My Best Growth Forecast Ever

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CAMBRIDGE – America's real GDP growth rate of 3.2% for the first quarter of this year is impressive, as was the 3% average growth in 2018 (measured from the fourth quarter of 2017 to the fourth quarter of 2018). Since the end of the Great Recession – from 2011 to 2017 – the US economy grew by only 2.1% per year, on average. What accounts for the recent acceleration?

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In January 2018, in the spirit of resolving some of the controversy, the Brookings Institution recruited Jason Furman (chair of the Council of Economic Advisers under President Barack Obama) and me to write a joint paper focusing on the prospective growth effects of the tax changes. No doubt Brookings thought that combining a liberal viewpoint (Furman's) with mine (which I view as pro-market) would avoid political bias and thereby generate estimates closer than usual to the "truth." I leave it to other observers to assess whether this bold attempt at consensus was successful.

Much of our analysis emphasized the tax changes for businesses, including a cut in the federal tax rate on corporate profits from 35% to 21% (for C corporations, which include the largest businesses) and a smaller reduction in the tax rate for pass-through businesses (partnerships, S corporations, and sole proprietorships). All businesses benefited from a move to full expensing for equipment, though this change did not apply to structures. Our research predicted a substantial long-term increase in capital accumulation, which would generate sizable gains in labor productivity and real wages. Real GDP growth was predicted to be higher over ten years by an average of about 0.2% per year. Thus, the predicted growth effect was moderate but long-lasting.

The other important change in the 2017 tax package was an almost across-the-board reduction in marginal income-tax rates on individual incomes. On average, the decline in the marginal tax rate was around 2.3 percentage points (adjusted downward from 3.2 points to take account of the reduced tax deductibility of state income taxes). By comparison, the average cut in marginal tax rates was 4.5 percentage points under President Ronald Reagan's 1986 legislation; 3.6 points under President John Kennedy and President Lyndon B. Johnson's tax cuts, passed in 1964; and 2.1 points under President George W. Bush's 2003 reform. Furman and I estimated from previous research that President Donald Trump's cut would propel GDP growth by a substantial 0.9% per year for 2018-19, but would not contribute to growth after that. Thus, the predicted growth effect was larger than that of the tax cuts for businesses in the short run, but smaller in the long run.

When we computed the overall boost to short-run GDP growth, we got an estimate of 1.1% per year for 2018-2019. When added to a baseline growth forecast of 2% (reflecting contemporaneous consensus views and recent history), our estimated incremental effect from the 2017 tax law implied a forecast of real GDP growth of 3.1% per year for 2018-19. Frankly, although there is doubtless a large element of luck here, this is the best growth forecast that I can recall ever making. Moreover, our forecast in early 2018 of incremental effects from the 2017 law contrasts with many economists' predictions of recession.

As an aside, I have a bet with a famous Harvard colleague who has promised to eat his proverbial hat if 3% GDP growth persists over a longer period. I recall that the bet specified the period as the full two years – 2018 and 2019 – but he now remembers it as the three years from 2018 to 2020. I think I must be right, because I never forecasted high economic growth for 2020.

Of course, it is always possible to find reasons for why one's forecast turned out badly. A currently popular argument of this type is that the Federal Reserve has turned out to be much more expansionary than one would have predicted. Similarly, expectations that a trade war with China and other countries would dampen economic growth – a particular concern of mine last fall – have brightened (though I remain worried on this score).

Basically, a prediction such as the one for 3.1% GDP growth that Furman and I advanced in early 2018 should be viewed as a non-contingent forecast that can always be conditioned on (or explained away by) an array of unanticipated events. And, more generally, there is always a lot of uncertainty in annual GDP growth rates, which is why the accuracy of our forecast has to be viewed as reflecting a good deal of luck.

I take it as self-evident that faster economic growth is better than slower economic growth. Underlying this sentiment is that millions of people benefit from higher growth rates, which are typically accompanied by higher wages and lower unemployment, which especially help the worse-off. Yet today, the antipathy toward the Trump administration is so intense that many people, including some of my economist colleagues, are rooting for lower economic growth just to deny Trump a political win.

I understand this viewpoint, but I still think that the direct benefits from a better economy outweigh this kind of political calculus. More to the point, the beneficiaries – which include most people and most voters – must favor faster over slower growth.

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