The Economic Agenda

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at the
International Tax Policy Forum
American Enterprise Institute

December 2, 2004

Thank you. I am delighted to be here. I would like to take this opportunity to briefly review the present state of the economy. More important, I would like to discuss some economic challenges facing the Nation and the President's ambitious agenda for his second term.

Economic Outlook

Let me begin with the economic outlook.

When I wrote my first economics textbook about a dozen years ago, I told students to keep an eye on three indicators of economic performance: gross domestic product, inflation, and the unemployment rate. By all three indicators, the U.S. economy today is fundamentally sound. Real GDP has risen by 4.0 percent over the past four quarters—a full percentage point above the historical average growth rate. The rate of inflation has risen over the past few months but remains moderate, with core inflation at about 2 percent over the past year. The unemployment rate of 5.5 percent is down from 6.3 percent last summer, and it is now below the average rate in each of the past three decades.

There is good reason to expect the positive trends of the past year to continue. The consensus of private forecasters puts GDP growth for the rest of this year and into next year at well above the historical average. The unemployment rate is expected to continue its decline.

This is a remarkable state of affairs in light of the powerful contractionary forces at work since early 2000. The United States faced the bursting of the high-tech bubble of the 1990s, corporate scandals, slow growth among our major trading partners, and, of course, the terrorist attacks. Most recently, the economy appears to be weathering the impact of rising oil prices. These have put a strain on family budgets but do not appear to threaten the ongoing expansion.

Prompt and decisive policy actions helped to counteract the effects of these adverse shocks. Substantial tax relief passed in President Bush's first term, together with expansionary monetary policy, provided economic stimulus that softened the recession and put the economy on a faster road to recovery.

The U.S. economy is now on a sound footing for sustained expansion. But it is important not to take this situation for granted. President Bush has set out an ambitious agenda to ensure a continued and expanding prosperity.

Tax Reform

One part of that agenda is tax reform. The current tax code is a drag on the economy, discouraging saving and investment, and requiring individuals and businesses to spend billions of dollars and millions of hours each year to comply with the system. The President has stated that his goals are to make the tax code simpler, to make it more fair, and to further promote growth and job creation. Let me talk a bit of each of these goals.

Simplicity is the easiest goal to understand. As the President has put it, our tax system is a complicated mess. Anyone who has ever completed his own tax return would heartily agree. A simpler tax code would lower compliance costs, which are estimated to range up to $100 billion per year.

The growing reach of the alternative minimum tax threatens to further complicate tax preparation, as filers would have to make two separate tax calculations. The Administration and Congress have taken actions over the past several years to limit the number of taxpayers subject to the AMT. These fixes, however, have only been temporary. Under the present tax system, it is only a matter of time before the AMT hits many tens of millions of taxpayers—far more than it was ever intended to affect. In light of the looming AMT problem, tax reform is more than a desirable goal: It is almost a necessity. As the enormity of the AMT issue becomes more fully appreciated by Congress and the broader policy community, it should provide a crucial catalyst for action, moving the tax reform agenda forward.

Fairness, unlike simplicity, is an elusive concept, which is as much in the realm of political philosophy as economics. The President has said that, in his view, maintaining a progressive tax system is an essential element of fairness. One fact that is insufficiently appreciated is that his tax policy to date has made the system more progressive. According to estimates from the Congressional Budget Office, Americans with the highest 20 percent of incomes are expected to pay 64.6 percent of all federal taxes in 2004, up from 64.0 percent without the tax cuts. Each of the bottom three quintiles is paying a lower share of federal taxes as a result of the Administration's tax relief.

Let me now turn to the third goal of tax reform—promoting economic growth. As a general matter, the less the tax code distorts decision-making, the better the allocation of resources, and the more prosperous the economy will be. Standard economic theory indicates that the distortion of any tax rises with the square of the tax rate. That is why the standard mantra for economists interested in tax reform is "broaden the base, lower the rates."

A large scholarly literature in economics has pointed out that another way to strengthen the economy would be to reduce the tax bias against saving and investment inherent in the current system. This literature suggests that the optimal tax system would use consumption, rather than income, as the tax base. Under an income tax, a person who immediately spends all his wages pays lower taxes over his lifetime than his neighbor who earns the same amount but chooses to save and invest in order to enjoy a more prosperous retirement or to leave a bequest to his children. By contrast, under a consumption tax, these two families would pay the same tax in present value. Savers would no longer be disadvantaged relative to spendthrifts. The result would be greater saving, increased capital accumulation, and higher growth in productivity and wages.

At first, the idea of taxing consumption rather than income can sound like a radical change from the status quo. But the idea seems more natural when one realizes that the current tax code, while nominally an income tax, is actually a hybrid of an income tax and a consumption tax. Over the past several decades, Congress has amended the income tax many times to encourage saving. Policies such as individual retirement accounts and 401K plans exempt saving from taxation and, in doing so, move the tax base from income toward consumption. Similarly, last year's Jobs and Growth bill lowered taxes on dividends and capital gains; by reducing the double taxation of income from corporate capital, that bill can also be seen as taking a step toward taxing consumption.

The President has not yet decided what further reforms he will advocate. To spur progress on this issue, the President will soon name a bipartisan panel to work with the Treasury Department to develop reform proposals.

The Fiscal Challenge

Another fiscal policy challenge the United States will face in the coming years is the budget deficit. Most fundamentally, budget deficits are mechanism whereby one generation of taxpayers passes the buck for its spending on to future generations. Deficits also can put upward pressure on interest rates and crowd out investment. This crowding out of investment offsets some of the expansionary effects of tax cuts, both in the short run and in the long run. This why, as the President has said, deficit reduction and spending restraint are so vital.

The deficits we have seen in recent years are an understandable response to the recession and to the spending required for the war on terror. But as the economy continues to recover from the recent recession, 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.

To meet this target, Congress must abide by two of the President's stated priorities. First, tax reform must be revenue-neutral relative to the President's budget. Second, government spending must continue to be restrained. In the President's most recent budget, growth in discretionary spending was kept to 4 percent. Discretionary spending other than defense and homeland security was kept to less than 1 percent—below the rate of inflation. You should expect to see continued spending discipline in the President's future budgets.

Social Security Reform

The greatest fiscal challenge facing the nation, however, is beyond the standard five-year budget window. As the population ages and the baby-boom generation retires, the entitlement programs for the elderly of Social Security and Medicare will put gradual but substantial pressure on federal spending. The President's budget correctly called this "the real fiscal danger." And the President has renewed his call for Social Security reform during the recent campaign.

The fiscal challenge in the Social Security System reflects two factors. The first is simple demographic reality. In 1950, there were 16 workers paying into Social Security for every person receiving benefits. Now there are 3.3, and that number will fall to 2 by the time today's young workers retire.

The second driving force is that, under current law, each generation of retirees receives higher real benefits than the generation before it. This stems from the indexation of the initial level of benefits to wages, which over time grow faster than prices. A person with average wages retiring at age 65 this year gets an annual benefit of about $14,000, but a similar person retiring in 2050 is scheduled to get over $20,000 in today's dollars. In other words, even after adjusting for inflation, a typical person's benefits are scheduled to rise by over 40 percent.

Because of these two forces, the current system is not sustainable. Benefits rising with wages could continue if the demographic shift were not occurring, because economic growth raises real payroll tax revenues. Conversely, the demographic shift could be accommodated by economic growth if real benefits were growing at a slower pace. But the combination of scheduled benefit increases and a growing elderly population puts the nation on an infeasible path.

Annual spending on Social Security will exceed the system's tax revenue in 2018, with deficits increasing from there. The Social Security trust fund will be empty in 2042, at which point the system will be insolvent. In total, Social Security faces an unfunded liability of more than $10 trillion in present value.

Without reform, the nation will face little choice but vastly higher taxes and the resulting drag on economic growth. Putting Social Security permanently on a sustainable basis through higher taxes alone would involve raising the tax rate from 12.4 percent of wages up to the earnings limit to 15.9 percent. Delay only makes the problem worse. Waiting until 2042 to fix the system would require a 7 percentage point increase in the payroll tax rate (to 19.4 percent).

Such large tax increases would have adverse effects on the overall economy. Ed Prescott, the most recent winner of the Nobel Prize in economics, has written that a large part of the difference between our economy and those in Europe is that Europeans work less because they are taxed more. Raising taxes to solve the Social Security shortfall would, in essence, make the U.S. economy more like those of Europe. That is not the direction we should be heading.

The President's Commission on Social Security proposed a number of possible reforms to fix the system. The commission's proposals are consistent with the President's principles for reform. They do not alter benefits for current retirees and those near retirement. They do not raise taxes. And they put the system on a sustainable basis for future generations.

Let me state clearly that there are no free lunches here. As the Administration works with Congress to fix the Social Security system, there will be hard choices to make. But without any reforms, starting in 2042, the system will not be able to pay retirees the full benefits scheduled under current law.

As the nation debates alternative reform measures, you should be careful to avoid the sophistry of those opposed to reform. In particular, be wary of comparisons between a new, reformed Social Security system and current law. The benefits now scheduled for future generations under current law are not sustainable given the projected path of payroll tax revenue. They are empty promises. Unless a listener is discerning, empty promises will always have a superficial appeal.

By contrast, the plans examined by the Social Security Commission are credible plans that recognize the no-free-lunch principle. Under these plans, future retirees receive benefits at least as high as those retired today, and they have the option of investing in a personal account and take advantage of the higher return that accompanies equity investment. More important, these reform plans put the Social Security System on a firm foundation for generations to come.

The Gains from Trade

Finally, I would like to discuss some aspects of international economic policy, which are at the center of this conference. Over the past year, the issues of outsourcing, the role of the United States in the world economy, and the appropriate role for international tax policy have featured prominently in the public debate.

As technology expands the range of commercial activities that can be traded across national borders, more American workers are exposed to global competition. The recent debate over offshore outsourcing of some service-sector jobs shows that this increase in global competition can be a source of anxiety for many families.

Political winds might change, but the basic laws of economics have not. Adam Smith's theory of the invisible hand and David Ricardo's theory of comparative advantage apply even to a world in which world trade flows over fiber optic cables. 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.

Open markets allow American firms to sell world-class products in a large and growing global economy, and they give American households and businesses the freedom to buy the greatest variety of goods and services at the best prices. Open trade allows American businesses to buy the best equipment and materials, and this benefits their workers, owners, and customers. Let me give you two examples.

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 good for fishermen, good for Montana, and good for people around the world. Good for everyone--except the fish.

As another example of the benefits of open markets, consider the mining trucks that Caterpillar manufactures in Decatur, Illinois and sells around the world. The Escondida copper mine in Northern Chile -- the largest copper mine in the world -- uses mining vehicles to move more than 350 million tons of material per year. Before the free trade agreement with Chile went into effect in January, Caterpillar’s mining trucks were subject to tariffs of $60,000 or more. Now they enter Chile duty-free, and mining trucks have become Illinois's biggest export. In the first half of this year, Caterpillar nearly tripled its sales to Chile and added more than 1,000 people to its U.S. payrolls.

International Tax Policy

The aim of international tax policy should be to make sure that the tax code does not stand in the way of the gains from trade. As I am sure members of this audience fully appreciate, the topic is one fraught with complexity, and there are often no easy answers to the most basic questions. For example, one of the first questions to ask about the corporate income tax is whether it should have a global reach, or whether it should apply only to income earned within the United States. My reading of the literature on this topic is that economics profession once favored a global tax system. But that consensus is now eroding, and recently many economists have favored a territorial system.

As you know, the current tax system is an uneasy compromise between these polar cases: Foreign-source income is taxed, but the tax is deferred until the income is repatriated. The recent repatriation holiday in the FSC-ETI bill suggests that many policymakers view even this degree of taxation as higher than optimal. But this tax holiday is far from an ideal solution. At best, such temporary measures are imperfect substitutes for fundamental reform; at worst, they threaten to undermine the tax system’s overall credibility.

During the recent political season, there was the suggestion that some U.S. job losses are attributable to our tax code’s treatment of foreign-source income. I have yet to see any evidence that would support this hypothesis. It appears to be based on the view that economic prosperity is zero-sum, so business expansion abroad must substitute for business expansion at home. A hypothesis with more empirical support is that overseas activities of U.S. companies are complementary with domestic activities. That is, when U.S. companies expand their operations abroad, they are likely to expand employment in their headquarters here at home as well.

The United States is the world's leader in many ways, and we remain the leading advocate for pro-growth policies around the world. When members of the developing world emulate our free-market principles and start the long climb up the economic ladder, as they have increasingly done, we should applaud their efforts. We should always remember that peace and prosperity go hand in hand, each reinforcing the other. The President's policies are designed to foster rising living standards at home, while encouraging other nations to follow our lead.

Thank you.