# The missing ingredients of growth

By Michael Spence and Karen Karniol-Tambour
January 2, 2018 – *Project Syndicate*

Several positive macroeconomic trends suggest that the global economy could finally be in a position to achieve sustained and inclusive growth. But whether that happens will depend on whether governments can muster a more forceful response to changing economic and technological conditions.

Most of the global economy is now subject to positive economic trends: unemployment is falling, output gaps are closing, growth is picking up, and, for reasons that are not yet clear, inflation remains below the major central banks' targets. On the other hand, productivity growth remains weak, income inequality is increasing, and less educated workers are struggling to find attractive employment opportunities.

After eight years of aggressive stimulus, developed economies are emerging from an extended deleveraging phase that naturally suppressed growth from the demand side. As the level and composition of debt has been shifted, deleveraging pressures have been reduced, allowing for a synchronized global expansion.

Still, in time, the primary determinant of GDP growth – and the inclusivity of growth patterns – will be gains in productivity. Yet, as things stand, there is ample reason to doubt that productivity will pick up on its own. There are several important items missing from the policy mix that cast a shadow over the realization of both full-scale productivity growth and a shift to more inclusive growth patterns.

First, growth potential can't be realized without sufficient human capital. This lesson is apparent in the experience of developing countries, but it applies to developed economies, too. Unfortunately, across most economies, skills and capabilities do not seem to be keeping pace with rapid structural shifts in labor markets. Governments have proved either unwilling or unable to act aggressively in terms of education and skills retraining or in redistributing income. And in countries like the United States, the distribution of income and wealth is so skewed that lower-income households cannot afford to invest in measures to adapt to rapidly changing employment conditions.

Second, most job markets have a large information gap that will need to be closed. Workers know that change is coming, but they do not know how skills requirements are evolving, and thus cannot base their choices on concrete data. Governments, educational institutions, and businesses have not come anywhere close to providing adequate guidance on this front.

Third, firms and individuals tend to go where opportunities are expanding, the costs of doing business are low, prospects for recruiting workers are good, and the quality of life is high. Environmental factors and infrastructure are critical for creating such dynamic, competitive conditions. Infrastructure, for example, lowers the cost and improves the quality of connectivity. Most arguments in favor of infrastructure investment focus on the negative: collapsing bridges, congested highways, second-rate air travel, and so forth. But policymakers should look beyond the need to catch up on deferred maintenance. The aspiration should be to invest in infrastructure that will create entirely new opportunities for private-sector investment and innovation.

Fourth, publicly funded research in science, technology, and biomedicine is vital for driving innovation over the long term. By contributing to public knowledge, basic research opens up new areas for private-sector innovation. And wherever research is conducted, it produces spillover effects within the surrounding local economy.

Almost none of these four considerations is a significant feature of the policy framework that currently prevails in most developed countries. In the US, for example, Congress has passed a tax-reform package that may produce an additional increment in private investment, but will do little to reduce inequality, restore and redeploy human capital, improve infrastructure, or expand scientific and technological knowledge. In other words, the package ignores the very ingredients needed to lay the groundwork for balanced and sustainable future growth patterns, characterized by high economic and social productivity trajectories supported by both the supply side and the demand side (including investment).

Ray Dalio describes a path featuring investment in human capital, infrastructure, and the scientific base of the economy as path A. The alternative is path B, characterized by a lack of investment in areas that will directly boost productivity, such as infrastructure and education. Though economies are currently favoring path B, it is path A that would produce higher, more inclusive, and more sustainable growth, while also ameliorating the lingering debt overhangs associated with large sovereign debt and non-debt liabilities in areas like pensions, social security, and publicly funded health care.

It may be wishful thinking, but our hope for the new year is that governments will make a more concerted effort to chart a new course from Dalio's path B to path A.

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