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COMMENTARY

Tax Cuts, Rate Cuts Put the Economy Back on Track

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The strong growth of the U.S. economy in recent months is neither an illusion nor an accident. It reflects good monetary and fiscal policy over the past year in an economy with sound financial conditions and a competitive structure capable of generating significant productivity gains. The outlook for continued expansion is favorable if policy mistakes are avoided.

A surge of consumer spending was the key to the growth of demand in the final quarter of last year. Real consumer spending rose at an annual rate of 6%, more than enough to offset the decline in business investment and the depletion of inventories, resulting in net GDP growth at an annual rate of 1.4%. This GDP growth was much lower than the growth of sales to households and businesses because more than half of the overall rise in such sales came from drawing down inventories. Simply stopping the depletion of inventories will bring much faster overall GDP growth in 2002.

A primary reason for the strength of consumer spending was the enactment of the tax cut in early 2001. Although the Bush tax plan was designed for long-term effects on individual incentives, its passage provided a substantial lift to demand that exceeded the direct effect of higher take-home pay in 2001 and the $600 payment that taxpayers received. For most taxpayers, the future rate reductions embodied in the new law were a greater source of economic well-being and therefore a greater stimulus to spend.

Although the legislated tax-rate reductions are phased in slowly, they eventually reduce the share of earnings taken in income taxes by about 10%. Moreover, although the cut in the maximum tax rate to 35% did not fully undo the sharp rise in the Clinton years, the reverse of direction from rising tax rates to falling tax rates was an important boost to consumer psychology.

The expansionary effect of the tax cut was supported by the Federal Reserve's repeated reductions in short-term interest rates. Industrial production began falling sharply at the end of 2000 and total sales of manufacturing, wholesale, and retail firms peaked in December 2000. The Fed was quick to respond, bringing the short-term federal funds rate down from 6.5% in November 2000 to 6% in January 2001 and 5.5% in February 2001. A continuing series of cuts brought the rate down to 1.75% by the end of 2001, the lowest rate in more than four decades. Net of inflation, the real fed funds rate fell from more than 4% at the end of 2000 to less than zero 12 months later.

Although the interest rate reductions were not enough to prevent the recession that began in March of last year, the lower interest rates did stimulate consumer spending through a variety of channels. The resulting reduction in monthly payments on adjustable-rate mortgages permitted cash-strapped households to spend more on a variety of goods and services. Lower monthly mortgage payments also increased residential construction, stimulating the demand for a wide range of consumer durables that accompany new house purchases. The decline in interest rates also contributed to spending by raising household wealth through increases in house prices and by limiting the decline in share prices.

The recent rise in consumer spending has reduced the personal saving rate to less than 1% of disposable personal income, down from more than 4% in the mid-1990s, 8% at the start of the decade and an average of 9% in the 1980s. If households were to return suddenly to the earlier saving rates, demand would fall and the economy would drop into a serious recession. Fortunately, such a sudden jump in saving is very unlikely because the fundamental reason for the lower saving rate -- the wealth accumulated over a 20-year stock-market boom -- will not be quickly reversed.

Since the stock market is very unlikely to experience the same 10-fold surge over the next two decades that it did since 1980, the future saving rates will probably revert eventually to the higher levels of the past. But that is likely to happen only gradually as current retirees and those close to retirement die and today's younger employees reach their peak saving years. As the saving rate gradually rises, the extra saving will be absorbed by increased business investment and by an expansion of exports made possible by a decline in the relative value of the dollar.

Although the Federal Reserve has to be vigilant about a return of inflationary pressures, there is certainly no evidence yet that calls for higher interest rates. The consumer price index rose less than 2% over the past year. The broader GDP price index actually fell in the final quarter of last year.

Since future prices will be driven largely by what happens to employee compensation and unit labor costs, it is very reassuring that the compensation per employee hour rose only 2.3% in the fourth quarter of 2001, the lowest rate since 1997. That moderate wage rise and the sharp 5.2% productivity growth caused unit labor costs to decline at a 2.7% annual rate, providing a good base for future price stability.

Although critics of the president's tax plan point to this year's budget deficit as a justification for raising future tax rates, the Congressional Budget Office projects relatively small budget deficits that will soon become surpluses. The CBO calculations imply that with the Bush tax cut and the president's spending proposals, the budget will be in surplus sometime in 2005, and the annual surplus will grow to about 1% of GDP by 2010, driving the national debt down to only 21% of GDP.

The deficit could become a problem if spending gets out of hand, but current projections are not a cause for concern over the rest of this decade. The challenge for policy now is to deal with the longer term budget problems of Social Security and Medicare that will begin when the Baby Boom generation retires a decade from now. Today's favorable economic and budget conditions now provide the basis for a successful shift in policies to deal with these problems. But if Washington keeps waiting, it will be too late.

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