The Economic Agenda

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Today I would like to offer you my views on the present state of the economy. More important, I would also like to discuss three of the key choices facing our nation as we look ahead and forge our economic future.

Economic Outlook

Let me begin with current economic conditions. 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. I believed, and still believe, that these were the best way to gauge how an economy is doing.

By all three indicators, the U.S. economy today is fundamentally healthy. Real GDP has risen by 4.7 percent over the past four quarters. Inflation is low, with core inflation below 2 percent and broader measures such as the PCE deflator below 2.5 percent. The unemployment rate is now at 5.4 percent, down from a peak of 6.3 percent last summer. The current unemployment rate is lower than the average rate in each of the past three decades.
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When evaluating the current state of the economy, it is important not to lose sight of the powerful contractionary forces that have been at work since early 2000. Over the past 4 years, the United States has faced the bursting of the high-tech bubble of the 1990s, revelations of corporate scandals, slow growth among our major trading partners, and, of course, the terrorist attacks. Business investment slowed sharply in late 2000 and remained soft for more than two years. The economy lost almost 900,000 jobs from December 2000 to September 2001, and then another 900,000 jobs in the three months after the 9/11 attacks.

Prompt and decisive policy actions helped to counteract the effects of these adverse shocks to the economy. Substantial tax relief together with expansionary monetary policy provided economic stimulus that softened the recession and helped put the economy on a faster road to recovery.

GDP growth and the pace of job creation moderated during the summer, but most signs suggest that the economy will expand solidly in the remainder of 2004. Surveys of purchasing managers point to continued expansion of both production and employment, and the index of leading indicators has risen impressively over the past 12 months. The consensus of private forecasters puts GDP growth for the second half of this year at well above the historical average of 3 percent. The unemployment rate is expected to continue its decline.

Of course, recent increases in oil prices are a drag on the economy, as well as a strain on family budgets. These increases are unwelcome. Fortunately, our economy has become less reliant on oil over time. As a result, recent price increases do not appear to pose a significant threat to the recovery. Standard macroeconomic models suggest that a $10 per barrel increase in oil prices, such as the one we have recently experienced, would reduce U.S. GDP by about 0.3 to 0.5 percent over the course of a year or two. Such a decline would be an undesirable headwind in the continuing recovery, but it would not reverse the upward trajectory of the economy.

In short, the economy is now headed in the right direction. Challenges exist – as they always do – but the economic outlook continues to be positive.

We should not take prosperity for granted. We face important choices that are critical to sustaining our economic growth. The President set out an ambitious agenda last week to ensure a continued and expanding prosperity. I would like to talk today about three pieces of that agenda. I like to think of these as the "three T's": taxes, trade, and tort reform.

Taxes

The first "T" concerns our tax system. Some have proposed reversing course and raising taxes. In my view, this is exactly the wrong policy if our goal is to promote employment and raise family incomes. The right approach is to make the tax cuts permanent and reduce the budget deficit over time through spending restraint.

Moreover, the tax code itself is a drag on the economy. As the President has put it, our tax system is a complicated mess. He has promised to make tax reform a key element of his agenda for a second term--to make the tax code simpler, to make it more fair, and to further promote growth and job creation.

The past four years have demonstrated that a pro-growth tax policy can make progress toward both short-run and long-run goals. The President's tax policies have provided important and timely stimulus, while improving incentives and boosting our economy's long-run growth rate.

The short-run effects can be traced in part to a classic Keynesian mechanism. The tax cuts let people keep more of the money they earned, supporting consumer spending and thus helping to maintain the aggregate demand for goods and services. This is conventional short-run stabilization policy.

Tax policy has also stimulated aggregate demand by providing incentives for investment, including 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 steps all reduced the cost of capital and, in doing so, boosted investment spending.

Over a longer time horizon, tax policy can enhance economic growth through its effects on the supply-side of the economy. Lower tax rates on labor income provide an incentive for increased work effort. Lower tax rates on capital income encourage individuals to save and invest. Investment increases the quantity and quality of the capital available for each worker, boosting productivity and raising wages throughout the economy.

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 by promoting the allocation of capital based on business fundamentals rather than a desire for tax avoidance.

Thus, the tax cuts have two macroeconomic roles—to bring the economy back to its potential level and then to improve its 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.

One challenge the United States will face in coming years is the budget deficit. Deficits 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 is one reason 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. Having inherited an economy sliding into recession, 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.

As I am sure you all know, there is another fiscal plan being presented to the American people. This alternative plan is not very detailed, and there is some question about whether the numbers really add up. But let me put that aside and note one important feature of this plan: The path of deficit reduction being proposed is almost the same as that proposed by the President. Nonetheless, the choice between the different approaches could not be more stark. The alternative plan would involve higher taxes, higher spending, and a larger government. The President wants to keep taxes low, maintain spending restraint, and place a greater trust in families' ability to control their own economic destiny.

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 economic 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. Although the past three years have been a difficult time for the U.S. economy, we have nonetheless had the best growth performance of any of the G-7 countries.

At the same time that we appreciate the dynamism of our economy, no one should underestimate the fiscal choices ahead. Looking beyond the standard five-year budget window, we face a great challenge. As the population ages and the baby-boom generation retires, the entitlement programs for the elderly will put gradual but substantial pressure on federal spending. The President's budget correctly called this "the real fiscal danger."

These entitlement programs need to be modernized for future generations. 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. The President renewed his call for Social Security reform last week as he looked ahead to his second term. Without reform of the entitlement programs, the nation will face little choice but vastly higher taxes and the resulting drag on economic growth.

Trade

Beyond taxes, there is another critical choice facing the Nation—a second "T"—our commitment to free and open trade and our choices regarding our role in the world economy. As technology expands the range of commercial activities that can be traded internationally, 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. Certain politicians, including some who have supported free trade in the past, are now seeking to exploit this anxiety.

Political winds might change, but the basic laws of economics have not. 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 exacerbated the economic hardships of the 1930s. 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 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 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.

As just one 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.

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. The goal of these programs is very simple: rather than denying the gains from free trade, the President wants to make sure that the gains are shared as widely as possible.

Tort Reform

The third "T" I would like to talk about today is tort reform. The President's economic agenda involves removing obstacles to growth. One such obstacle is the considerable burden placed on everyone by excessive lawsuits. Our tort system is based on some admirable ideas: that injured parties deserve compensation and those responsible should be held accountable. But our current system often fails to deliver on that ideal.

Our tort system fails victims. Of every dollar spent on the tort system, only 46 cents make their way to injured parties. The other 54 cents go to attorneys' fees and insurance costs. The tort system thus distinguishes itself as one of the least efficient ways in which we compensate victims. By contrast, transaction costs amount to only 15 to 20 cents on the dollar in comparable systems, such as state workers' compensation programs and the federal Vaccine Injury Compensation Program. Although these programs are far from perfect, the comparison illustrates the inefficiency of the tort system. The tort system compensates some people for their injuries, but it does so at a large cost of wasted resources.

Our tort system fails to impose fair penalties and provide the right incentives. In principle, the tort system should encourage individuals and businesses to take reasonable care and to be mindful of potential injuries. In practice, our tort system often delivers "roulette justice," in which outcomes bear little relationship to economic rationality or notions of fairness. The undesirable side effects are manifest. Doctors are discouraged from high-risk procedures and practices, but are encouraged to prescribe unnecessary tests and procedures as they practice defensive medicine. Companies are discouraged from developing new products. Costs go up for all of us as prices build in a "tort tax" to cover the cost of litigation.

Our tort system fails our economy. In 2002, tort costs amounted to more than $233 billion--over 2 percent of GDP. This cost is high as judged by either historical or international standards. The share of national income going to tort costs is about twice what it was thirty years ago. If we look around the world, we see that the United States has the highest tort costs of any developed nation. As a percentage of GDP, Canada, France, and Japan each spend less than half of what we do.

In short, our tort system is needlessly expensive. And these figures don't even count the hidden costs of tort excesses – the planes that don't get built, the drugs that don't get marketed, and the extra miles a pregnant woman has to drive to find a doctor willing to deliver her baby. This is the excess burden of the tort system—the part that is not just a transfer from one pocket to another, but a true reduction in the size of the economic pie.

The President's tort reform policies are intended to rein in some of the excesses of our current system and prevent frivolous litigation from hindering our economy's growth. The President favors medical liability reform to control the cost of health care, retain qualified medical professionals, and ensure that patient care is the central concern in all medical decisions. He supports class action reform to eliminate the waste, inefficiency, and unfairness of multiple overlapping class action cases. And he supports reforms to the asbestos litigation system in order to protect victims with asbestos-related injuries without needlessly bankrupting dozens of companies and endangering thousands of American jobs.

Like any change, reducing the burden of our tort system will cause some painful dislocations. In the future envisioned by President Bush, the nation will need fewer trial lawyers. But I have little doubt that the economy can create other, more productive jobs for these individuals. I came dangerously close to being a lawyer myself—and in fact spent a year and a half in law school. I can attest that there are more rewarding lines of work than suing Peter to pay Paul.

Conclusion

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. Maintaining our flawed tort system would perpetuate existing injustices and the resulting drag on our economy. The better choice is to continue the President's agenda, which aims to fuel growth and capitalize upon the strength and creativity of the American people.