A fiscal plan with global benefits

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Recent US economic policy has limited recessionary declines in spending. Proponents point to the shallowness of the downturn in the face of collapsing equity values, the September 11 terrorist attacks and geopolitical risks, and to the continued outsized contribution of the US to global growth. Critics point to the growing deterioration of the US fiscal position and current account deficit. The witticism of Herb Stein, the late chairman of the US Council of Economic Advisers, sums up their fears: "Something growing too fast forever will stop."

The author of the big shift in US fiscal policy, George W. Bush has recently suggested potent and gradual remedies to these imbalances - not currency high jinks but something straight from an economics textbook: tax reform and Social Security reform.

These big fiscal initiatives address domestic and global imbalances by providing a means to increase national saving gradually, while increasing the economy's ability to substitute investment spending for consumption. Viewed generally - and sensibly - as long-term measures, tax and Social Security reform offer strong medicine for near-term imbalances as well.

This juxtaposition is not new. Mr Bush's signature tax cuts were justified as promoting long-term economic growth by decreasing marginal tax rates on work and entrepreneurship, providing incentives for additional plant and equipment investment and decreasing the double taxation of equity-financed investment. At the same time, these tax cuts cushioned declines in consumers' disposable incomes, enabling households to maintain spending during the downturn. Reductions in tax rates on dividends and capital gains increased equity values, repairing balance sheets. Along with temporary investment incentives, they reduced the costs of capital for fixed investments, bolstering capital expenditures and durable goods orders.

Of course, monetary policy also helped limit declines in spending during the recession - notably for households. But particularly when nominal interest rates were at very low levels, fiscal policy provided a key boost to economic activity.

The substitution of the federal government's balance sheet for those of households and companies cannot, of course, continue. A gradual increase in national saving is required. There lies the link to fundamental tax reform: leading reform proposals would encourage private saving by reducing or eliminating the tax bias against saving.

In a similar vein, many proposals to reform the Social Security system would do so by slowing the rate of growth of its benefits and funding personal accounts for individuals. These departures from the presently unsustainable pay-as-you-go system could raise saving significantly. In contrast to previous "Social Security surpluses" (excess of current payroll tax receipts over current benefits), funded personal account balances would be unlikely to be spent in the political process. And slowing benefit growth could remove trillions of dollars of unfunded liabilities from the US government's balance sheet, while allowing younger households to save more for retirement.

What about America's yawning current account deficit of $600bn? Reform of Social Security - by moving to a more funded system with lower unfunded obligations - could gradually increase national saving, which, all else being equal, would reduce the current account deficit.

Tax reform could also increase saving by reducing the tax bias against capital accumulation and help the US economy adjust to a lower current account deficit. The nation needs a shift from domestic consumption to the capacity for exports of tradable goods (and substitutes for imports) to roll back the current account deficit. Part of this adjustment will occur as interest rate increases by the Federal Reserve restrain domestic consumption. But tax policies to increase investment could play a significant role.

Fundamental tax reform in 2002 included a 50 per cent tax allowance for new capital goods purchases. Congress recently allowed this to expire. Fundamental tax reform under a consumption structure would permit complete expensing of capital goods purchases, cutting the user's cost of capital and stimulating investment. Indeed, the big gains in economic activity made possible by tax reform would occur because of greater capital availability. The more tax reform can expand the US's fixed capital stock, the easier it will be to reduce the external deficit without a large drop in domestic spending.

America has many reasons to bring its inefficient tax and Social Security systems up to 21st-century standards. But policymakers in Asia and Europe have a stake in the debate, too. The fiscal reforms proposed by Mr Bush offer a clear step towards raising US saving and reducing imbalances. The writer, dean of Columbia Business School, was chairman of the White House Council of Economic Advisers from 2001 to 2003