Huh? A Surprising Success!
R Glenn Hubbard
The International Economy; Spring 2004; 18, 2; ABI/INFORM Global
pg. 28

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-

Glenn Hubbard, a former Chairman of the Council of Economic Advisers under President George W. Bush, is the Russell L. Carson Professor of Finance and Economics at the Graduate School of Business and Professor of Economics in the Department of Economics at Columbia University in New York.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

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 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.

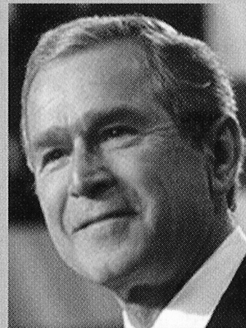
Cries of "What about the good old 1990s?" miss both the unaddressed seeds of the downturn and the reality that policymakers must respond to the economic shocks they experience.

The 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.

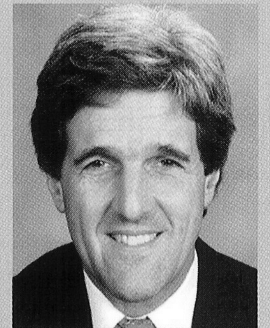
Consumption was unusually strong during this recession, and the latest research suggests that the tax cuts played a big

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

How to Handle the Budget Gap



George W. Bush


John Kerry

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.

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.

—G. Hubbard

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;

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

- 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 international 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.

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.

—G. Hubbard

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

Continued, page 71

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Continued from page 31

reductions—with government on the sidelines to ensure integrity. It protects those reductions from future climate policies, so firms acting in good faith to contribute to the national goal are not penalized by any future policy. And it lets firms transfer the reduction credits to other firms, so even those without immediate reduction opportunities can contribute as well as hedge against future climate policies. This creates an incentive, encourages a flexible response, but does not take economic risks. From the perspective of expanding the scope of market incentives, it also encourages the development of useful institutions regardless of the course we pursue in the future.

TOWARD A PRO-GROWTH INTERNATIONAL ECONOMIC POLICY

President Bush has provided three major international economic policy initiatives that are consistent with these pro-growth principles. First, as I mentioned earlier, the President sought (and, in contrast to President Clinton) received Congressional authority for streamlined negotiation of trade agreements reached under Trade Promotion Authority. Second, the administration's ambitious Millennium Challenge Account program builds on recent economic research on finance and growth, extending additional developmental aid to the world's poorest countries provided they have adopted pro-growth policies. Third, the President has called for reform of the World Bank and regional development banks, so that they may increase their effectiveness in fostering economic growth through private-sector development.

Importantly, President Bush's economic policy agenda has centered not only on sustaining and advancing economic growth and living standards in the United States, but also around the world. In dialogues with OECD countries, the administration has urged more accommodative macroeconomic policies in the Eurozone and Japan to add engines to the global recovery, and the President has wisely pointed out that improvements in economic and financial flexibility in our major trading partners can improve prospects for long-run global growth.

But the challenge is broader. As the 2003 *Economic Report of the President* observes:

> *Many developing countries throughout the world have taken important steps in recent years to promote the growth of their economies. Their actions have lifted millions out of poverty, improved the health of their populations, and contributed to progress in addressing environmental challenges. Other countries, including some of the world's poorest, have had less success in achieving and sustaining strong economic growth. Developed and developing countries alike face the challenge of improving economic performance around the globe, so that more people can share in the benefits that come with growth.*

The President's agenda here focuses on three principles—securing economic freedom, governing justly, and investing in people.

LOOKING FORWARD

Economic policymakers in the next administration, be it that of President Bush or Senator Kerry, face challenges and choices in four areas. How those challenges are addressed and the choices that are made will shape America's role and message in economic policy around the world.

First, the substantial improvement in economic growth in recent years cannot be taken for granted. Support for institutions for risk-taking and organizational flexibility, as well as policies that limit the tax and regulatory burdens on entrepreneurship, is vital. We have a choice. The continuation of an agenda that promotes economic flexibility and growth is in the national interest. The alternative vision is one of higher taxes and greater regulatory involvement in private decisions, with consequences for economic flexibility and living standards.

Second, openness of markets in the United States and abroad continues to offer great promise for American workers and businesses. The Bush administration has supported this promise through tax policy and trade negotiations, while advancing policies to help workers displaced by competitive forces to acquire new skills. An alternative is economic isolation, using tax or regulatory policy to hold back the competitive forces so large in the present recovery and the next decade.

Third, continued reform of the international financial institutions is needed to focus their efforts on promoting private-sector development and economic growth. President Bush has articulated a vision in which U.S. support for IMF assistance in emerging markets financial crises should be linked to programs that lead to sustainable economic growth or that are in the strategic interests of the United States. The Clinton administration's more *ad hoc* approach stimulated the concerns about moral hazard that figured prominently in the Meltzer Commission's 2000 report to the Congress on international financial institutions. About that earlier approach, I have two questions: When would an intervention approved by the U.S. Treasury in a foreign financial crisis not be warranted? Should such intervention be limited to cases in which a global-taxpayer-financial program could lead to a sustainable path for economic growth and public finances?

Continued, page 71

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Continued from page 27

WHERE ARE WE HEADED?

The big question is, are we eventually going to start paying a price for our neglect of the responsibilities of international economic leadership, and for poor economic policies more generally? Britain's economic and political hegemony did not long survive the loss of its large international creditor position. The record of the United Kingdom in the 20th century (1914–1956) suggests that a great power that becomes a great debtor will, after a few decades, lose its dominance. The United States passed from largest net creditor to largest net debtor in the 1980s. With the re-emergence of the twin deficits, and prospects for continued widening, will we see adverse economic and political ramifications? In the 1960s, Germany was willing to offset the expenses of stationing U.S. troops on bases there so as to save the United States from a balance of payments deficit. In 1991, Saudi Arabia, Kuwait, and a number of other countries were willing to pay for the cost of the war against Iraq, thus temporarily wiping out the U.S. current account deficit for the only time in a twenty-year period. Repeatedly the Bank of Japan, among other central banks, has been willing to buy dollars to prevent U.S. currency from depreciating (late 1960s, early 1970s, late 1980s).

The dollar has fallen sharply over the last year in response to the widening U.S. current account deficit. So far, it has not spun out of control: U.S. interest rates remain very low and securities prices high. Will other countries be willing to help us out the next time there is substantial unwanted downward pressure on the dollar, without setting conditions in return? I fear not. Sometime soon, newspaper stories will begin reporting that central banks in Asia and elsewhere are diversifying out of dollars into euros, and that the dollar is in danger of losing its status as premier international currency. This will be the most obvious symbol of what is already clear: the Bush Administration has failed spectacularly the obligations of international leadership. ◆

Continued from page 70

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.

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.

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. ◆

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.