A New Role for Government in the “New” Economy

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What’s “new” about the economy in the 21st century?
#1 Low interest rates

Interest rates are significantly lower than they were in the 1990s.
Lower interest rates are not just a crisis story, not just a US phenomenon. The downtrend appears to reflect a very broad reduction in desired investment relative to saving. Most of the forces thought to be driving the downtrend (e.g., demographics, technology) are not expected to reverse. Interest rates may not stay this low but most forecasts have them only reach levels that imply a very different environment for policymaking than anyone was projecting when the 21st century started.
#2 More economic volatility

US Real GDP
Percent change, annual rate

So much for the “Great Moderation”
#2 More economic volatility (continued)

The “Great Recession” underscored the potential for “economic scarring”

## Actual GDP and Projected Potential GDP

- **CBO 2007 projection**
- **Actual**

### Real Median Household Consumption for Households 50-59
By weeks unemployed, 2009-2012

Nonhousing consumption in 2019 dollars; total weeks unemployed for head and spouse combined

Author’s calculations based on the Panel Study of Income Dynamics

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#2 More economic volatility (continued)

Heightened economic volatility is *likely to continue*

Low interest rates and a more complex financial system make the economy *more prone to bubbles, financial cycles*

*More cycles of COVID*, other diseases?

We have also learned that monetary policy, because of low interest rates, is going to struggle more to fight recessions
#3 More worries about economic inclusion

Measuring economic inequality is not straightforward, and there are disagreements about exactly how it has evolved over the past decade or two but it is clear that the hope of the late 1990s that “a rising tide would lift all boats” has not been borne out
#3 More worries about economic inclusion (continued)

Instead, we have:

- Stark **income inequality**, starker **wealth inequality**

- A **variety of other measures showing lives are not improving** or getting worse across much of the socio-economic distribution (limited economic mobility, unequal increases in lifespans, deaths of despair, communities decimated by China trade shock, …)

Beyond the concerns at the individual-level, **these trends are hurting everyone** via damage to the social fabric, more polarization, less trust in institutions, more support for populist policies, and so on
What’s “new” about the appropriate role for government in the 21st century
#1 [Even more] need for good countercyclical fiscal policy

As already discussed—because of more economic volatility, the limitations of monetary policy

Also, the last two recessions have underscored that we shouldn’t just be focused on stimulus as an objective (particularly if supply is constrained!)

Need more study of the importance of economic scarring and the role of policy in limiting it

Need to enhance automatic stabilizers:

Aim for fewer gaps in safety net coverage, take-up [e.g., Kuka and Stuart, 2021]

Make more use of automatic triggers linked to economic data to turn on, expand, reduce, turn off, etc.
#1 Need for good countercyclical fiscal policy (cont’d)

But there are limits to automatic stabilizers, so we still need to be ready to use discretionary countercyclical fiscal policy.

Data-based triggers wouldn’t have been fast enough in spring 2020.

Moral hazard considerations differ by episode (less worry about “taking advantage of the system” in a massive unexpected pandemic).

Relatedly, we’d be well-served by more granular high quality real time data.

Explosion in “big data” speaking to distributional issues over the last two years but it hasn’t helped policymaking as much as one might expect: different sources pointed in different directions, concerns around representativeness, lack of transparency on underlying methodology.
#2 [Even more] need for fiscal policies that invest in kids and education/training

**Investment in kids** is important because of the heightened worries about economy inclusion, and because we have seen research in the 21st century showing that **a number of interventions are “win-win-win”**

- Reduces immediate hardship
- Pays off over the longer-run for the economy by raising adult skills, adult labor force participation, adult health, and so on [e.g., see Brown et al on Medicaid, Hoynes et al on nutrition assistance, Hendren and Sprung-Keyser on marginal value of funds]
- Pays off over the longer-run for individuals by enhancing economic mobility
#2 Need for fiscal policies that invest in kids and education/training (continued)

**Investing in education and training** means programs for **the very young**, programs for **school-age children**, and programs for **adults**

The literature on education generally shows that more money can help and also that there are better and worse ways to use the money [e.g., see Schanzenbach *et al* 2016, Aspen Economic Strategy Group proposal to push more money to community colleges but couple it with reforms]

Knowing how to do effective training for people later in life has been a longstanding challenge, but there is an emerging view that there are some things that work [e.g., see Katz *et al* forthcoming]
#2 Need for fiscal policies that invest in kids and education/training (continued)

Cautions:

Literature on successful specific interventions is very important but it’s still developing ... it doesn’t imply that everything along these lines will be worth it and we don’t know how scalable many of the interventions are.

Moreover, there is a real opportunity cost because of fiscal constraints, bringing me to my third topic ...
#3 Despite the new feature of low interest rates, the federal government still faces a real budget constraint

The good news—because of low rates, federal debt service today is about the same share of GDP as 20 years ago even though debt has risen sharply.

Net Interest on Federal Debt, 2002-2021

Federal Debt, 2002-2021

Data from Congressional Budget Office; 2021 value is projection

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Despite the new feature of low interest rates, the federal government still faces a real budget constraint (continued)

Even with low interest rates, debt is projected to soar relative to GDP over long run because of the disconnect between the growing older population/rising health care spending and a stable revenue base.

And there’s more risk—the combination of high debt and low rates means that any given percentage point change in rates has an outsized effect on government finances [adding 5 bps next year, another 5 bps the following year, and so on raises debt by nearly 60 percent of GDP by 2051]
Despite the new feature of low interest rates, the federal government still faces a real budget constraint (continued)

Therefore increases in spending, apart from true emergencies, should generally be accompanied by cuts in other spending / increases in taxes

In my view, though, given the huge costs from a lack of inclusive economic growth, spending to facilitate inclusion is worth those trade-offs.
Before I wrap up …

One particular fiscal program that will need to get more attention in coming years is Social Security—if you are interested, there’s a panel later this afternoon on this topic.

Crucial issues related to the “new” role of government that I didn’t get to:

- Monetary policy
- Need to address climate challenges