

It is very good to be here. I have visited ICRIER once before, almost exactly four years ago. Rather than presenting an academic paper, I am going to talk more about the domestic US issues, particularly fiscal policy. I will be referring to a book which I co-edited with Peter Orszag and which came out six months ago, titled *American Economic Policy in the 1990s*. This was quite an interesting project that we ran at Harvard.

My view is that social scientists ought to spend some of their time analysing and examining the decisions that the policy makers actually make. During my time in the White House—where dozens of different policy questions came up for decision every single day – I was struck that in most of them we could not get good guidance from outside. Academic research was not of that much use because it was always a little too theoretical or too ivory-towered. But, what journalists would write was not that useful either. Reporters would not dig deeply into the policy issues, finding that reporting on perceptions of others was easier and less likely to lead to charges of bias than would reporting on the issues and policies themselves. Op-eds were not of much use because they would set up an artificial debate, pretending that the issue was easy and we in the government had been idiots for doing whatever it is we had been doing. Of course, these critiques would come from opposite directions. Typically writers would not try adequately to consider in one single writing all the pros and cons. Analysis frequently abstracts from the political constraints that actual policy makers have to deal with. If there was a crisis in East Asia, it followed that the IMF must have got everything wrong; and the US Treasury must have got everything wrong. Who took the time to go through the very specific decisions the policy makers actually had to make?

So at Harvard we held a conference in the Summer of 2001, less than six months after the end of the second Clinton term. We invited the top policy makers from that administration. We had, for example, Bob Rubin and Larry Summers, both of whom had been Secretary of Treasury; Laura Tyson and Gene Sperling, both of whom had been the President's top economic

adviser; Bob Reich, the Labour Secretary; Charlene Barshefsky, who was trade negotiator; and so on. And we also invited counterparts from Republican administrations, especially Martin Feldstein, Director of the National Bureau of Economic Research (NBER) and former Chairman of Ronald Reagan's Council of Economic Advisers, who had organized a similar meeting ten years earlier on economic policy in the 1980s—on which my project was modeled—and other officials from other Republican Administrations, plus leading academic economists who wrote background papers, and other commentators. Three participants had just gone into the current Bush Administration at high levels, or have since done so. We went through 14 areas of economic policy and looked at the decisions that were actually made and what were the alternatives.

As a conference organizer and an editor I took great pains to be balanced to have equal representation from the Left and the Right, Republican and Democrat, etc. I am not necessarily going to do the same in my talk today; I will feel free to tell you what my own views are, which will definitely lean in the direction of one party.

Decades, terms and cycles

Perhaps we can also talk a bit about the business cycle dating committee of the NBER - National Bureau of Economic Research, the outfit I am associated with and which gave me the opportunity of this visit to India. It is a leading research outfit in the United States. The Business Cycle Dating Committee of the NBER decides when a recession is a recession. We met last year and declared that the US economy had gone into recession as of March 2001. Some people are now wondering, waiting for us to say when the recession is over. To the extent that I have time I will also talk about other issues.

My main topic is recent economic history in the US, but I am not going to do so in chronological order. I will cover some overall themes and lessons and generalizations. I will make generalizations about decades, which is a ten-year cycle, about

business cycles, and about Presidential terms. In the US a presidential term can be of four or eight years—Clinton had eight, of course. How long is a business cycle? Over the last half century—the average post-War recession has lasted 11 months, the average expansion has lasted 50 months—for a total cycle of 61 months. By that guideline, by the way, if our recent recession was typical, then the recession should have ended at the beginning of 2002. And probably it did. The NBER committee will eventually determine that.

Taking a step back, I see a pattern whereby the first few years of each of the last four decades has been dominated by one or sometimes two recessions in the US, and the rest of the world to some extent has been correlated. The latter half of each decade has then seen pretty steady expansion. So in the 1960s, we had a recession in the first couple of years; in the 1970s we had a slowdown—one recession in 1970 and again in 1973; in the 1980s, we had one recession in 1980, and another one in 1981–82. In each case the first few years are recessionary and then we had some pretty good expansion in the last five or six or eight years of each decade—in the case of the 1990s it lasted ten years, which was the longest expansion the US has ever had.

Box1: What is different about the most recent business cycle?

The expansions of the 1960s, 1970s and 1980s were each driven by expansionary monetary and fiscal policy. Many of the jobs created were in the government.

The expansion of the 1990s was driven by the private sector, not the government.

By 1969, 1979, and 1989, the budget deficit and inflation were rising. Thus, the need to raise taxes to fight the deficit, or to raise interest rates to fight inflation, played a role in causing some of the recessions of the early 1970s, 1980s, and 1990s. In any case, monetary and fiscal policy were not free to respond counter-cyclically.

By the end of the 1990s, inflation was still low and the budget was in record surplus, which implies that monetary and fiscal policy have been free to respond to the current recession.

A couple of interesting aspects of Presidential terms. One is something called the political business cycle which says that the determination of whether the incumbent party will be re-elected depends on what the rate of growth of the economy was during the year preceding the election. It says that people have very short memories and they forget completely if things were awful early in the term. There is pretty good statistical evidence for this. Many of us in the year 2000 were placing bets. The traditional rule would have said that because the economy was very strong, the incumbent party would win the presidential election, which would have meant Al Gore. I still don't know whether the 2000 election was an exception to the rule. It

turned out that one needed to distinguish between which candidate got more votes and which candidate actually was named President, because under our system which turned out to be less reliable than most people realized, it was possible in our electoral politics that a candidate with a fairly substantial majority in the popular vote may not still be designated president. Maybe we have to make our definition of the political business cycle more precise.

I want to go beyond the 1990s or 1980s, and draw some lessons that are applicable for the current decade as well. Let me start off with one pattern that I see recurring in different administrations. One pattern is that most presidents, when they are running for office, promise low taxes. Usually they are sincere in that—they usually think that they can cut taxes and still reduce the budget deficit, but they generally find out once they get into office that it is not as easy as they thought when they were candidates. Each of the last three Presidents has reversed course. Ronald Reagan cut taxes when he first came to office in 1981, quite a lot, but the resulting record budget deficits forced him to raise taxes subsequently. Bush Sr. reversed himself in the middle of his first term. He had made his famous ‘no new taxes’ pledge at the 1988 Republican National Convention when he was running for being President. He ended up having to change his mind, which, I think, was a good thing -- you have to give him credit for it -- because it was necessary, given how big the deficits were, even if it came at the wrong time. That was in the middle of his first term. Clinton made promises before he took office—he campaigned on a middle class tax cut—but by the time of his inauguration, he had talked enough to Bob Rubin and thought about it enough to realize that the budget deficit was a high priority, so he ended up actually raising some taxes.

So then the question is when is the second Bush going to make the same realization? He needs to do some mathematics. It is going to take him awhile, but I hope he eventually figures out that fiscal realities are going to constrain him in his second

term, assuming he has a second term. But I will come back to that.

The book that I mentioned—*America's Economic Policy in the 1990s*—is organized around areas of economic policy. A typical chapter, titled International Financial Crises in Emerging Markets, featured Summers, Stan Fischer (who was the Deputy Managing Director of the IMF during this period) and Allan Meltzer, a leading critic. We also had an excellent background paper for this chapter, by Brad DeLong and Barry Eichengreen.

Policy areas where the Clinton Administration moved toward intelligent intervention

Many of these chapters can be used to illustrate an important generalization, the principle that good economics does not mean leaving everything to the market. There are sources of market failure—externalities, imperfect competition, income distribution issues, imperfect information—that do call for some kind of government response, some kind of intervention, hopefully interventions that are well targeted to address the particular failure in question. Five policy areas covered in the book are particularly relevant:

- International financial crisis: We are not quite sure why the world financial system does not operate quite as well as the textbooks say. It is true that countries can derive lots of advantages from borrowing and lending. Thinking of the crises that hit Mexico in December 1994, East Asia in 1997-8, Russia, Brazil, and so on, however, more of us now think that the markets are not working the way they should. Some kind of a government intervention is called for.

Incidentally, this is one area that serves as a striking counter-example to the common accusation that Clinton always did what was popular or acted according to the polls. He agreed to the Mexican bailout, even though

his advisers warned him that it could have well cost him the election. The bailout was at the time very unpopular politically, but he said this is the right thing to do.

- Competition policy: Anti-trust policy is one of several areas of regulation where the Clinton Administration was more aggressive than the Reagan or Bush Administrations that had come before. An example was the Microsoft suit. Now, looking back, we are talking a lot about corporate governance. A lot of these problems we have seen—Enron, etc.—developed during the 1990s, and then came to light when the stock markets went down sharply during the Bush Administration. I think the Clinton White House did not do enough, but at least wanted to move in the right direction. The head of the Securities and Exchange Commission, Arthur Levitt, whom Clinton appointed took up issues such as whether accounting firms were subject to conflict of interest and needed to be regulated, but he was blocked by the Congress—both Republicans and Democrats. The Chairman of the Securities and Exchange Commission that was appointed by Bush in 2001 came from the accounting industry and was initially much more in favour of letting the accounting firms do what they wanted.
- Energy and the Environment: Pollution is the quintessential market failure, an externality requiring a proper government response. One environmental policy where the Clinton Administration was aggressive was the Kyoto Protocol on Global Climate Change, which happens to be something on which I spent a lot of time working, along with lot of other people. I think it is not too popular in India, the idea that the developing countries ought to participate in the first round of emission targets is not popular. One of the most dramatic visible differences between the Clinton

Administration and the preceding one is the degree of activism on environmental policy.

- Education: The Administration created various tax credits and deductions to allow lower income people, who otherwise may not be able to go to college, to do so, for example to go to junior college for a couple of years. This was a successful policy. One drawback is that having too many special breaks like that makes the tax code even more complicated than it had been. Many of us would like to have a simpler tax code if that is possible.
- Health care: Probably Clinton's biggest failure was the big Health Care Bill that he tried to push in his first year of his Presidency. You could say that the absence of a lot of big initiatives in the subsequent years and the tendency instead to pursue a lot of small issues, or to be reactive as crises came up, was in part because the health care effort was such a failure, and he had to pull back. He also lost control in Congress, which the Republicans took over in 1995.

Policy areas where the Clinton Administration moved toward market discipline

These are the areas that illustrate the principle of good mainstream economics that when there is a market failure the government should try to do something about it, if it can be effective. But there are other areas where good economics says to leave it to the market. Even though the Clinton Administration was a Democratic Administration—and the Democrats are traditionally associated with big government and intervention—to my way of thinking, the Clinton Administration was more in tune with what the economic textbooks say is good economics, more in tune with moving towards the market when it comes to microeconomics and enforcing macroeconomic discipline when it comes to macroeconomics, than the

Republican Administrations have been. I wrote an article saying that the Democrats and Republicans have switched places over the last 25 years. In the 1960s, the Democrats stood for big government and protectionism and deficits, and the Republicans stood for macroeconomic discipline, free trade, and small government. But since then—I am just speaking of the President, the White House, not the Congress—they have switched places! For example, deregulation actually started under Carter, not under Reagan, in the late 1970s.

Let us go through some of these areas where the Clinton Administration moved in the direction of market discipline, and where I think this was the right thing to do.

- Monetary Policy: There are many who would give the credit for the good economic performance in the 1990s to Greenspan rather than to Clinton or other historical forces. I think Greenspan does deserve a lot of the credit. The Administration's policy was to leave the monetary policy entirely to the Fed, the Central Bank, which is supposed to be independent under our system of law. But this was a more radical change than may be evident at first, because previous Presidents had never been able to resist the temptation to pressure the Central Bank for easier monetary policy. Nixon did it, Reagan did it, Bush did it. A book by Bob Woodward, Maestro, makes it pretty clear that Reagan tried to appoint easy money people to the Federal Reserve Board, and that the first Bush actually leaned quite hard on Paul Volcker, Chairman of the Fed, making such demands on him that he asked not to be reappointed in 1987.

I can attest from personal experience what a great effort it takes to avoid the appearance of putting pressure on the Fed. One of the first things I was told when I was ushered onto the President's Council of Economic Advisers was never to say anything at all

about monetary policy when I had to spoke in public. “You do not even say something like “we think the Fed is doing good job’ ”. You just do not say anything.” And we stuck to it. That meant that the Fed was free to do its job. Particularly the fact that budget deficits were reduced, gradually, during the 1990s allowed the Fed to reduce interest rates. So I think we got lower interest rates by leaving the Fed alone than we would have if we had pressured them to lower interest rates. We see sometimes in Europe, the finance ministers or the politicians put pressure on the European Central Bank (ECB) to lower interest rates and the ECB reacts by becoming more reluctant to lower interest rates. If the government stands back, you will be more likely to get lower interest rates in the long run. This is one lesson that also carries over to developing countries like India.

- Fiscal policy: The elimination of the US budget deficit in the late 1990s was a dramatic accomplishment. I do not think anybody at the beginning of the 1990s thought that we could eliminate the huge budget deficits that we had by the end of the decade, but we did. It was not all due to Clinton, of course. Strong growth was a big part of it, and a booming stock market was a part of it, because it generated tax revenue in the form of capital gains. Three policy steps that were taken were key in my view. First, again, to give Bush Senior credit, in 1990 he reversed himself on the ‘no new taxes’ pledge. An historic meeting with the Congress put some long-range caps on spending, and raised taxes. That was one major step.

The second key policy step was Clinton’s first budget, in 1993, which decided not to increase spending and, as I mentioned earlier, raised some taxes (while cutting others). Those steps, together with strong growth, did succeed in reducing deficits and by 1998 we could see

that we were going to have surpluses—and record surpluses, at that. There was a great temptation to spend the new surpluses. The Democrats in Congress wanted to spend on their pet spending programmes—build highways, whatever. The Republicans wanted, especially, to have tax cuts. The third key policy step: In the State of the Union Address in 1998, Clinton declared a strategy, expressed in the slogan, ‘Save Social Security first’. The US, like other industrialized countries has this ‘population bulge’, we call the baby boom — it is my generation, though Clinton called himself the ‘oldest baby boomer’—which is going to start retiring ten years from now. We have a current surplus in social security, but not enough to pay all the pension benefits to those who will be retiring. Hence the idea, ‘let us first save the surplus for social security’. If and when we think we have succeeded in putting social security on a firm footing -- and also Medicare, the healthcare equivalent -- only if we have those on firm footings should we start thinking about goodies like tax cuts or other kinds of spending. It was a pretty attractive political mechanism— and was effective in preventing Congress from either cutting taxes or raising spending, and thus in preserving the new surpluses. But in retrospect it worked for only two years, until the end of the Administration. I thought it would have lasted longer than that, but when Bush came in everything changed.

Perhaps the lesson of recent US fiscal history that is most relevant for other countries as well is the desirability of running countercyclical budget deficits, rather than procyclical. When the economy is booming, that is the time to gradually reduce the budget deficit and, as the US did in the 1990s, and if possible run a surplus. It prevents the debt from getting out of control, and allows you the very nice luxury of running a deficit when a recession comes, to cushion the

magnitude of the downturn. The worst thing to do is to think that rapid growth will last forever, to spend the resulting tax proceeds on expensive new spending programs or tax cuts, and to postpone the day of fiscal reckoning until the turning point comes. This is what the first George Bush did, waiting to raise taxes in the year in which it was least appropriate (1990) and it arguably cost him reelection. His son seems determined to head down the same path.

- Trade policy: When I was in the government I spent a lot of time, as an economist, arguing against measures which I thought were either outright protectionist, or at least insufficiently free trade. But in retrospect I think the Clinton Administration did well. Look at some of the things the current Administration is doing—putting up steel tariffs, agricultural subsidies and all that. Compared to that, and compared to the Reagan Administration, I think we did fairly well by free trade principles. Two big successes were NAFTA (North American Free Trade Area) which was passed in the beginning of the Administration, and the accession of China into the WTO, which came at the end.
- Information Technology: One of the distinguishing characteristics—perhaps *the* distinguishing characteristic in many people's minds—of the 1990s was the Internet revolution, the electronics revolution. It was mostly in the private sector. People who favour government intervention always remind us that the Internet was actually invented by an agency of the US government, was originally a creature of the government. Nevertheless, as it prospered it was taken over by the private sector. And there were some key decisions, such as whether domain names should be handed out by the government or by a private agency. Contrary to what some people had thought, it was the Clinton

Administration which basically turned it all over to the private sector. And that was probably the right decision—contrary to those who thought that the Democrats would be unable to resist the temptation to regulate a new sector.

- Income distribution: This is an area where one needs government intervention. In the United States the welfare system is a major safety net for low-income people. But by the beginning of the 1990s there was a rough consensus that welfare needed to be reformed. Clinton did go along with the Welfare reform. That got many people on the Left very upset, but in retrospect it worked pretty well. Also the “Earned Income Tax Credit” is a provision in the US tax code, which implies that low income working people do not have to pay taxes until their incomes get up to a certain base. Keeping marginal tax rates low for low-income people, it seems to me, should have higher priority than keeping them low for rich people.

Why was US economic performance so good in the 1990s?

In the introduction to the book, inevitably we had to give some sort of an answer to the question of why the US economic performance was so good in the 1990s. Of course, not everything was good—we had a widening trade deficit, the poverty rate was still higher than anyone would like. But all in all, if you look at all the indicators—unemployment, inflation, budget—they were better than they had been in some decades. I see three categories of explanations for good US economic performance in the 1990s. I have not had to change this list of explanatory factors at all since we thought about it at that time; it is exactly the same list now, looking backwards.

First on the list are the short run factors: temporary good luck on prices. Oil prices were low, agricultural prices were low, prices of computers were falling, health care costs were for the first time going down relative to other prices, and US import

prices were going down, partly because of the strong dollar and partly because export prices in Asia were low. We knew it would come to an end, most of these trends did turn around at the end of the decade.

Next on the list are the medium run factors. Here is where I would give some credit to what I would call skillful macroeconomic policy management: fiscal policy that eliminated the budget deficits, and monetary policy, which together, as I have already mentioned, allowed the reduction in interest rates and increase in investment.

Finally on the list are the long-term structural factors. Some would sum them up under the label “the new economy.” The revolution does not look as sweeping in retrospect, when it has been confirmed that there was a bubble component to the stock market and that information technology was oversold. Nevertheless, there were indeed some long-run fundamental structural trends that went in a positive direction, many of which had begun in the late 1970s and 1980s but really bore fruit in the 1990s. These are the three ‘ations’: globalisation, deregulation, and innovation. First is globalization: international trade and investment, are good for growth in any country and we benefited from an increasingly open US economy. Second is deregulation. Deregulation, as I mentioned, actually started in the late 1970s with airlines, trucking, natural gas and banking; in the 1980s it continued with telecommunications; and in the 1990s with electricity. Now some of these deregulation efforts were bumpy along the way, notably banking and, more recently, electricity. Nevertheless, all in all, I think these were pretty successful and made the US economy even more flexible and market-oriented, and helped account for the good performance of the 1990s. Finally comes innovation. This includes technological innovation, such as the Internet, as well as managerial innovation, such as the just-in-time inventory practices, a concept re-imported from Japan which was put together with the new information technology and meant that corporations could keep their inventories low and respond much

more flexibly and quickly to changes in supply and demand conditions. There was also innovation in government such as the welfare reform programme, and defense conversion, i.e., reducing the military during the period after the end of the Cold War, from which we benefited.

Some of these trends are still with us in terms of the productivity growth that is higher than it had been in the 1970s and 1980s. We had 4 ½ per cent growth in the US economy in the late 1990s, which is 3 ½ per cent productivity growth, unusually high for an industrialized country. I don't think the long-run rate of productivity growth is that high. But it is higher than it was in the 1970s and 1980s.

A post September 11 perspective on the last five decades

Let me now talk about other decades, past and present. In the immediate aftermath of the terrorist attacks of September 11, 2001, I drew up a conceptual framework for the last five decades, which is excessively grandiose, I am sure. In each decade there are certain developments that put their stamp on that decade in a way we remember, and there are certain important lessons that we learn. I am especially emphasizing US economic policy, but not only. In each case, there are also some lessons that we think we have learned, that become everybody's conventional wisdom by the end of the decade in question. And then, right at the beginning of the next decade, some "big bang" comes along and completely disproves the conventional wisdom that we had before and puts us on a completely different track. All the articles that were written, trying to forecast what is going to happen in the future, are just thrown away in the waste basket and we start all over again.

Table 1: Five Decades: An Economist's View
*The conventional wisdoms of each decade
 are rudely reversed at the start of the subsequent decade.*

Decade	Shock that set stage for the decade	Other features	Defining aspect of decade	Lesson that held up subsequently	Forecast that was quickly proven wrong in subsequent decade
1960s	JFK assassination (Nov. 1963)	Civil rights movement; Vietnam; Moon landing	The problems of technology and economic scarcity had been solved	The next order of business was to address social problems	US economic growth would continue. Big government held the key.
1970s	Oil shock (1973)	Stagflation	Natural resource scarcity	Need to pay attention to the environment	Rising oil prices, and inflation in general, would continue
1980s	Recessions (1980–82)	Disinflation; debt crises; return to materialism	Reaganomics	Private markets and National saving promote economic growth	US was in decline, losing competitiveness to Japan
1990s	Collapse of USSR, Gulf war (1990–1)	Bursting of Japan bubble; East Asia crises; IT revolution	New Economy; US triumphalism; 'Era of big government is over'	Deregulation, globalisation and innovation promote growth	US could continue as an island of economic prosperity in a troubled world, with a unilateralist/insular foreign policy
2000s	Terrorist attack on WTC (9/11/01)	Bursting of NASDAQ bubble (2000–1)	'Masque of the Red Death' ?		

So the big shock for us early in the 1960s -- and this is certainly US-oriented but some of it applies to rest of the world as well -- was Kennedy's assassination. The 1960s were also the decade of the landing on the moon and civil rights and Vietnam. I have as the defining aspect of that decade, the feeling that we had solved the big technological and economic problems for the first time in history, and that now we had to turn to the next order of business, which were the social problems. I think that

putting social problems and civil rights at the top of the agenda was a correct lesson. What was the lesson that was learned incorrectly? By the end of the decade there was a feeling that US economic growth would continue strong forever and that activist US macroeconomic policy was a big part of that. One of my old teachers at MIT, Robert Solow, made a comment, which he has never been able to live down, that we economists had figured out how the economy works and how to move the monetary and fiscal policy levers and that all that remained was filling in the boxes -- estimating the parameters -- so we know exactly how far to move the levers.

In 1973, the global oil shock upset that worldview. It gave us stagflation: we had slow growth and inflation at the same time. It was not just oil prices, it was commodity prices generally, natural resource prices generally. The lesson derived from the commodity shocks of the 1970s was that natural resources were scarce. We added the needs of the environment to the list, and began to address them with the Clean Air Act and so on.

What was the lesson that was incorrect? At the end of the 1970s, almost every energy sector forecast—with a couple of exceptions, but very few—said that oil prices were going to keep rising forever, that demand was very inelastic, that supplies were inelastic, and that this was the way the future was going to be. And there were some who made doomsday forecasts that the world was going to run out of resources by the year 1980.

That turned out to be wrong. We learned very quickly in the 1980s, beginning with the US monetary tightenings and recessions of 1980 and 1981-82. It was a time of high interest rates pretty much everywhere around the world. Higher interest rates started in London and New York, but ended up impacting just about everybody, and contributed the impetus for the international debt crisis to some extent. In the US, there was also a certain return to materialism under Ronald Reagan. The lesson for good economic policy that held up well subsequently was the importance of market mechanisms and saving—the

lesson that Reagan was slow to learn, I think, but that the rest of us learned was that you have to watch your national saving rate and if you have low private saving rate, as the US did, and if you have a high budget deficit, that necessarily is going to crowd out investment and lead to a trade deficit. I will come back to that later, because we are seeing a repeat of the same debate today in the current decade.

The lesson that was wrong was an assertion made by many writers, many journalists and academics, that the US was now in economic decline and was losing competitiveness. It was said that Japan was “eating our lunch” and was going to take over the world, with the rest of East Asia close behind. That view reversed pretty quickly in the 1990s. Three events—the fall of the Soviet Union, the Gulf War victory in 1991, and the bursting of the Japan bubble—suddenly left the US looking awfully good in terms of economic performance and also political power.

So the defining aspects of the decade were the New Economy and US triumphalism. Everyone else felt the pressure to emulate the United States; even Asia, which, in the previous decade had been doing so well. There is no doubt that this view was overdone.

The implicit lesson at the time seemed to be that the US was doing great and if other countries wanted to emulate us that was good for them; if they did not it is their problem. We did not have to worry about the rest of the world; we could continue as an island of economic prosperity. We had a pretty unilateral foreign policy. We could intervene militarily sometimes if we thought it necessary—in Kosovo our pilots could drop some bombs and be home to Nebraska in time for dinner, and we did not have to get our hands dirty.

The terror attacks of September 11, 2001 were the big shock of the new decade that changed the sanguine view on foreign policy. Also the bursting of the bubble in the stock market, that of the IT bubble. I do not know what will turn out to have been the defining aspect of the decade. But an unpleasant metaphor occurs to me—the Masque of the Red Death, a short story

written by an American short story writer, Edgar Allen Poe. I believe it is set in the Middle Ages in an Italian city state. There is a plague called the 'red death'—I don't think it really exists—that appears in its victims as bright red spots of blood on the face and skin. The aristocracy withdraws into the countryside, into a villa to eat, drink and party in isolation until the plague is over. They have, on one night, a masquerade ball, a costume ball. In the middle of it, someone appears with a costume, looking like a victim of the red death, with bright red blotches; he walks through the rooms of the castle and gradually people realize that this is someone from outside who has gotten in and now they are going to be infected. This is not a pleasant analogy; but I think the US is coming to realize that what goes on in the rest of the world really does affect it.

I do not know if it is evident from this distance, from the perspective of India, but September 11 had an amazing effect on the US. It changed the way almost everybody felt about lots of things. To some of us, it seems like the Bush Administration used it as an excuse to do things that they were planning to do anyway and had already proposed. One example is NMD—Nuclear Missile Defense. They had and still have these plans to spend tens of billions of dollars in an attempt to discover some technology to shoot down missiles that may come in. Many said beforehand that this was a problem of the Cold War, whereas the problem of the current age is that terrorists might get a nuclear suitcase bomb into the US and missile defense won't be any good against that, so you are wasting a huge amount of money on something that does not even address the threat we have got. Some of us thought that the September 11 attack would make that point clear; but no, they are going ahead and building missile defense. They say it shows what a dangerous world is against us.

Second, you might think that if you are fighting a war, that would be a reason, if anything, to raise taxes. But no; they seem to think it is another reason to do what they want to do anyway, which is to cut taxes.

A third example is ANWR, the Arctic Northern Wildlife Refuge—huge federal lands in Northern Alaska that the environmentalists want to preserve. The oil industry would like to drill there eventually. My view is that instability in the Middle East is a reason why the US should want to be a little more self-sufficient in oil than it is. But I don't see how long-run self-sufficiency is aided by the idea that you are going to develop now, when oil prices are relatively low, one of the last oil fields on US territory. It is a strategy of 'drain America first.' It seems to me we should want to keep our oil as insurance against a disaster scenario, and work on conservation in the short to medium term.

The last example is actually one I agree with. The Bush Administration used the war on terrorism as an additional argument for persuading Congress to give it fast track authority in trade negotiations, and thereby launch the so-called Development Round of trade negotiations at the Doha summit of WTO ministers. They used September 11 as an extra motivation for why they needed to do this. In any case, I do give them credit for pursuing it, at the same time that I criticize them for the steel tariffs and other trade issues.

These are areas where they have gone ahead with what they were planning to do anyway. But in some other areas where their first position was that whatever they do should be the opposite of the Clinton Administration, they eventually changed their mind.

Korea is an example. The initial instinct was, 'we do not like Kim Jong Il; why should we be nice to him if we do not like him?' Then the North Koreans reacted by backing off from the kind of very slow process of rapprochement that had been underway. Now, all of a sudden, the Administration is trying to downplay strains with North Korea.

Offshore money laundering is an example of something they did not take seriously at first, and then all of a sudden they discovered after September 11 that maybe it actually is an important area.

Fiscal policy in the Bush Administration

Let me get back to fiscal policy, which is what I promised to talk about, and tax cuts.

Box 2: Five desirable characteristics of a tax cut

- **Timing**, regarding the business cycle
- **Responsible**, regarding long-run fiscal outlook
- **Efficient**, regarding economic incentives
- **Equitable**, regarding low-income workers
- **Simplifying**, regarding taxpayer planning

Amazingly, the tax cuts proposed and passed by President Bush in 2001 largely failed all five tests!

The biggest shift in economic policy that the Bush Administration has undertaken is large tax cuts, which add up to 1.3 trillion dollars over a ten year period, passed in 2001. And now they are working on another one in 2003. I do not have anything against tax cuts, if you can afford them. Taxes are kind of a distortion and the more you can get them down the better! But there are smart tax cuts and dumb tax cuts. I show in the box five characteristics that a good tax cut ought to have.

It should have good timing with regard to business cycles. If you are in recession now, you need a stimulus now, not in some other year. It should be responsible with regard to the long run fiscal outlook, recognizing that you have to raise revenue somehow if you are going to fund the spending you have chosen.

It should be efficient—to promote economic incentives, so you want to get marginal income tax rates down if we can. It should be equitable in the distribution of income. And it should be consistent with simplification and make it possible for tax payers to plan ahead. Maybe I am being too harsh, but to me it seems that most of the tax cuts that Bush proposed and passed largely fail all those five tests, which is a fairly remarkable achievement!

This is most notably true of the temporary abolition of the estate tax in the year 2010. If you die with an estate over a million dollars, for example, currently you have to pay tax on the amount over one million; but that limit is being raised and eliminated completely just for the year 2010, so that it does not matter of how many millions of dollars, your heirs get to keep all of it if you die in that year. That plan seems to me to fail on every one of these criteria.

When the Bush Administration first came in in January 2001, the official forecasts were very optimistic for what the surplus was going to be, both in the short run and for ten years ahead. But they have continually been revised downward. The official estimate from the Congressional Budget Office (CBO) in August 2002 was that we still have a \$1 trillion surplus if you add up, over the next ten years, the current deficits to future surpluses. As I said, that itself is a very sharp downgrading of the previous forecasts both from CBO and White House, but the fact is that it is already far too optimistic. A few weeks from now, the White House and then the CBO will issue their 2003 budget forecasts, and they are in effect going to say ‘Oops!’—they do this every six months— ‘Oops, it is a lot worse than we told you!’ That is going to keep happening over and over again.

Here are many reasons why the current forecasts are still far too optimistic. I will explain a few of them. First, the official projections assume that discretionary spending is constant in real terms, i.e. that it will only increase at the rate of inflation, which is 2.6 per cent. Well, that is not going to happen. There are a number of reasons for why it is not going to happen. A more

realistic, but still conservative, estimate for the trend in spending over the next ten years is enough to wipe out the supposed the \$1 trillion surplus.

Second, there is also over-optimism on the tax revenue side, which is as bad as the over-optimism on the spending side. They have used overly optimistic forecasts for the growth rate. They have failed to build in the likelihood that a recession would occur sometime during the next ten years.

Third, the Republicans' current proposals are to make the tax cuts permanent. Under the 2001 bill, those estate taxes that are abolished completely in the year 2010 bounce back in 2011, to the current system under which everything over a million is taxed, and they did that just to appear to generate some revenue in 2011. But nobody thinks that they are actually going to do that. That would mean – this example is semi-facetious – to safeguard a hundred million dollar estate in 2009, you might pay to set up a private intensive care unit to keep your benefactor's heart beating until the year 2010 starts and then during the year sometime you decide, well, Uncle Joe would not have wanted his life artificially prolonged by such extraordinary measures anyway, and you make sure you pull the plug before the year ends, because it is worth millions dollars. The Republicans intend to make this tax cut permanent, and many others besides; but it will cost money.

Another problem with the forecasts is that they are counting tax receipts that are supposed to go to Social Security. Once you take account of all these factors, and some other tax provisions that they are going to have to fix, then the supposed \$1 trillion surplus is really a \$5 trillion deficit over the next ten years.

Budget deficits in India

Let me turn to the effects of budget deficits. There is a huge amount of academic research behind the effects of budget deficits, and it has some relevance for India.

India has a budget deficit problem. The capsule summary version of India's macroeconomic history over the last two decades, as I understand it, is as follows. A few reforms took place in the 1980s but most reforms came at the beginning of the 1990s. Economists believe that reforms should give you long-term growth. It is a bit of a puzzle as to why India's growth rate, though pretty good in the 1990s, was the same as in the 1980s, which was higher than in preceding decades. Why did the big increase come in the 1980s?

From what I have read or heard during the short time I have been here, it seems that perhaps an explanation is that India's macroeconomic policy was expansionary in the 1980s, both fiscal and monetary policy, and that gave an extra Keynesian push on the demand side, which is a temporary source of growth. But that only works in the short run. In the long run, you have to reverse such a fiscal impulse because if debt is rising, you have to undertake some fiscal contraction to meet the interest payments; and if inflation is rising, you have to undertake some contraction in monetary policy—so the longer-run effects are contractionary. That perhaps would explain what happened over the last ten years, in that the need to reverse some of the macroeconomic expansion dating from the 1980s inevitably put a contractionary effect on the economy at the same time as the 1990s reforms boosted the growth on the supply side—that is why the average growth rate, though higher than in the 1960s and 1970s, has been no higher than in the 1980s.

The economic implications of large future deficits

Right now, in the United States, in connection with these tax cuts, there is a debate developing, which is the same debate we had in the 1980s. In the early 1980s I was on the staff of the Council of Economic Advisers working for Martin Feldstein,

who was a great person to work for (even if it was in a Republican Administration!). That was when the budget deficits were first getting very large and trade deficits were getting very large. We had exactly the same issues to debate.

It is important to distinguish between the effect of budget deficits on the total level of Gross Domestic Product (GDP) or the growth rate of GDP versus on the composition of GDP. Income, as the introductory economic textbook says, is equal to C (consumption) plus I (investment) plus G (government) plus X (exports) minus M (imports). Output has to be sold either to households for consumption, to firms for investment, to the government as goods and services, or to foreign residents in the form of net exports. Those are the components. The usual textbook view, which I think is right, is that fiscal expansion does produce faster growth in the short run, but there is some crowding out of the private sector, and the crowding out usually comes through a couple of price signals, a couple of mechanisms. One is you drive up short-term interest rates, so households make fewer purchases of cars and consumer durables and housing perhaps, so there is a negative effect on consumer spending. Another channel is that high interest rates attract capital inflows, they cause the currency to appreciate and that causes a loss of net exports. Certainly, the US trade deficit got much worse in the 1980s, and that is happening again today. Also you drive up long-term interest rates and that tends to matter more for firms' investment. So we have reduced investment, even in the present. So we have crowding out of all those factors.

So what are the implications of this? Fiscal expansion stimulates growth in the short run, because crowding out is only partial. We do not think that increases in demand can have permanent effects on output; eventually output is constrained by capacity, by potential output, and unemployment reverts to the natural rate of unemployment. But we are left with the fact that if we have been investing less for the last ten years due to crowding out by the budget deficit, then we have a smaller

capital stock, so long-run growth is going to be lower. That is especially true once you take into account the fact that eventually you have to service the debt, at a minimum to pay the interest bill that you have incurred on debt in the meantime, so eventually you have to either raise taxes or cut spending. So that is another reason why you get a contraction in the long run that reverses the expansion in the short run.

The alternative view

I think that the foregoing is consistent with the views of most economists, regardless of their political affiliation, in the United States, and I imagine in most of the rest of the world. But there is an opposing school of thought that says that excessive budget deficits do not really matter. To put a precise name on that school of thought, Robert Barro, a colleague of mine at Harvard, called it Ricardian equivalence. David Ricardo had a line about how budget deficits imply that eventually debt has to be serviced, and eventually governments may have to raise taxes, and people know that, since this is very much a rational expectations view. If they are looking forward to the future, people know that they or their children will have eventually to pay higher taxes in order to service that debt. So they start saving money today to put it aside so that they or their children can pay back the debt. That logic implies that when the government spending goes up, consumption goes down to offset it, so there is a net effect on national saving. It implies you get neither the expansion in the short run nor the negative effect on growth in the long run; you get no effect at all.

That is probably the theoretical rationale behind some recent claims in Washington that we do not have to worry about deficits. There is some quarrel with the statistical evidence, in the White House for example—saying there is no statistical evidence that budget deficits affect interest rates. This is exactly the debate we went through in the 1980s. They may be a little more careful about how to phrase it; Glenn Hubbard, the first Chairman of Bush's Council of Economic Advisers, formulated

the sentence “interest rates do not move in lockstep with budget deficits.” Of course, deficits are not the only things that affect interest rates. So often we see an episode when the deficit went this way and the interest rate went the other way. For example, in 2001-02 interest rates went down while deficits were rising. That is not a very convincing argument. We know what the other variable was: the recession and consequent easing of monetary policy brought interest rates down. We know that most things in life are determined by more than one variable. Standard theoretical models and standard regression analysis allow you to put many influences into the equation. Many studies have done that. And a majority do find an effect of expected future budget deficits on long-term interest rates.

But sometimes they do not. Econometrics in macroeconomics is usually messy. The reality is that everything is simultaneous, so it is hard to get clear results. You do not have as many observations, or data points, as you do in microeconomics. If you have a panel data set of 1000 households, you can hope to get a lot of information to bear on the subject. That is much harder with macro data, where typically we have only so much time series data. So it is true that a number of studies do not find a statistically significant effect of budget deficit or the level of debt on interest rates. It is true of the United States and it is true of other countries as well. Some people find a significant effect, some people don't. But to my mind, even if you want to be very conservative there and say we are not going to believe in it unless we get a high level of significance, it would be asymmetric to conclude that therefore you do not have to worry about deficits. Because, remember what the mechanism is under the Ricardian hypothesis. The claim is that private saving rises to finance the deficits and you do not have effects on the economy. We can test that proposition directly. We can run a regression of private saving against budget deficits. And then you have got to deal with all the same econometrics problems, and it is just as hard to find a statistically significant effect in that direction.

This is the kind of trend I see in econometrics over the last 20 years. It is always hard to find significant results that hold up robustly, that is, even under different specifications. It used to be that in order to assert a conclusion you had to find statistically significant results. If you did not, you had a problem; maybe you had trouble publishing your paper. But the rules have changed. You are allowed to get up and say that you have found that such and such has no known effect. Examples of this are claims such as “I have found, that the exchange rate policy is a random-walk,” or “the stock market is a random walk,” or “GDP is a random walk.” In reality, those are just sophisticated ways of saying that you have absolutely nothing to say about the direction in which the stock market moves. It is not a finding, but the absence of a finding!

To get back to the debate over the effects of budget deficits, you are still going to have trouble finding something either way. If you are on the Republican side, you run a regression of interest rates against deficits and you do not find anything and say the deficit does not have any effect. If you are on the new Democratic side, with the emphasis on fiscal responsibility in recent years, then you run the regression of private saving on budget deficit; again you do not find anything, and you say, therefore deficits do have an effect.

The important point is that national saving is equal to private saving plus public saving, and that determines total national investment. If you don't think the interest rate is the transmission mechanism, if you don't think that is the signal that crowds out private investment or that the exchange rate is the signal that crowds out exports, it does not really matter. The crowding out takes place nonetheless. It is an identity, it is a national saving identity. If national saving is low, then as a share of GDP, it must be that investment plus net exports are low and vice versa. It does not matter whether the crowding out comes via the interest rate or not.

Are deficits a deliberate device for shrinking inefficient government?

I will just mention one more aspect of the debate, a political economy argument, that comes up in the current debate over deficits in Washington.

It is a popular argument, which surfaced in the mid-1980s under Reagan when the record deficits first emerged. The promise originally was that if we cut taxes it would stimulate growth so much that tax revenue would go up rather than down. But that did not happen, and when it did not happen, a new rationale came out. It is a consequence of the idea that government spending tends to be inefficient, tends to be driven by special interests and it usually reduces the efficiency of the allocation of resources rather than increasing it. So the goal is to restrict the size of the government. That is hard to do directly, so the way to do it indirectly is to cut taxes, create a big budget deficit, and then Congressmen won't be able to vote for higher spending, because you have taken the money away from them. The claim is that they cannot spend what they don't have. That is the argument and it has surfaced again as a rationale for the current tax cuts and deficits.

The argument about the political economy, about the way you put pressure on a Congressman or a Congresswoman, to my way of thinking doesn't really make sense. In the 1980s, we did cut taxes, we did have these deficits, but they did not succeed in putting downward pressure on spending. The idea that Congress can't spend money it does not have is not true—they have and they will; they do all the time! The US can get away with that more than other countries can. That surely leads to borrowing abroad, and we are lucky enough to get to borrow in dollars, so we can keep it up for decades before the rest of the world becomes satiated with their dollar assets.

But the alternative is what we did in the 1990s, which was to have a set of laws and procedures that matched taxes and spending and said you can't cut taxes without cutting spending. That has got to be a more effective way of putting political

pressure on a Congressman than running a deficit. If the Congressman knows that every time he votes to increase spending, taxes are going to go up immediately, he is going to worry a lot more about protests from his constituents than he would if he were creating deficits and had to worry only about constituents fearing that their children might have to pay taxes someday.

About the Author

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