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COMMENTARY

## **The Economists' President**

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President Bush deserves generally very high marks on economic policy in his first term, although there were some stumbles (e.g., too much non-defense spending growth, steel tariffs). His approach to economics and economic policy -- a combination of philosophical principles and practical business experience -- will continue to serve him well in his second term.

Even before the formal start of his first campaign for president, George W. Bush had a list of economic issues that he sought to accomplish: (1) Cutting taxes, to prevent wasteful spending that had accelerated abruptly in the second Clinton term; to strengthen the supply side of the economy for long-run growth; and to ensure against the economic downturn his advisers, myself included, thought likely after Y2K. (2) Reforming Social Security and Medicare, to deal with their long-run insolvency; and (3) reforming the tax system. Mr. Bush has made considerable progress in each area, but much remains to be done. And the economic environment as he begins his second term is different from what he confronted when he initiated his presidency.

First, the economy is in expansion and is likely to approach full employment over the next year or two, not sliding into recession following a stock-market bubble and crash. Second, the stock-market crash, recession, and homeland security and military spending needs have changed the fiscal environment from one of large (partly temporary) budget surpluses to sizable budget deficits (again, partly temporary). Third, several of his signature initiatives have important features that are due to expire (the reductions in marginal tax rates, dividend double tax relief) or have not yet been implemented (paying for the prescription-drug benefit added as of 2006; energy policy; litigation reform).

In light of this, what should the second-term agenda be? And how does it compare to the president's declared intentions? Start with what is, objectively, good economic policy, which should be aimed primarily at maximizing non-inflationary growth. That requires the lowest possible tax rates, continuously rigorous spending control, reform of Social Security and Medicare, regulatory and litigation reform, trade liberalization, and sound monetary policy.

Thus, Mr. Bush should make the lower marginal tax rates -- so important to strengthening incentives in the economy -- permanent. Tax reform should at the very least lower them further and broaden the tax base by eliminating or combining deductions, exemptions, credits and definitions. It is not widely appreciated that, under current law, the federal tax share of GDP is scheduled to bloat over the next 20 years to almost 25%, due to real bracket creep, the alternative minimum tax, and other factors. Thus, tax cuts will be necessary to prevent a huge future tax drag on the flexibility and dynamism of the economy. It is also not appreciated how much reform was included in the president's first-term tax cuts: lower marginal rates, reduced marriage penalty, lowered tax rates on dividends -- all were steps toward economists' notions of an ideal tax system, especially reducing the double and triple taxation of saving.

Spending control is vital. The litmus test for acceptable spending should be whether it is necessary for government to be spending at all; if so, whether that spending should be federal, state or local; and whether the funded programs are target-effective and cost-conscious. We have a problem because so much government spending is not effective (OMB estimates that only 30% of programs have demonstrated even modest effectiveness). The spending problem may be more visible because of large budget deficits, but we would have a serious spending problem even if the budget were balanced. So Mr. Bush should redouble the good start finally made this year in slowing non-defense discretionary spending growth (after seven years of rapid growth), expanding performance budgeting, and restricting or eliminating ineffective programs.

Social Security should not merely be modernized with a personal account component, but combined with other reforms, such as future changes in retirement age, and price- instead of wage-indexing initial benefits, at least above some threshold. The Bureau of Labor Statistics should soon be making some additional improvements in the consumer price index. Implementing the "Chained-CPI" it has been computing for several years now -- to account for consumers adjusting their buying habits to relative price changes -- will more accurately measure inflation and decrease the national debt by more than a trillion dollars in coming decades. Above all, sensible reform must first reduce the unfunded potential future liabilities (they are not legal obligations like Treasury bonds). They should not be made explicit first, before a reform of the structure. That would lock in large unnecessary real growth in spending and taxes.

Future benefits based on the current formula cannot be sustained without damaging tax increases. Further, annual benefits, which are due to rise substantially in real terms, are due to be paid for more years as life expectancies rise. Large real benefit increases will be trimmed back but will still be higher than current levels. Honest discussion would label only decreases from current levels as reductions, as opposed to Social Security Beltway-speak that describes any slowing of projected growth as "cuts."

Mr. Bush must continue reform of regulation by pressing for serious scientific cost-benefit analyses and rigorous risk-benefit analyses. The first-term attempts at specific litigation reform (asbestos, medical malpractice, etc.) should be tried again, along with a modified loser-pays-the-costs system that would target frivolous litigation at its source.

Mr. Bush should also press on with bilateral and regional free trade agreements, redoubling efforts on the Doha round of multilateral trade liberalization -- important not just to U.S. economic interests but even more so to the developing world. This should be a centerpiece of foreign as well as economic policy (and Robert Zoellick's departure to the State Department, in fact, suggests just such an "economic foreign policy" course).

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None of this will happen without sound monetary policy, essential to durable economic expansion and long-term growth. Paul Volcker and Alan Greenspan deserve great credit for the improved monetary policy of the last 25 years, but Mr. Bush should not take high-quality central banking for granted. He must be sure to appoint talented economists with backbone to the Fed's Board, especially when he chooses Mr. Greenspan's successor.

Most of the attention on economic policy will focus on the budget deficit. Rigorous spending control and the lowest possible tax rates will keep the deficit and debt/GDP ratio well under control, but Mr. Bush must not be misled by large-headline, nominal deficit numbers. Adjusting for cyclical conditions, for the inflation erosion of the real value of previously issued debt, and for a separate capital account for federally financed net investment and the military buildup, recent deficits were quite reasonable. As the economy returns to full employment and most of the military spending buildup concludes, deficits not exceeding 2% of GDP will be benign.

Mr. Bush's agenda coincides pretty closely with the one derived from basic economic principles described above. Successful implementation of that agenda will mark him as the most accomplished practitioner of good economic policy in a generation.

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