Restoring American Prosperity

A provocative new book attacks the myth of the "new normal" and argues why new stimulus is not the answer.

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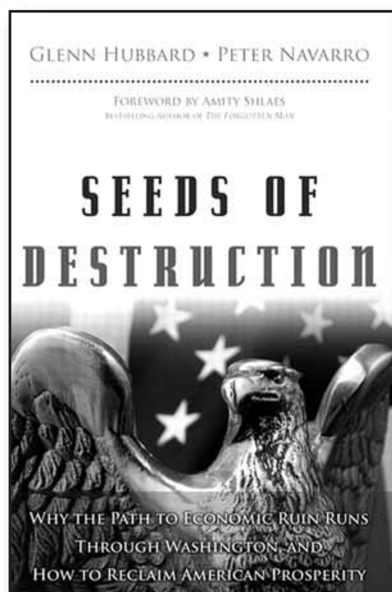

This article is adapted from ***Seeds of Destruction: Why the Path to Economic Ruin Runs Through Washington, and How to Reclaim American Prosperity,*** *the new book by* **Glenn Hubbard** *and* **Peter Navarro** *(FT Press, 2010).*

"Republicans want to go back and live in the 1950s. Democrats want to go back and work there."

As Amity Shlaes writes in the foreword to our new book, *Seeds of Destruction,* "That's the joke circulating about the American attitude toward our current economy, our past, and our prospects."

As Shlaes tells it, "It's a short joke, but one that captures Americans' dark suspicions about our future. In the 1950s, jobs were available and pay was high. Americans found they were able to work fewer hours than before and buy better cars and appliances. Mortgages were low. Education was available and universities were good. The Midwest drew workers rather than sent them away. When someone lost a job, he found another. Teenagers went joyriding in their parents' cars. It all looked easy at the time. But today no one seems to be putting forward a plan that can take us to a 1950s level of broadly shared prosperity."

With America's GDP growth now rate having fallen back under an anemic 2 percent—even after a historically enormous fiscal and monetary stimulus—we must redouble our efforts to find a workable bipartisan plan that will take us back to prosperity.

We must begin our search for such a Seeds of Prosperity plan by confronting this ominous question: Is slow growth really the "new normal" as many pundits insist? Or can we find our way back to a world where our

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The Policy Blueprint

1. We cannot stimulate our way to prosperity. To avoid the debilitating long-term effects of excessive government spending and debt, reject any further use of discretionary fiscal stimulus while having the patience to allow automatic stabilizers to do their job. Any future stimulus should favor tax cuts to stimulate business investment over increased government expenditures as the best way to stimulate job creation.

2. The Fed's Easy Money Street is a dead end. The Fed must turn its emphasis away from discretionary fine-tuning and firmly embrace a rules-based policy that targets price stability, a sound dollar, and sustainable long-term growth. We cannot simply print more money and expect our economy to recover.

3. The American economy will never return to full prosperity until it completes a very broad-based tax reform because the current complex income-based tax system discourages both saving and investment, handcuffs American exporters, and promotes a cult of fiscal irresponsibility. Any broad-based tax reform must broaden the tax base, reduce marginal tax rates, and remove tax biases against saving, investment, entrepreneurial risk-taking, and exports.

4. America's chronic trade deficits act as a brake on growth. Boosting the American saving rate should be part of our overall trade policy. And trade reform with China, our largest trading partner, is important. China engages in protectionist and mercantilist practices that make it very difficult for American businesses to compete on a level, free-trade playing field.

5. America's oil addiction acts as a stiff tax and strong brake on growth. As oil prices rise, consumers lose purchasing power, businesses face higher production and transportation costs, and growth slows. A flexible oil import substitution fee set equal to the difference between the actual world price for a barrel of oil and the target price necessary to achieve a targeted reduction in oil import dependence is the best market-driven solution.

economy regularly grew at well over 3 percent a year and full employment and rising wages were the norm?

THE MYTH OF THE NEW NORMAL

Before we answer these questions, we must first dispel this myth: Many Americans—including most of our elected officials—mistakenly believe our current economic woes began with the 2007–09 financial crisis. This error has led to ill-conceived short-term fixes. In fact, our slow-growth malaise dates back at least a full decade.

Consider that from 1946 to 1999, our GDP grew at an average annual rate of 3.2 percent. However, during the nought decade of the 2000s, the American economy averaged only 2.4 percent—0.8 percent below an historical average which is generally taken to be the American economy's full potential output.

While a 0.8 percent difference may seem small, it makes an enormous difference in terms of job creation. The rough rule of thumb is that every one percentage point increase in GDP growth creates about a million jobs. Thus,

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on a cumulative basis, a 0.8 percent underperformance in growth over the course of a decade translates into a failure to create close to ten million jobs—just about the number we need right now to get our economy back to full employment.

The economic implications of these statistics are profound: The American economy is not in a short-term cyclical decline triggered by a financial crisis, but rather faces structural problems.

The policy implications of this basic observation are equally profound: Because the American economy's problems are structural, they can't be fixed simply by applying short-term fiscal and monetary stimulus. In fact, continued

use of short-term stimulus will lead us further away from the path of long-term prosperity.

STRUCTURAL IMBALANCES PLAGUE OUR GDP GROWTH EQUATION

To understand the source of America's structural economic problems, it is critical to remember that the GDP growth of any nation is driven by consumption, business investment, government spending, and net exports (the difference between imports and exports). In fact, America's GDP "growth driver equation" suffers from these four severe imbalances: overconsumption, underinvestment, chronic trade deficits, and excess government spending.

Regarding overconsumption, in the post-war period from 1946 to 1999, consumption expenditures accounted for an average of 64 percent, or just shy of two-thirds, of America's GDP growth. However, the share of consumption jumped to 70 percent in the nought decade and, as the latest GDP report indicates, it remains there. Much of this overconsumption stemmed from policies that ignored structural sources of stagnating incomes for many Americans in order to promote easy credit and spending. Of course, this overconsumption is mirrored in a low saving rate and a second major structural imbalance—underinvestment and the lack of adequate research and development, technological innovation, and new productive capacity required for the job creation process.

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And chronic trade deficits? From 1946 to 1999, net exports were near zero percent. However, during the 2000s, our current account deficit more than doubled and may have reduced our annual GDP growth rate by as much as half a percent.

Finally—and not coincidentally—during this last decade of stagnant growth, the federal government's share of America's GDP has steadily risen from its historical base of around 20 percent. While fast-growing federal government spending has provided some short-term stimulus, an overfed Uncle Sam represents the ultimate seed of destruction, through upward pressure on taxes and interest rates.

It should be clear from this discussion of America's four major structural imbalances that there is no single "magic policy bullet" that can be fired to get America back on a robust and sustainable long-term growth path. Rather, any policy blueprint must address, at a minimum, both tax and trade reform, as well as a phased withdrawal from our over-reliance on discretionary fiscal and monetary stimulus.

OUR SEEDS OF PROSPERITY POLICY BLUEPRINT

With regard to tax reform, America's complex income-based system reinforces all four major structural imbalances in the U.S. economy. It discourages both saving and investment, while handcuffing American exporters even as Washington's enormous power to tax promotes a cult of fiscal irresponsibility within the Beltway. However, returning the American economy to widely shared full prosperity requires broad-based tax reform.

Any effective tax reform must seek to broaden the tax base, reduce marginal tax rates, and—most important from a growth-stimulating perspective—remove tax biases against saving, investment, entrepreneurial risk-taking, and exports. Until we are ready to discuss fundamental tax reform—likely after the 2012 presidential election—it would be a mistake to let the Bush tax cuts expire, as the resulting *de facto* "hikes" will further penalize capital formation, harming long-term growth as well as further retarding the flagging recovery.

With regard to trade reform, if we want to reduce America's large and chronic trade deficits, we must increase our nation's saving rate and constructively engage America's largest source of its trade deficit—China. America's "Chinese import dependency" problem is rooted in a wide range of Chinese protectionist and mercantilist practices that make it very difficult for American businesses to compete on a level, free-trade playing field and equally difficult for the United States to reduce its trade deficit with China.

In thinking about how to reduce our chronic, growth-stalling trade deficits, we must acknowledge that America's oil import dependence is likewise unacceptably high. While complete energy independence or "autarky" is neither feasible nor desirable, we can nonetheless reduce our dependence on foreign oil to a level more consistent with economic prosperity and national security.

Toward this end, we believe the truly smart path to reducing our oil dependency lies in simultaneously embracing both "hard path" energy options such as more drilling and nuclear power that Republicans support, and "soft path" options such as more conservation and renewables that Democrats support. To use market forces to bring more domestic soft and hard path oil substitutes into the market, we propose a flexible "import substitution fee" equal to the difference between the actual world price for a barrel of oil and the target price necessary to achieve the desired reduction in oil import dependence.

Such a flexible fee is quite different from the kind of permanent taxes on oil (and gasoline) that have frequently been proposed. It is only levied when the world price of oil falls below the target level. As the world price of oil moves toward the target price, the size of the fee is reduced. Moreover, whenever the world price of oil rises above the target level, the fee is removed and the desired level of oil import reduction is achieved purely through market forces.

This market-based flexibility makes our proposed oil import substitute price floor a far more politically palatable solution than any permanent tax on either oil or gasoline—neither of which have any broad support among the general public. We also believe that any revenues raised from such a fee should be rebated back to the American people in the form of tax cuts—thereby making the foreign oil tax revenue-neutral.

WE CAN'T STIMULATE OUR WAY TO PROSPERITY

Underlying these major components of our "seeds of prosperity" policy blueprint must be these realizations. First, the Federal Reserve's overly accommodative policies over part of the past decade played a key role in fueling a housing bubble and America's structural imbalance of overconsumption. The Fed should turn its emphasis away from discretionary fine-tuning and firmly embrace a policy that has as its goals price stability and sustainable long-term growth.

Second, we must wean ourselves from the idea—adopted on occasion by both political parties—that we can stimulate our way to prosperity, and instead embrace the principle that it is only through structural reforms that we will return to the path of long-term prosperity. To avoid the debilitating effects of the structural imbalance of excessive government spending, we therefore must shy away from further use of discretionary fiscal stimulus, while having the patience to allow automatic stabilizers to do their job. If a further fiscal stimulus is deemed to be absolutely necessary, it should strictly meet the test of being temporary, timely, and targeted.

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Over the longer term, in implementing any stimulus, we should favor tax cuts to stimulate business investment over increased government expenditures as this is the best way to stimulate job creation over both the short and longer term. Reducing the fiscal burden of entitlement programs is also essential to restoring prosperity.

Our bottom line: These are realistic, sustainable policies we can and must pursue. In order to succeed, however, both parties need to broaden their positions. For Republicans, "tax cuts" can't be the answer to every question. For Democrats, more short-term stimulus and a larger government can't be the cure-all.

And for all of us? Slow growth does not have to become the new normal. The obvious question is whether we will see new leaders and candidates emerge with an appropriate "Seeds of Prosperity" blueprint to compete for places in the White House and Congress on a platform of structural reforms. Absent such reforms, we will continue to be surprised and disappointed with GDP growth rates such as those we are now witnessing. ◆