons on the economy.]

How about capital investment? Savings and investment rates in the United States are at record lows. In part, this is due to the Great Recession, but both measures had followed long-term declining trends prior to the onset of the crisis. In the U.K., net national savings have followed an even steeper decline, reaching a negative 1 percent of GDP in 2011. Unsurprisingly, business investment in the U.K. has long been declining, with the crisis leading to a bigger fall there than in any other country of the G8.

Of course, new growth could come from innovation. Yet, since the publication of economist Tyler Cowen's "The Great Stagnation" in 2011, a small industry of pessimists emerged, arguing that coming up with truly transformational technological discoveries has become more difficult over time, resulting in a slowdown in the rates of productivity growth. In the book, Cowen argues that between 1910 and 1950, a fairly typical American kitchen, for example, went from not having indoor plumbing or electricity to owning a range of appliances, including a refrigerator and a stove. In contrast, with the exception of a microwave oven or an odd sous-vide machine, today's kitchens look very similar to what they looked like 50 or 60 years ago.

Artificial intelligence and computers promise to be the transformational technologies of today and tomorrow. Computers, the internet and smartphones are already revolutionizing entertainment, journalism and retail. But how likely are they to lead to an economic renaissance comparable to the three postwar decades?

[See a collection of political cartoons on the budget and deficit.]

Because economic growth is getting "harder" – as Lindsey puts it – economic policy becomes more important. When labor force participation was rising steadily, savings and investment rates were high and there was a large pool of new technologies waiting to be turned into useful new gadgets, governments could get away with bad policies. The postwar decades saw the rise of tax and regulatory burdens in the West, as well as spending that was not always justified on the grounds of economic efficiency.

When these economic fundamentals are weaker, bad policies have larger adverse effects. For Lindsey, this is a reason for optimism. As long-term growth falters, he argues, public opinion will be more likely to scrutinize anti-growth policies and demand change. After all, the reforms of the Thatcher and Reagan years – and the wave of deregulation started during the Carter administration – were to a large extent results of the underwhelming economic performance of the 1970s.

Yet, five years since the global financial crisis, there seems to be little popular demand for pro-market reforms on either side of the Atlantic. So little, in fact, that it almost seems that Western populations have become accustomed to stagnation in incomes and high unemployment rates. We can only hope that "muddling through" has not yet become accepted as the highest virtue of economic policy.