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*Commentary*

## ***Stick to the Basics***

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Teaching "Economics I" to hundreds of freshmen, it's dismaying to see the usual election-year distortion and hyperbole morph into outright economic illiteracy. From convenient economic-historical amnesia, to refusal to acknowledge facts, to suspension of basic economic principles, what we're hearing from the Kerry campaign trail is truly remarkable.

Let's start with the Kerry claim that this is the "worst economy since Hoover." Hoover was in office in October 1929, when the stock market crashed and the Great Depression began. The unemployment rate, at a time when very few families had two earners and there was a much smaller safety net, reached almost 25% by 1933; indeed, it was still 15% under FDR in 1939. The current unemployment rate is 5.4%, less than the average for the last 30 years, and about what it was when President Clinton ran for re-election in 1996, though certainly above the 4.2% when President Bush assumed office.

That low unemployment rate was the result of a mini-bubble in the labor market accompanying the maxi-bubble in the stock market. Few economists believe we can push unemployment permanently back down to 4.2% without accelerating inflation and risking much worse economic harm. By President Clinton's last year in office, inflation had doubled to 3.4%, the Fed was raising interest rates, the bubble had burst, and the economy was sliding toward recession.

While there certainly are pockets of hardship (if you're unemployed, you're 100% unemployed, not 5.4% unemployed), the Hoover comparison is bizarre. In 1980, President Carter's last year, the unemployment rate was well over 7% while the contemporaneous inflation rate was over 12%, a misery index -- the sum of the two -- of 20%, or two-and-a-half times the current misery index of 7.9%! In fact, the misery index has been lower only five times in the last 35 years.

The Kerry campaign claims the Bush tax cuts did economic harm. This is exactly backwards. While in the long run, deficits -- as well as the level and structure of spending and taxes -- do matter, war and recession are times when deficits naturally occur and can

be downright desirable. This was one of the most efficacious uses of fiscal policy ever. Only a couple of years ago, there was serious concern about outright deflation, falling prices and a Japanese-style lost decade. It would have been better to have had all the rate cuts in 2001, rather than phased in slowly. Better still to have combined the tax cuts with effective control of future spending as the economy returned to full employment. But it's no coincidence that a moribund economy mired in an uneven, uncertain recovery took off exactly when the 2003 tax cuts were passed.

John Kerry wants to repeal the reduction in the top two tax rates, and the dividend and capital gains relief. He says it would have been better temporarily to provide larger rebates for lower- and middle- income people. First, the evidence is that temporary tax rebates have very little stimulative effect. Second, the lower rates and dividend and capital gains relief moved us closer to an economically desirable tax base by significantly reducing the double taxation of saving and investment. Indeed, if the concern is the potential long-run harm of deficits crowding out private capital formation, it's strange to propose raising taxes on private capital formation.

To be sure, the deficits (and lower tax rates) have longer-run consequences. CBO projections of the budget over the next decade shows a debt-GDP ratio rising slightly to peak just above 40% in two or three years. This is hardly a debt spiraling out of control, leading to inflation fears fueling economic calamity. It would be better to eventually reduce the debt-GDP ratio over the next 10 years, preferably by controlling spending still further and stronger economic growth. And, of course, the Bush tax cuts and the Kerry spending (about three times his tax hikes) have ramifications beyond 10 years, when the financial problems in Social Security and Medicare become progressively more severe. The Bush proposal for personal accounts in Social Security does have short-run costs and should be combined with other reforms. Mr. Kerry has explicitly ruled out all reforms in benefits and that only leaves large tax increases or bigger deficits. As to Medicare, Mr. Bush's prescription drug program has some good reform elements, but was not financed; Mr. Kerry complains it wasn't large enough, again leaving only even larger tax increases or even larger deficits.

The Kerry campaign is no better at micro than macro economics: Suggesting it's the government's role to prevent any price from rising (tuition, pharmaceuticals) is reminiscent of the former Soviet Union, where prices never went up but there were never any goods available. In fact, overall inflation has been quite low and some other prices are falling (computers, cell phones). President Bush is no more to blame for the decreases than the increases.

Economic policy should be aimed primarily at maximizing non- inflationary economic growth. That would require the lowest possible tax rates, continuously rigorous spending control, gradual Social Security and Medicare reform, regulatory and litigation reform, trade liberalization and sound monetary policy. That's the recipe most likely to lead to rising living standards, low unemployment, better- paying jobs and upward mobility for those who've not yet made it on the economic ladder. It would also keep the debt-GDP ratio well under control.

President Bush promises a more modest role of government, trade liberalization, reigning in litigation, slower growth of government spending and lower taxes; in short, about the right mix, although one can argue with the details. To be sure, the first term was far from perfect (too much spending, steel tariffs). But Mr. Kerry is proposing quite a bit more spending, higher taxes, especially on capital formation, greater government regulation and restrictions on global trade. That plan would be a sizeable step toward a European-style social welfare state, with its concomitant double-digit unemployment and economic stagnation. So which candidate is out of touch with economic reality?

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