President Bush’s selection of Goldman Sachs CEO Hank Paulson to be the next Treasury Secretary is cause for cheer. Mr. Paulson’s distinguished experience gives him a platform to offer counsel on economic policy, tax and entitlement reform, and global financial issues. His nomination should also offer a pause for reflection about the economy’s performance and its muse – and about imagined and real concerns about the economic outlook.

Secretary Snow and Secretary-designate Paulson should take heart: Headline data for the U.S. economy show clear present strength. Last month’s report of first-quarter GDP revealed growth at a nearly 5 percent annual rate. And many commercial forecasters estimate that GDP growth over the full year will be in line with the economy’s potential GDP growth (around 3.5 percent). The nation’s unemployment rate has declined to 4.7 percent, and the economy has been adding to payrolls at a clip of about 200,000 jobs per month. Outside the United States, much improved growth prospects for Japan and nascent growth in Europe are good news for global economic activity.

Today’s Fears…
The American public’s anxiety over the economy poorly matches those headlines. One possibility, cheered on by many quarters, is that the economy’s performance simply is not as good as the data suggest. In this view, Americans have borrowed against their individual and collective futures, using housing equity gains to finance consumption, expanding the already large U.S. current account deficit. As housing price appreciation starts to vanish, the engine for spending growth stalls, and foreign investors may be losing faith in the U.S. economy’s spendthrift ways.

While such developments make for high drama, economic practice is likely to be different. Flattening house price growth – already embedded in most forecasts of reasonably good top-line growth for the economy – will lead consumers gradually to rebuild their saving. At the same time, the recovery’s strength has already rotated to business capital spending. The combination of gradually rising U.S. saving and a pickup in domestic demand growth in key emerging economies should facilitate gradual adjustment of U.S. external imbalances in the medium run.

Interestingly, proponents of “imbalances” in the recovery view often suggest that public policy played an unwelcome role in getting us to our present situation. The Federal Reserve pursued a very accommodative monetary policy in the aftermath of balance sheet deterioration, business uncertainty, terrorism, and geopolitical risk – and that accommodative policy put wind in the sails of the housing market, consumer spending, and the current account deficit. Inflation risks are a legitimate concern, of course. But can one seriously believe that a much tighter monetary policy over that period would have proven better for incomes and employment – particularly for lower- and middle-income workers?

And tax policy? Though accidental in their conception, the tax cuts championed by President Bush cushioned declines in disposable income in the past recession, supporting consumption. And, more important, investment incentives, lower marginal tax rates for entrepreneurs, and cuts in dividend and capital gains taxes promoted investment at a time when investment decisions faced many headwinds, and such tax changes comprise a good part of fundamental tax reform. Are we to believe that higher marginal tax rates would have led to better outcomes for output and employment over the past five years? Should we think that raising taxes on capital income would
be an encouraging sign for foreign investors about the U.S. investment climate? Are we to believe that raisin marginal tax rates on productive activities is a better answer than tax reform?

...Miss The Big Story
While pundits’ handwringing about the economy misses the mark, there is a void in Washington in talking about the really big story – the extraordinary performance of productivity growth in the U.S. economy over the past five years (and the five years before that). If an economist had correctly forecasted five years ago on this page the extent of asset price declines, September 11, corporate accounting scandals, and geopolitical risks, readers would doubtless have predicted an economic calamity. Instead, high productivity growth (with aggregate demand growth supported by public policy) has led to a different and more pleasing outcome.

“Dark cloud” stories about housing or foreign borrowing or monetary and fiscal policy miss the point that productivity growth has accelerated a full percentage point over the past ten years, with enormous implications for growth in living standards. And this growth reflects the power of openness, innovation, and entrepreneurship in the U.S. economy. The productivity performance in the rest of the industrial world has been less impressive.

It is tempting to credit ‘technology’ with this central success story for the U.S. economy. But those who say the answer is technology have spent too little time in Tokyo, Seoul, and Berlin. The fact is, technology is better in many other countries. Cell phones and PDAs do things abroad that put us to shame. Broadband, both wireless and fixed, is faster and more ubiquitous in many other countries.

So what is going on? Technology may be at the heart of the success of our greatest companies, but these companies did not become more productive simply by buying faster computers. They became more productive by having managers and entrepreneurs who faced global competition knew how to integrate these investments with new business models to raise productivity.

More generally, U.S. markets allow entrepreneurs to create the celebrated “resilience” of our economy, in which labor and capital swiftly respond to shocks from financial market downturns, or disasters such as Hurricane Katrina, just as they do in response to opportunities for innovation and expansion.

Entrepreneurship, in turn, supports economic stability. Twenty-five years ago, large firms took weeks to find inventory imbalances – and excessive stockbuilding required a sharper cut in production than would have been needed if inventory knowledge had been current. Entrepreneurial and managerial innovation spurred information technologies to allow real-time responses to inventory imbalances.

As Mr. Paulson knows well, nowhere is this entrepreneurial contribution to economic stability more evident than in financial services, where deregulation, coupled with innovative technologies, has fostered the development of financial products, such as asset-backed securities and credit-default swaps, that make possible much greater spreading of risks. Championing healthy financial markets and institutions abroad – particularly in emerging economies like China – should be high on the Treasury to-do list.

Returning to anxiety about the present economic outlook, a more reasonable question might be whether workers with average income are sharing in the surplus created by faster productivity growth. Simple economic intuition suggests that in a competitive economy, workers will see the benefits of higher productivity in higher wages. And looking at postwar data for the United States, productivity and real compensation grow together.

Three features of this relationship merit additional commentary in discussion of economic policy. First, while productivity and real compensation grow together, the co-movement is not instantaneous. In the mid-1990s, for example, higher productivity was not immediately reflected in
compensation. GDP growth of about 4 percent in 1994 was drowned out by worries over job cuts and downsizing until compensation shared more fully in productivity growth’s dividends later in the decade. Likewise, a lag in the incorporation of productivity growth into compensation today has called forth fears of outsourcing and the outsized greed of corporate chieftains.

Second, many commentators point to the observation for recent years that real wages are not keeping pace with productivity growth. ‘Wages’ differ from ‘compensation’ because of health care and other benefits. Health care costs rising more rapidly than inflation strip out potential wage growth (while allowing greater compensation growth, including employer-paid health care costs). A more fulsome policy discussion of rising health care costs is surely in order. Allowing productivity growth to pass more completely into wages would be easier if market forces were used to help restrain health care costs.

Third, the growth boom in the United States carries with it change – business starts, successes, and failures. And steady aggregate growth can mask shifts in the returns to different skills and industry occupations. To maintain growth, we must resist the strong political pressure to protect existing ‘jobs’ and ‘firms.’ Rather, well-functioning labor and capital markets – cushioned by public support for training and education – offer a better route to success.

But There Is Real Danger

There is a real potential fear out there that could be weighing on the public’s mind – a very large tax increase that could leach the innovative capacity of our vibrant and entrepreneurial business sector and eliminate the growth dividend of the past decade. Impossible? No.

The lurking challenge lies in our entitlement programs. If there are no changes in these programs, after a generation, we will spend 10 percentage points of GDP more on Social Security and Medicare than we do today. Financing this change would require a 50-percent across-the-board tax increase. Ratifying even half of the anticipated increase in entitlement spending would necessitate a 25-percent tax increase, not exactly pro-growth policy.

A recent front-page story in USA Today put the problem more crisply: The story assigned Americans a bill for the present value of all federal obligations not currently funded of about $500,000 per household. For those wagging their finger at current federal budget deficits (as troubling as the recent lack of spending discipline is) about 8 percent of the bill was for conventional federal debt, while 80 percent was for Medicare and Social Security benefits.

Economic policy – and its communication – face challenges and opportunities. Secretary Snow has rightly celebrated the U.S. economy’s success, and Mr. Paulson will no doubt do so, too. But explaining the fount of that success and confronting real fears about entitlement spending would be a welcome addition.

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