The Second-Term Economy
By **R. Glenn Hubbard**
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The past year's monthly employment reports played an outsized role in the recent presidential campaign. Indeed, the election focused America's mind on jobs and growth. With the election behind us, it is useful to reflect on how the economy works and what the new administration and Congress can do about jobs and incomes.

To start, last Friday's employment report made it official -- the pace of payroll employment growth is robust, and the U.S. economy has added nearly 2.4 million jobs since the labor market turned around in August 2003. The surging payrolls help explain steady consumer spending, even against the backdrop of higher energy prices. The employment gains also represent rising business confidence that the economy will continue to grow at, or perhaps a bit above, its potential growth rate.

Part of the to-ing and fro-ing of the campaign season forced a debate over whether practices that raise business flexibility and productivity are job killers for the future. Indeed, despite economists' paeans to the virtues of a high rate of productivity growth, many commentators associated economic growth with efficiency practices of downsizing and outsourcing.

But over the long haul, what keeps our economy growing is entrepreneurial innovation, by creating and satisfying new wants. In the labor market, entrepreneurial booms are associated with job creation that significantly outpaces job destruction. New firms and even new industries figure prominently in this process. Less than 30% of the goods and services we consume today were available at the turn of the previous century. Some of these goods replaced old ones -- as the automobile consigned stagecoaches and buggy whips to history. But much is new -- medicines and therapies to treat diseases, for example. And airplanes made it possible for us to fly to places to which we would not have driven.

In the much-talked-about world of information technology, it is true that some creation is also destructive -- as when calculators replace slide rules. But e-mail has not made the telephone obsolete. And PCs did not kill mainframes so much as introduce millions of new users to word processors or spreadsheets.

Entrepreneurial growth -- through innovation and flexibility -- is not a job slayer in the economy. Over the past 25 years in the U.S., a 67% increase in productivity and the higher wages that accompany that gain occurred alongside the creation of 40 million new jobs.

Good public policy can support America's entrepreneurial growth machine. Some policy directions are obvious and (hopefully) uncontroversial. Support for basic research and education and skill development are important priorities. Monetary policy that promotes low and stable inflation mitigates cycles that can dampen growth and business formation. Well functioning financial markets make it possible to spread risks and increase business flexibility; policy should not make this flexibility costly. The tort system taxes innovation and risk-taking and should be reformed. Other policies are more controversial if the recently concluded presidential campaign is a guide.

Free trade benefits the economy by spurring growth and jobs in exports, to be sure. But openness also benefits consumers through imports, often made possible by entrepreneurial distributors (Wal-Mart, for example). Competition from foreign producers also stimulates entrepreneurial thinking in small and large firms alike on how to be more efficient. The cost savings to our economy raise the standard of living in the U.S. We should continue the push for multilateral trade agreements and avoid protectionist temptation. Given the importance of innovation for growth, we should continue to pay special attention to protection of intellectual property in agreements.

Research by Eric Engen of the American Enterprise Institute and Jonathan Skinner of Dartmouth College, among others, concludes that a large government share in the economy reduces growth through the large tax burdens it ultimately requires along with regulatory intrusions. In the presidential campaign, President Bush correctly identified the substantial increase in the size of government that Sen. Kerry proposed.

But the second Bush term faces challenges as well. In the near term, forceful statements about ways to control discretionary spending would be useful. Over the longer run, the spending problem lies in the entitlement programs. The Congressional Budget Office projects that over the next 40 years, Social Security and Medicare spending will increase to consume an additional 10% of GDP annually. This rise would be equivalent to a 50% increase in the federal government's share in the economy. While Social Security reform is, rightly, a domestic policy priority for the president, a shift to personal accounts alone will not solve the program's funding gap. And the bigger problem lies in the Medicare program, where fundamental reform of health-care markets to make consumers more cost-conscious (as in recently enacted Health Savings Accounts) is a vital first step.

This discussion differs from the "deficits" debate during the campaign. The federal budget deficit is simply the difference between two variables over which the president and Congress have some control -- spending and taxes. Over time, choosing "deficit reduction" through spending restraint or raising taxes implies significant differences in future economic growth. The Engen-Skinner study finds that a balanced-budget increase in government spending and taxes -- as deficit reduction through tax increases implies -- would reduce U.S. output growth markedly. Indeed, closing the long-term entitlement funding gap through tax increases could reduce output growth by as much as one percentage point annually in the long run.

The past four years have witnessed a shift toward lower marginal tax rates on work, saving, and entrepreneurial risk-taking. Recent research (including work by William Gentry of Williams College and me) suggests an economically important relationship between "success taxes" (high marginal tax rates on successful business ventures without the government sharing equally the risk of failure) and entrepreneurial entry, even in innovative industries. And estimates of the effect of the user cost of capital on investment indicate links between recent investment incentives and the cut in dividend and capital-gains taxes, as well as the resurgence in business investment.

President Bush has said that "tax reform" is another domestic priority. But not all reforms or simplification proposals are equal. Tax reform to promote growth and employment should keep marginal tax rates low and remove tax biases against saving, investment and risk-taking. And while there is much to recommend consumption tax reform, many gains can be achieved by reform of the present income tax.

Periods of growth are always accompanied by change, as entrepreneurs and innovators create new products and services, markets and industries. The second Bush term can play a constructive role to help citizens cope with change. The president's earlier proposal for Personal Reemployment Accounts would complement Unemployment Insurance by giving an individual likely facing a long spell of unemployment funds for individually chosen training and a bonus for early re-employment. Health Savings Accounts offer the beginning of more portable, individually chosen health insurance not tied to a specific employer. And the stronger savings incentives the president has proposed give individuals a chance to build up larger portable retirement benefits.

Last week's employment report is a cause for cheer. But the deeper satisfaction comes from admiration of the U.S. economy's growth machine. The administration and the Congress do not "grow the economy," but good public policies can enable entrepreneurial growth to take place. The public -- faced with platforms of looking back to "the good old days" versus better-looking days to come -- looked beyond monthly employment reports to see how the economy works.

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