

Huh? A Surprising Success!

BY R. GLENN HUBBARD

First came the bursting of the Clinton bubble, then 9/11, then the accounting scandals and all the other shocks to the system. Who would have predicted such a vigorous U.S. recovery?

When I speak to business audiences, I generally open my remarks by asking the group to imagine that I had spoken to them in late 2000 and told them I could foretell the future perfectly. That is, I could see the consequences of equity price declines, a recession, the terrible events of September 11, corporate accounting scandals, geopolitical risks, and war. I ask the audience what they would expect the impact on the economy to be of these forecasted events. Most people agree that these events should have precipitated a significant and prolonged downturn.

That did not happen. And there are lessons in that story about our economy and about economic policy. With two shallow recessions as punctuation, the U.S. economy has enjoyed a two-decades-long boom. There were some policy influences—such as tax and regulatory policy in some periods and the Fed's successful battle against inflation—but the seeds of success lay mainly in the U.S. private economy. Faster economic growth since the mid-1990s was made possible by effective institutions for allocating capital, labor, and risk. With this flexibility in hand, American business and consumers were resilient in the face of the shocks I described above.

U.S. economic policy must focus on maintaining these favorable trends. American leadership in international economic policy requires a strong econo-

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my at home and the encouragement of pro-growth economic policy around the world. If we examine the tax policies that became law over the past few years and tally up their impact one by one, the conclusion that they generally succeeded is almost inescapable. They had the effects that many economists predicted and made the recession much shallower and shorter than it otherwise would have been. Moreover, other recent changes in economic policy have set the economy on an improved long-run trajectory.

A PRO-GROWTH ECONOMIC POLICY FOR THE UNITED STATES

The most recent business cycle posed substantial challenges for the economy and for policymakers. Cries of “What about the good old 1990s?” miss both the unaddressed seeds of the downturn and the reality that policymakers must respond to the economic shocks they experience. The current vigorous recovery in the U.S. economy—in output, investment, corporate profits, and now employment—is testimony to the strength and flexibility of the U.S. private sector and to the effectiveness of public policy in combating the set of forces weighing on the economy. There are important lessons here—stressed by President Bush in his most recent *Economic Report of the President*—valuable lessons to consider given the economic policy choices U.S. voters will make this year.

The first lesson is that structural imbalances take time to resolve, and raise challenges for policymakers. The “capital overhang” that developed with excessive optimism about expected profitability in the late 1990s has taken a few years to work through. While consumption and government spending held up in the most recent recession, capital spending dropped sharply, and stayed at a low level for much longer than is typical in a recession. Depreciation and improvements in economic growth have worked through most of the overhang. Reductions in marginal capital income tax rates through the introduction of partial expensing and the passage of a reduction in the tax rate on dividend income also helped fuel a turnaround in business investment in the second half of 2003 and into 2004. While the academic studies are only now being written, the combined reduction in the cost of capital from these policies was in the 6–10 percent range. Given the historical relationship between the cost of capital and investment, this suggests that about half of the recent equipment spending recovery could be attributed to tax policy. Proponents of the dividend tax reduction also argued that it would increase payout rates and lift the stock market. Both patterns are strikingly in the data, with the market even rising about two percentage points the day the dividend tax cut passed the Senate.

There have, of course, been many factors working in the opposite direction. It goes without saying that economic shocks

associated with the September 11 terrorist attacks, stock market decline, corporate accounting scandals, and geopolitical tensions surrounding the Iraqi conflict added headwinds to the U.S. economy over the past few years. But they also contributed another lesson—uncertainty matters for economic decisions. Household spending decisions were influenced by uncertainty over the economy’s near-term growth prospects. Even more significant, many business leaders with whom I spoke regularly in 2001 and 2002 cited economic uncertainty as constraining investment and employment decisions. The

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Bush Administration’s aggressive tax cuts on investment leaned against this headwind. Equally important, the Administration and the Congress moved rapidly to address uncertainty surrounding the effectiveness of corporate governance that hung over financial markets. The President’s proposed reforms, announced in March 2002, were largely translated into the Sarbanes-Oxley Act passed by the Congress in July 2002.

The third lesson is a more familiar one, though the different economic experience gave it added importance: Well-timed monetary policy actions can limit the severity of a downturn. The Federal Reserve has pursued an aggressively accommodative policy since 2001 to counter recessionary forces and uncertainty—without triggering substantial inflationary pressures. The Fed’s boldness aided the recovery through boosting consumer spending (particularly on housing) and business fixed investment. President Bush’s appointments to the Federal Reserve Board have added to the Board’s strength in banking, financial markets, and monetary policy, and have contributed to a vibrant debate over the conduct of monetary policy under uncertainty.

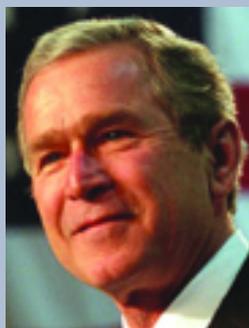
Consumption was unusually strong during this recession, and the latest research suggests that the tax cuts played a big

How to Handle the Budget Gap

As of this writing, the President's challenger has racked up an additional budget gap of at least \$1 trillion—the excess of spending proposals over promised tax increases—over ten years, and he has offered no clues as to his thinking on the outlook for Social Security and Medicare. That gap implies higher deficits, another tax increase, or both.

When discussing the fiscal imbalances of the United States, it is important to remember which conversation we are having. According to the 2004 Social Security and Medicare Trustees Reports, unfunded liabilities of entitlement programs are \$10.4 trillion for Social Security, \$21.8 trillion for Medicare Part A, \$23.2 trillion from Medicare Part B, and \$16.6 trillion for Medicare Part D (prescription drugs). In contrast

to the large unfunded liabilities of Social Security and Medicare, Jagadeesh Gokhale and Kent Smetters have estimated that the forward-looking fiscal imbalance of the rest of the federal budget (in present value) is only \$0.5 trillion in 2004, assuming that the Bush tax cuts are made permanent. That is, general revenues were calculated to be approximately equal to non-Social Security and Medicare spending plus obligations to Social Security and Medicare (via the trust funds) plus debt held by the public. Let us be clear—the discussion of the long-term fiscal outlook requires a conversation centered on Social Security and Medicare.



George W. Bush



John Kerry

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part in this. As economists have long understood, tax cuts can boost economic activity both through raising after-tax income and aggregate demand and by improving incentives to work and invest. Recent empirical analysis of the 2001 tax cuts suggests large boosts in consumer spending traceable to the tax cuts. Indeed, there is a clear pattern suggesting that consumption was unusually high precisely in the quarters where tax refunds were the largest. This consumption response was no mistake. Ever since the seminal work of Milton Friedman, economists have known that consumption responds much more to permanent tax cuts than it does to temporary ones. The latest evidence suggests that even the consumption of upper-income individuals responded sharply to the tax reductions. This would not have occurred if a Keynesian temporary tax reduction had been pursued.

Putting it all together, the recent tax cuts provided both short-term support for consumption and investment in the current economic recovery and advanced the economy's long-run growth prospects. The responses of investment, consumption, and the stock market matched the predictions of economic theory fairly well. It is also the case that in the present low-interest rate, low-inflation environment, countercyclical policy may offer a more important complement to monetary policy than in earlier periods.

Finally, while strong productivity growth raises standards of living, public policy should be both encouraging of that growth, but also mindful that more rapid economic growth is necessary to raise employment. The Bush Administration's economic policies have emphasized support of long-term growth through low marginal tax rates, limited regulation, and the encouragement of organizational and financial flexibility. Public policy's support for aggregate demand growth is also beginning to stimulate employment. Contrary to recent handwringing in some quarters, it is important to remember that while rapid productivity growth requires faster output growth for employment growth, the economy is at the same time capable of growing faster. That capability is a good thing, and policies to promote domestic employment at the expense of potential growth are not in the overall interest of the nation.

These lessons suggest several courses of action that have served as cornerstones of the President's economic policy, by:

- Advancing steps toward reform of the nation's tax system;
- Making health care costs more affordable and predictable by helping individuals save for future health expenses, permitting small businesses to band together to acquire coverage, and reducing frivolous litigation;

- Decreasing the burden of litigation on the economy, and limiting the tort tax that is borne by all of us as consumers, workers, or investors;
- Rationalizing energy and electricity policy;
- Streamlining regulations;
- Opening international markets to American goods and services; and
- Increasing support for our nation's infrastructure for basic research.

AN EXPANDED SCOPE FOR MARKET INCENTIVES

The Bush Administration has emphasized expanding the scope of markets through a U.S.-led effort for more open global trade. The large contribution of reduced trade barriers to growth in our standard of living has long been recognized. Still, the United States has the opportunity to reap significant gains from the future trade agreements. The 2002 *Economic Report of the President* highlights a study that finds that a new World Trade Organization (WTO) round that lowers barriers to services and reduces tariffs by one-third on agricultural and industrial products would yield gains roughly equivalent to a \$2,500 permanent increase in the annual income of the average family of four. An agreement on the Free Trade Area of the Americas that removed bilateral tariffs would generate about an \$800 permanent increase in the annual income of a family of four.

This is an example of the benefits of trade. Trade itself—not just either exports or imports in isolation—is the key. Trade helps our domestic productivity. Expanding global trade allows the most efficient producers to grow because selling goods in the competitive international marketplace demands higher productivity. Imports also provide competitive stimulus to improve domestic productivity growth.

Formal trade agreements are the key here. We're seeing this today in the success of NAFTA. The United States strongly supports a new round of global trade negotiations. Similarly, among our trading partners, a commitment to open trade represents a commitment to sound economic policy. This serves their self-interest, our foreign policy objectives, and global development objectives. To make the case for global trade, we can point to our own history, which demonstrates the link between trade liberalization and faster economic growth.

The scope of market incentives in economic policy should expand in a second way as well—into non-market settings. It is now widely recognized that market incentives can serve our environmental interests. However, by crafting a suitable institutional framework for these incentives, we can achieve faster, sustainable growth.

Consider the debate over the appropriate policies toward global climate change. Certainly this debate will be with us for the foreseeable future, along with the need to analyze in-

The Greenhouse Effect

The ultimate goal of a sound climate change policy is long-term stabilization of atmospheric greenhouse gas concentrations at levels that avoid costly environmental or economic damage. However, this complicated problem requires a gradualist approach: Emphasize long-term goals, but focus short-term efforts on developing durable domestic and international policy architectures to learn about the benefits and costs of alternative strategies.

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ternational agreements and institutions. The ultimate goal of a sound climate change policy is long-term stabilization of atmospheric greenhouse gas concentrations at levels that avoid costly environmental or economic damage. However, this complicated problem requires a gradualist approach: Emphasize long-term goals, but focus short-term efforts on developing durable domestic and international policy architectures to learn about the benefits and costs of alternative strategies. We need to develop institutions to seek out and exploit the lowest-cost abatement opportunities wherever they are in the world. This is a tall order, but one should not pretend that they need to be developed right away. In contrast to a premature, Kyoto-style agreement, the conversation should become broader and deeper over time, much like the fifty-year effort for the General Agreement on Tariffs and Trade/World Trade Organization.

Relying on economic analysis, President Bush introduced a new climate change mitigation goal for the United States and outlined the basic steps to get us there. The President identified greenhouse gas intensity, the ratio of emissions to economic activity, as a better way to measure progress, and set a serious but reasonable goal of reducing our greenhouse gas intensity substantially over the next decade. He challenged industries to voluntarily commit to reducing emissions, promised businesses that their investments in emissions reductions today would not be penalized by future policy decisions, and announced that these reductions, once registered, could be traded. Finally, he established a check at the end of this ten-year period to determine whether further measures were necessary, including the possibility of a broad, market-based program in the future.

The President's plan builds on private incentives by first establishing a convincing goal, then allowing businesses to figure out innovative ways to measure and record their

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Finally, the United States faces very significant fiscal challenges, particularly with an aging society's need for retirement support and health care support. These challenges require a strong attention to economic growth. But we also have to confront the massive unfunded liabilities of entitlement gains. President Bush has submitted a detailed budget blueprint to the Congress with a plan to reduce the budget deficit relative to GDP by half over the next five years. The President has also spoken often of the need to implement reforms of Social Security and Medicare that would improve the sustainability of those programs. By contrast, as of this writing, the President's challenger has racked up an additional budget gap of at least \$1 trillion—the excess of spending proposals over promised tax increases—over ten years, and he has offered no clues as to his thinking on the outlook for Social Security and Medicare. That gap implies higher deficits, another tax increase, or both.

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Given the stakes, I would like to hear more from both candidates about the long-term entitlement challenges facing the country. This is because our adaptation to these challenges will impact significantly our economic flexibility and economic growth. Success in reforming our entitlement programs toward empowering individuals will be consistent with lower future tax burdens and a larger economy. Choosing the alternative of a larger government share in our economy risks both our living standards and the viability of the very programs championed by the President and his opponents. ◆