Washington Center for Equitable Growth
Evidence for a stronger economy

equitablegrowth.org

FACT SHEET: TAX & MACROECONOMICS

Overheating is not a concern for the U.S. economy

April 2021 **By Equitable Growth**

Critics of President Joe Biden's $1.9 trillion American Rescue Plan and further public investments financed through a combination of tax increases and deficit spending—such as his administration's proposed American Jobs Plan, at roughly $2 trillion, and the forthcoming American Families Plan—often argue that the U.S. economy will "overheat" if policymakers pump too much support into the U.S. economy too quickly.

Yet plans for further public investments should be judged primarily on the merits of those investments. Arguments that the U.S. economy will overheat ignore the need for additional investments in the economy and rely on the possibility of future policy errors to argue against needed investments today.

This factsheet explains how economists and policymakers colloquially use the term overheating, why it's not really a concern, and why it distracts from the more important debate about the kind of investments required to create a more equitable and sustainable economic recovery coming out of the coronavirus recession.

What is overheating?

The term overheating refers to an economy in which the actual level of goods or services produced, or the Gross Domestic Product, exceeds potential GDP.

What is potential GDP?

Potential GDP is a theoretical quantity. It is the estimated amount of output that would be produced assuming full utilization of inputs. In this situation, unemployment is low and reflects only transitions between jobs or new entrants to the labor force.

Importantly, potential GDP is a theoretical quantity that cannot be directly observed. Economists can estimate potential GDP, but they will never know with certainty what it is. As a result, policymakers never know for sure whether GDP is above or below potential. One part of the debate about whether the Biden administration's policies could cause overheating is a debate about what potential GDP is.

Why is potential GDP important?

The Congressional Budget Office's estimates of potential GDP are highly influential, but critics argue, with substantial justification, that CBO analysts have been unduly pessimistic about the capacity of the economy in recent years, and thus overstate the risk of overheating.

As economists Adam Hersh at the University of Massachusetts Amherst's Political Economy Research Institute and Mark Paul at the new College of Florida point out, these estimates also include assumptions that embed racial disparities into their forecasts of the "natural rate of unemployment," which is an estimate of the level of unemployment where potential GDP is reached. The Congressional Budget Office, for example, estimates that the "natural rate" of unemployment for Black workers, at 10 percent, is more than double that of White workers (4.4 percent), and the "natural rate" of unemployment for Latinx workers (6 percent) is more than one-third higher than that of White workers.

Can potential GDP be misleading?

The implications of the Congressional Budget Office's assumptions about potential GDP and the natural rate of unemployment can be misleading. These assumptions would mean that the Black unemployment rate—which reached a record low of 5.5 percent in August 2019 without any inflationary consequences—would never be expected to fall below the overall peak unemployment rate during the Great Recession, at 10 percent. Moreover, these assumptions would also mean that the

Latinx unemployment rate—which reached a record low of 4 percent in September 2019, again without any inflationary consequences—would never be expected to fall below 6 percent.

Notably, the CBO's baseline deficit projections assume that current law is unchanged, just as CBO's estimates of potential GDP assume current law and regulation. But changes in law and regulation can change potential GDP. This is particularly important when evaluating policies that aim to invest in the productive capacity of the economy in the future, including investments in people or physical infrastructure.

What is the likelihood of overheating?

The U.S. economy has 10 million fewer jobs today than it likely would absent the coronavirus pandemic and resulting recession. This is why now is not the time for concern about overheating. The prominence of the concern, in fact, reflects the scale of the policy response to the pandemic and the recession, especially the recently enacted $1.9 trillion American Rescue Plan.

Even so, it is difficult to state with confidence how the actual level of GDP will compare to potential GDP in the near future. Wendy Edelberg and Louise Sheiner of The Brookings Institution estimate that legislation of approximately the scale of the American Rescue Plan would restore actual GDP to potential GDP after the third quarter of 2021, cause GDP to exceed potential GDP temporarily by a modest 1 percent in the fourth quarter of 2021, and then allow GDP to roughly match its potential path in the middle of 2022.

If potential GDP is higher than Edelberg and Sheiner estimate or the American Rescue Plan causes less spending than they project, then the U.S. economy will be less likely to overheat. If potential GDP is lower or the American Rescue Plan causes more spending, the economy would be more likely to overheat.

Then, there are the two forthcoming public investment packages from the Biden administration. The president's American Families Plan will be unveiled later this week, but there are enough details about his American Jobs Plan for some early analysis. A projection by Mark Zandi and Bernard Yaros of Moody's Analytics implies the American Jobs Plan may set the real GDP (after accounting for inflation) on a path that modestly exceeds the Congressional Budget Office's pre-pandemic projections for potential GDP. Yet the general macroeconomic benefits—such as long-term employment gains and fully recovered labor force participation among women and workers of color—significantly outweigh any concern for possible overheating.

What happens if the economy overheats?

From many perspectives, an overheated economy is a strong economy. Unemployment is very low, and it becomes much easier for workers to find jobs, and especially better-paying jobs. It is harder for employers to discriminate and may have disproportional positive effects on traditionally excluded workers such as Black Americans. Low unemployment may also create wage pressures, especially for low-wage workers who generally face much greater competition for jobs.

Concerns about an overheated economy typically focus on a set of potential consequences that could arise if it remains overheated for a long time. If an economy remains overheated for many years, then that could lead to higher inflation. If the Federal Reserve, in response to that inflation, pushes the U.S. economy into recession by pushing up interest rates, then that could cause widespread harm.

Yet this concern is less about overheating specifically, and more about extended overheating followed by a bad policy response. There is no obvious reason to believe that a short period during which GDP exceeds potential GDP will lead to this set of outcomes. This is the case because concerns about overheating often rely on analyses of what has happened in prior periods of U.S. economy history, such as the inflationary years of the 1970s, which were followed by the disinflation and recessions engineered by then-Fed Chair Paul Volcker. But there are important ways in which the economy has changed since then.

Indeed, the rise of economic inequality over the past six decades makes the experience of the 1970s less relevant for forecasting the future. There also is no compelling reason to view narrowing the scope of policy ambition now as a superior approach to avoiding these theoretically adverse outcomes before they might possibly happen. A better approach is for the Fed to change the nature of its response down the road or for Congress to change its fiscal policy response if inflation were to emerge.

Should policymakers be focused on overheating?

Concerns about overheating are offered as a reason to scale back the scope of forthcoming economic recovery legislation, specifically the Biden administration's approximately $2 trillion American Jobs Plan and forthcoming American Families Plan. These concerns, however, are more about the scale of the tax increases on higher-income families and corporations needed to pay for these investments, as well as the smaller amount of deficit financing envisioned in these two legislative packages, compared to the recently enacted American Jobs Plan.

In fact, this factsheet details why overheating is of relatively little direct concern. Much of the actual concerns about overheating could be better addressed down the road should the symptoms of possibly arise.

Conclusion

The entire conversation about overheating distracts attention from where economic policymakers should be focused. They instead should be focused on the investments in the two forthcoming legislative packages—whether the proposed investments are a good idea, regardless of how they are financed. The primary case against investments is that they may be unwise or perhaps unmerited, not that they are financed by higher taxes and more deficit spending.

The primary case for these large public investments is that they are valuable and important. Debates about investments should focus more on that question and focus less on overheating.

Washington Center *for* Equitable Growth

Evidence for a stronger economy

equitablegrowth.org

facebook.com/equitablegrowth

@equitablegrowth

equitablegrowth.org/feed

info@equitablegrowth.org

1156 15th St. NW Suite 700

Washington, DC 20005

202-545-6002

Equitable Growth

The Washington Center for Equitable Growth is a non-profit research and grantmaking organization dedicated to advancing evidence-backed ideas and policies that promote strong, stable, and broad-based economic growth.