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***The Serious Policy Issues Facing the United States***

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The presidential election campaign has started early. That is usually a bad time for any serious discussion of public policy. I still remember one presidential campaign where the most important issue was the status of Quemoy and Matsu. Those are two trivial and virtually deserted little islands off the coast of Taiwan. There also was a presidential debate on closing the missile gap. After the campaign, it turned out that there was no U.S. missile gap. It was the Soviets who had the missile gap.

On the economic front, we more recently witnessed a campaign successfully attacking the sitting president for not doing anything to get us out of recession. The data now show that the upturn in the economy started well before election day. Under current circumstances, I confidently forecast Republicans will tell us how great this wonderful economy is, Democrats will be crying in their beer because of the horrible economy.

Before we get caught in the campaign crossfire, let me sketch out what I believe to be the serious questions that will face the president of the United States, Republican or Democrat, who is inaugurated in January 2005. This is the kind of advanced planning that the staff of both candidates will be

doing in the year ahead. We can summarize that future presidential policy agenda with seven key questions:

1. How can the United States achieve a stronger economy?
2. Related to that, how can we avoid inflation as well as deflation?
3. How can we reduce those huge budget deficits?
4. What do we do when the temporary tax cuts expire?
5. How can we finance social security and medicare when the baby boomers retire?
6. How do we cope with rapidly expanding government regulation?
7. How can we meet the global competitive challenge, especially from China and India?

Even if I had the capability, I do not have the time this morning to answer each of these questions. However, as an economist I believe that I can provide some helpful starting points for each item.

### A Stronger Economy

As you may have noticed, the American economy is not exactly booming. Nevertheless, an upturn is now underway. The economy is rising by about 2-1/2 percent this year. Three rounds of tax cuts and quadruple that number of interest rate cuts have provided lots of stimulus to a sluggish economy. A drop in the value of the dollar is also encouraging exports. The continued upturn in military procurement is another plus.

Nevertheless, my rubber band theory of business cycles is working well — surely better than the more formal econometric models. Sharp and long

recessions generate big snapbacks. Mild recessions, however, are usually followed by shallow recoveries. That is because there is no opportunity for the accumulation of large backlogs of unmet business and consumer demands. Surely, this is our current experience. The result is a slow and drawn out recovery which only now is picking up steam.

At this point we should let the economic medicine do its work and not overdose the patient. Politicians in Washington always want to show how active they are. However, they now should take an economic form of the physicians' Hippocratic Oath: first do no harm.

We had a recent reminder of the need for a moderate economic policy during this summer. When the new higher budget deficit numbers were published, interest rates suddenly started to turn up. At this point, new federal spending programs, to prod the economy, could hurt rather than help — especially if they led to another round of interest rate increases.

We have to get used to the fact that we are now living in a very different economic environment than the 1990s. That was an unsustainable boom time. The economic future is going to be more modest than the feverish pace of the last decade. Fortunes will not be made as frequently, nor lost as quickly in this new and more sustainable economic environment.

I know that a lot of people are suspicious of any report that the economy is turning up, so long as unemployment stays high. A little lesson in economics: We have a growing population — about 1 percent a year. With rising productivity, the average worker produces more, about 2 percent a year. That

means that the economy has to grow by 3 percent just to keep unemployment steady. We only bring down the unemployment rate when the economy is growing faster than 3 percent. That is why earlier this year, while the economy was growing slowly, the unemployment rate was edging up.

I console my students with the fact that, if the economy were not so complicated, we would not need so many economists.

### Inflation and Deflation

In recent years, the United States has avoided the extremes of inflation and deflation. Of course, some prices — especially of services — continue to rise even when the economy is weak. Also, the prices of manufactured goods decline even when the economy is growing. But on balance, we have achieved an unusual degree of overall price stability — neither inflation nor deflation. The peddlers of doom and gloom may generate headlines. But, inevitably, they depart from the scene.

The time for additional monetary stimulus is over. So far, the Federal Reserve has done a good job and they should leave well enough alone. I believe that the Fed Board would be well advised to take a long vacation.

### Tax Cuts

Very quietly, Congress has added a new gimmick to the already complicated Internal Revenue Code. They want to minimize the estimated loss of revenue from the tax cuts. So they set expiration dates. In the case of the tax reductions voted earlier this year, the child credit and the marriage penalty relief

run out in 2005 — after the election. Small business expensing ends in 2006. Dividend rate reductions in 2009. And the general rate cuts in 2010. There are so many “sunrises” and “sunsets” in the new tax bill that the tax experts in Washington call it the Fiddler on the Roof Law.

It is unlikely that Congress will let all those tax benefits expire. That would be equivalent to a series of painful tax increases. However, extending the cuts will reduce the future flow of revenue to the Treasury. That would make it more difficult to return to smaller deficits, much less to the budget surpluses of 1998-2001. That’s going to be a problem for the next administration.

### Social Security and Medicare

Now let us turn to the spending side of the budget. To put the problem in a nutshell, Congress has voted more benefits than revenues to pay for them. When we try to quantify that future imbalance, the results are staggering — trillions of dollars of promised but unfinanced benefits. The big surprise, at least to me, is that, however large the social security deficit will be, the Medicare finance problem will be many times worse. Adding a new prescription medicine benefit won’t exactly reduce the medicare deficit.

Financing social security in the years ahead will be especially difficult because of the underlying demographic trends. In plain English, we are living longer and retiring earlier. Despite all the scare talk about dangerous chemicals and other hazards in the environment, over the past 30 years, average life expectancy in the U.S. has increased from 71 years to 77 — one year to go. At the same time, *on average* we are retiring earlier. The most common age of

retirement has fallen from 65 to 62. That means reducing the number of years that Americans pay into the social security trust fund and lengthening the period over which we receive benefits. That is a tough combination to deal with.

Fundamentally, Congress has to decide whether social security is a retirement system or a welfare program. Now it is a combination of both, I know we do not think about it that way.

It sounds harsh, but we grant every social security retiree an automatic annual cost-of-living increase (COLA). That is the economic equivalent of welfare. The COLA is paid for by somebody else, by the working population. Just look at the typical private insurance policy. It does not have a COLA. If it did, insurance premiums would have to go sky high. When I made this point in public during my White House days, one congressman called for my impeachment. Fortunately, I worked for a president who knew when to laugh.

While I am voicing unpopular thoughts, let me point out the basic shortcoming of medicare. It is an attitude encouraged by both political parties: “I want the best possible medical care, especially if somebody else is going to pay for it.” True reform will be very hard. For starters, I would use the approach imbedded in the typical automobile insurance policy: a reasonable deductible so that we do not swamp the health care system with paperwork for small claims. Medicare should not cover routine visits to the doctor, like a flu shot. But it should extend generously to major illnesses.

Unless big changes are made, social security and medicare will run out of money — but not in the next few years. Unfortunately, government is not good at

making tough long-run decisions early. There is an important lesson to be learned from the S&L bailout of the 1980s — the longer we wait to act, the more difficult and more expensive is the bailout.

### Government Regulation

Since 2001, we have seen the fastest increase in government regulation in a very long time. The number of federal regulators today is 47 percent higher than last year. The largest part of the increase — but not all of it — is in airline security. Like most Americans, I believe that preventing terrorist attacks is very important.

Nevertheless, it was sad to see that, in setting up the new Transportation Security Agency, Congress did not learn the lessons from previous regulations. One of those unlearned lessons is that hastily written laws are most likely to contain serious defects. That is especially so in the case of statutes setting unrealistic deadlines.

The unfortunate result has been unnecessary costs and needless disruption. As in many other areas of regulation, the unanticipated consequences are severe. I believe that a major reason for the poor financial shape of the airlines is that many passengers have been scared off by the arbitrary and inconsistent application of those inspection rules — when do you take your shoes off? When do you take your belt off?

The most fundamental shortcoming of government regulation is that each regulation is written in isolation, as if nothing else mattered. Just try asking whether there is a better way of achieving a given regulatory objective —

whether there is a more cost/effective approach to global warming or airline security. From my own experience, I assure you that you will be lambasted for being a green eye shade type. Nevertheless, every incoming president since Gerry Ford tries to reform regulation.

### Global Competition

Let us take up another political hot potato — global competition. American companies are facing rising competition. Most of the specific charges that foreign producers are dumping their products in our markets turn out to be groundless. It is not unfair for a company with lower costs to charge less than their competitors. American firms do that whenever they have the opportunity. We also have post-Christmas clearance sales without violating any laws, but when foreign producers try to do that, they run afoul of our punitive anti-dumping statutes.

We should worry about the real reasons why some domestic firms cannot meet foreign competition. Many government regulation and union rules increase the cost of production in the United States. Featherbedding is a luxury that we have to dispense with if American companies are going to meet increasing tough foreign competition.

The most serious competitiveness shortcoming is the inadequate education and training of millions of young Americans. They are our workforce in the years ahead. We cannot blame the dropout rates in our high schools on foreign companies. It is sad to boast that the United States is number one. Among all the industrialized nations, we have the highest high school dropout

rate. By the way, we spend a lot more per student than other countries. The problem is not the result of a lack of dollars for education. It goes deeper than that.

There is a positive side to international competition. The puppet-parading protesters so visible in Seattle were wrong. Globalization is working. When we penetrate the noise, it turns out that those “terrible” multinational corporations are creating widespread wealth, and not just for their shareholders. More people have moved out of poverty in the last two decades than ever before in world history.

### Conclusion

As you can see, there will be no shortage of problems facing the United States in the years ahead. But we should put these matters in perspective.

Warts and all, the United States is still the freest society with the strongest economy of any nation on the face of the globe. That is not just the result of good luck. Our country possesses five special characteristics that are the key to our continued economic prosperity. Too often we take these factors for granted:

1. *A strong entrepreneurial spirit.* Americans are constantly starting up new enterprises. In contrast, Europeans are satisfied with the status quo. One obvious manifestation: they take much longer vacations — and resent our greater economic success.

2. *We have a substantial small cap stock market.* That’s unique. In no other country can a new business with a promising product idea raise substantial

amounts of capital in the equity market. Elsewhere, a new business is limited to bank loans and family wealth.

3. *Comparatively low taxes.* We all love to gripe about the high taxes we pay. I am no exception. However, in comparison with most other nations, we have a smaller public sector and therefore lower tax burdens.

4. *High labor mobility.* Yes, it is easier to lay off workers here than in Europe. But there is another side to the coin: American employers are far more likely to hire new workers. The overall result, over the years, is striking: job stagnation and high unemployment in Western Europe and job growth and much lower unemployment here.

5. *World class higher education.* Where do people in other countries send their youngsters to college, especially for advanced degrees? Not to Beijing University or Tokyo or Berlin, and certainly not to Riyadh University. Parents who can afford it send their young people to American universities. Moreover, the research being performed at our major universities is a vital asset.

To sum up briefly, the United States will face a host of challenging public policy problems in the years ahead — and we will have tremendous resources to deal with them. Whoever is president in the years ahead, we can wish him or her good judgment and especially good luck. Let me leave you with the forecast of my favorite economist, the cowboy humorist Will Rogers. “Things will get better, despite our efforts to improve them.”