Economic Choices

Remarks at the
National Association of Business Economists
2004 Washington Economic Policy Conference

Dr. N. Gregory Mankiw
Chairman
Council of Economic Advisers
March 25, 2004

Today I would like to offer you my view on the state of the economy. I will look both backwards and forward in time—to the challenges the Nation has faced since President Bush took office and to the choices we confront as we move ahead.

Over the past several years, powerful contractionary forces have weighed on the economy. These include the end of the high-tech bubble, the revelation of corporate governance problems, and geopolitical uncertainty stemming from terrorist attacks and the war in Iraq. The most noticeable impact was on business equipment investment, which slowed sharply in late 2000 and remained soft for more than two years. The slump in investment demand occurred in other countries as well, depressing U.S. exports and growth.

The bursting of the high-tech bubble and the subsequent recession had an immediate effect on employment. Since December 2000, payroll employment has declined by 2.3 million. More than three-quarters of this decline occurred in 2001. Payrolls fell almost 900,000 during the first nine months of that year, following the stock market decline that began in September 2000. Then, in the three months following the 9/11 terrorist attacks, almost a million more jobs were lost.

Policymakers took prompt and decisive actions to counteract the effects of these adverse shocks to the economy. The Administration and Congress passed substantial tax relief to provide a much-needed economic stimulus. Together with expansionary monetary policy, the tax cuts softened the impact of the recession and helped put the economy on the road to recovery.

The economy took a decided turn for the better in the middle of last year, following passage of the last of the tax cuts, the Jobs and Growth Act. Real GDP expanded at an annual rate exceeding 6 percent in the second half of 2003. This was the best half-year performance in nearly 20 years and the best among the major developed economies.

Financial markets responded enthusiastically to the economic news. Last year, stock prices recorded their best annual gain since 1995. The net worth of U.S. families reached a new record level.

Payroll employment gains have lagged the rest of the economy. In an arithmetic sense, weak employment growth can be linked to substantial productivity gains. With productivity

growth over the past three years at its fastest pace in decades, the output of goods and services has been able to expand without typical increases in employment.

But we should not lament the recent productivity gains. These gains have boosted national income, and they have reduced inflationary pressures by holding down growth in unit labor costs. In the short run, bursts in productivity add to business profits, but in the longer turn, they benefit workers as well. Economic theory and history both point to productivity growth as the primary determinant of rising real wages.

Although the pace of job creation remains unsatisfactory, the labor market has been moving in the right direction since last summer. The unemployment rate has fallen from 6.3 percent in June to 5.6 percent—below the average levels in each of the past three decades. Since August, the economy has created 364,000 jobs according to the payroll survey, and 981,000 jobs according to the household survey.

Most signs suggest that the economy will expand vigorously in 2004. The index of leading economic indicators has risen impressively over the past 12 months. The Blue Chip consensus of private forecasters predicts that real GDP will expand by 4.2 percent over the four quarters of 2004. This is a bit better than the Administration's December projection of 4.0 percent growth. We now must ensure that the labor market continues to strengthen and that the broader economy moves onto a long-run path of strong, sustained growth.

The Nation faces a critical choice on taxes. Some have proposed reversing course and raising taxes. In my view, this is exactly the wrong policy to increase employment and family incomes. The right approach is to make the tax cuts permanent and reduce the budget deficit over time through spending restraint.

The tax cuts over the past three years provided important stimulus that helped turn the economy around. Without these policy actions, economic conditions would be much worse today. According to simulations of a conventional macroeconometric model, if the President had left the tax code unchanged in response to the adverse economic shocks, about 2.5 million fewer people would be working today.

When assessing the role of the recent tax cuts, it is crucial to consider both short-run and long-run goals. The short-run effects of the tax cuts can be traced in part to a classic Keynesian mechanism. The tax cuts let people keep more of the money they earned. You can see this in the data: Over the past three years, real after-tax income has increased much more than before-tax income. Real disposable income per capita is now near an all-time high.

The boost to income from the reduced tax burden supported consumer spending and helped maintain aggregate demand. This type of stimulus represents conventional short-run stabilization policy. There is nothing novel about it—you can find it in all of the leading textbooks.

In addition to their effects on consumption, the tax packages provided stimulus through several provisions that increased firms' incentives to invest. These provisions include temporary

bonus depreciation, enhanced expensing for small businesses, and lower taxes on dividends and capital gains. The lower individual tax rates reduced the tax burden on income from sole proprietorships, partnerships, and S corporations. These various initiatives reduced the cost of capital and, in doing so, boosted investment spending at a crucial time.

The President's tax policy, however, should not be viewed solely from a short-run perspective. The tax cuts were intended not only to address the cyclical slowdown but also to encourage stronger economic growth over the longer run.

The tax cuts have long-term benefits because they enhance incentives to work, save, and invest. Lower tax rates on labor income provide an incentive to increase work effort. Lower tax rates on capital income—the reward for saving and investment—encourage individuals to do more of these activities. Investment increases the amount of capital available for each worker and also increases the rate at which new technology embodied in capital can be put to use.

Lower tax rates on dividends and capital gains also move the tax system toward a more equal treatment of debt and equity, of dividends and retained earnings, and of corporate and noncorporate capital. A more level playing field increases economic efficiency because it promotes the allocation of capital based on business fundamentals rather than a desire for tax avoidance.

Greater work effort and higher rates of capital accumulation mean higher potential output. The tax cuts will do more than just bring the economy back to its potential level. The tax cuts will put the economy on a new and better long-run growth path. This is why the choice now facing the Nation on taxes is so important. Making the tax cuts permanent is the most reliable way to keep the recovery on track and to boost growth in our standard of living over time.

Some would have us choose differently. In considering the alternatives, we should take a lesson from our major trading partners across the Atlantic. Many European countries have opted for higher taxes and larger governments, and we can see the results. Such a choice can reduce the uncertainty that comes with living in a dynamic economy. But it also means higher unemployment, lower growth, and lower mobility. In many of these countries, it is more difficult to start a business, to tap capital markets, and to switch occupations and start a new career.

It can be tempting for Americans to take the dynamism of the U.S. economy for granted. But we should remember that this dynamism reflects the policy choices we have made, and that the economic stagnation of other nations illustrates the downside of other choices.

One challenge the United States will face in coming years is the budget deficit. The expansionary effects of tax cuts, both in the short run and in the long run, are offset to some degree by the effects of the budget deficits that arise from lower revenues. Deficits can raise interest rates and crowd out of investment, although I should note that the magnitude of this effect is much debated in the economics literature. The main problem now facing the U.S.

economy is certainly not high interest rates. But, at some point continued deficits would matter and could impede growth. This is why, as the President has said, spending restraint is so vital.

The Administration would prefer not to have deficits, but deficit reduction is only one of many goals. This is simply a matter of priorities. The President made growth and jobs his number one economic priority.

Yet it is crucial to have a plan to reduce the deficit over time relative to the size of the economy. This is the case under the President's policies. The deficit as a share of GDP is projected to diminish by more than half over the next five years.

The greatest fiscal challenge ahead is the growth in entitlement spending from the aging of the population and the retirement of the baby boom generation. The president's budget correctly called this "the real fiscal danger." Unless the entitlement programs are modernized for future generations, truly worrisome budgetary pressures will arise over the next few decades. This is one reason why, as a prescription drug benefit was added to Medicare, the president moved to include greater choice for seniors and competition among private providers. It is also why the president has stressed the need for fundamental reform of Social Security, including a role for personal accounts.

Beyond taxes and spending, there is another critical choice facing the Nation—the choice regarding our role in the world economy. The world trading system is undergoing dramatic changes. We are all used to goods being produced in one country and transported to another on ships or planes. We are less used to services being sent across borders over fiber optic cables. As technology expands the range of commercial activities that can be traded internationally, more American workers are exposed to global competition.

The basic laws of economics, however, have not changed. Free markets remain the best way to promote growth, create good jobs, and ensure rising living standards. That is why the President has actively sought to open markets.

Some would respond to the recent challenges facing the economy by erecting trade barriers. But we will not prosper by hiding behind walls or by filling our harbors with rocks.

History teaches that a retreat to economic isolationism is a recipe for economic decline. For example, the Smoot-Hawley tariffs of the 1930s contributed to the hardship of that period. By contrast, the North American Free Trade Agreement, negotiated by the first President Bush and implemented by President Clinton, took effect just as the U.S. economy began a spree of growth and job creation.

The right response to these recent challenges is to maintain a commitment to a free and open system of world trade. Open markets allow American firms to sell world-class products in the large global economy, and they give American households and businesses the freedom to buy the greatest variety of goods and services at the best prices. Because of international trade, American children have more toys in their toy boxes and more clothes in their dressers, while American parents have the opportunity to sell the fruits of their efforts into the large global

marketplace. Open trade allows American businesses to buy the best equipment and materials, and this benefits their workers, owners, and customers.

A Montana newspaper, the *Missoula Missoulian*, recently wrote an editorial about fly fishing that illustrates well the gains from trade. Until the 1970s, the artificial flies used by fisherman in this country were mostly produced domestically. Tying flies is labor intensive and hard work, so now it is mainly done abroad. The resulting availability of lower-cost imported flies allows the average fisherman to buy a larger and more diverse selection. Some flies are still made in the United States, but these are special ones—the very best and the most expensive. Meanwhile, the U.S. sport fishing industry has thrived and is booming in Montana. Montanans who a generation ago would have been commercial fly tiers can now get better-paying jobs building boats, making rods, and leading fishing tours. Trade in fishing lures has been win-win for fishermen, for Montana, and for people around the world.

As trade expands and the world economy evolves, it is natural to ask what new jobs will be created in the future. That question is best answered by market forces. Policymakers should foster an environment in which businesses will expand and jobs will be created. The President's initiatives to reform the tort system, to ensure a reliable energy supply, to make health care more affordable, and to streamline the regulatory burden will remove barriers to prosperity and promote sustained economic growth.

Policymakers should not try to determine precisely which jobs are created, or which industries grow. If government bureaucrats were capable of such foresight, the Soviet Union would have succeeded as a centrally planned economy. It did not, providing the best evidence that free markets are the bedrock of economic prosperity.

It is hard to predict what changes American ingenuity will bring to the U.S. economy. For example, over the past half century, new technology has led to great advances in farm productivity. As a result, the number of Americans working on farms has declined from almost 20 percent of the workforce in 1940 to about 2 percent today. In 1940, no one could have predicted that some of the grandchildren of farmers would become website designers and CAT scan operators. But they did, and at much higher wages and incomes. Farming remains a vital sector of the economy, but we would be far poorer today if public policy in 1940 had stifled the forces of change in order to keep 20 percent of Americans on farms.

At the same time that we recognize the gains from free and open markets, we must appreciate that any economic change, whether arising from trade or technology, can cause painful dislocations for some workers and their families. Public policy should ease the transition and help workers prepare for the global economy and the jobs of the future.

The President's policies are aimed at doing exactly that. He has proposed a "Jobs for the 21st Century" initiative to help prepare U.S. workers to take advantage of better skilled, higher paying jobs. Since 2002, he has nearly tripled spending on Trade Adjustment Assistance. His 2005 budget provides more than $20 billion for worker training and employment programs.

As the economy grows and changes, the choices facing the Nation are clear. Raising taxes and turning inward, as some have proposed, would depress economic growth. The better choice is to continue the President's policies to fuel growth and capitalize upon the strength and creativity of the American people.