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Seeds of Destruction

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Foreword

"Republicans want to go back and live in the 1950s. Democrats want to go back and work there."

That's the joke circulating about the American attitude toward our current economy, our past, and our prospects.

It's a short joke, but one that captures Americans' dark suspicions about our future. In the 1950s, jobs were available and pay was high. Americans found they were able to work fewer hours than before and buy better cars and appliances. Mortgages were low. Education was available and universities were good. The Midwest drew workers rather than sent them away. When someone lost a job, he found another. Teenagers went joyriding in their parents' cars. It all looked easy at the time. But today no one seems to be putting forward a plan that can take us to a 1950s level of broadly shared prosperity.

No one, that is, until these authors. In this dramatic nonpartisan book, Glenn Hubbard and Peter Navarro lay out the true roots of the current troubles. They then open their hands and show "seeds of prosperity," a new set of policies that can, if planted, make the economic garden grow even more dramatically than it did in the past.

No pair of authors is more qualified than these to undertake this. While he was Chairman of the Council of Economic Advisers at the White House in the early part of the nought decade, Glenn Hubbard wrote the soundest components in the 2001 and 2003 tax laws. As a scholar and dean of Columbia Business School, Hubbard has identified those changes in tax and regulatory law that can yield the most efficacious growth. Peter Navarro, a noted speaker and teacher, is author of numerous prescient and insightful books, including *The*

Coming China Wars, *Always a Winner*, and *What the Best MBAs Know*.

Hubbard and Navarro begin their work by laying out the aspects of the problem the rest of us can merely sense. In this decade, the economy has grown an average of 2.4 percent. That compares with an average of 3.2 percent in the period from 1946 to 1999. Employment is in trouble. After other downturns, American companies have been quick to rehire. Not this time. Workers are being rehired after the crash of 2007–2008, but at a dreary rate conforming more to European patterns than our own.

The authors also expose what might have been wrong in the assumptions about a decade like the 1950s. One is that strong unions can force the economy to grow by demanding high wages. The only thing that made the high-wage policy of the 1950s possible was that, back then, the United States had no international competitors. Europe was flat on its back amid its own rubble. Asia was a rice paddy. Today, the effect of a high-wage policy, whether instituted because of union pressure or because of pressure from the federal government, would be to drive employers overseas even faster than they are already going.

The authors then proceed to offer recommendations that appeal to simple common sense. The first is that the country begin to recognize something we have been ignoring: the importance of business and investment. To be sure, Americans pay lip service to the concept that the private sector matters. President Barack Obama has, for example, often said that the private employers will lead recovery. Yet we don't think about the fact that our tax structure holds those employers and investors back. The Internal Revenue Code currently punishes savings and investment relative to other economic activities. The bias also disadvantages us internationally. Other nations have long since recognized the importance of the corporate tax. They have cut rates, leaving our corporate tax one of the highest in the world.

A second step then would be to realign the tax code so that it moves into balance. The authors format an overhaul of the tax code that reduces capital gains taxes and other taxes on business and capital formation. Such a move sounds like it is "a gift for business," something some voters, having been laid off by business, are not inclined to make. But the effect of reducing taxes on capital will be to create new employers for ourselves and our children. Reducing taxes on capital also improves the quality of jobs that will be on offer. Instead of a future as a municipal official, a child will find a job with the next Google.

Giving capital its fair chance entails a third move—abolishing or curtailing the elements of the tax law written to favor the consumer above the producer. Such moves would include a reform that is hard to sell politically—a reduction in the home mortgage interest deduction. But the gift of the interest deduction is only precious because of the punishment the rest of the tax code metes out. In combination with lower tax rates and more jobs, ending the mortgage interest deduction will not hurt families. A balanced tax structure would, again, begin to channel money to where it is most productive—innovative projects and worthy investments.

The fourth major change the authors call for is that the country reject government as a manager of the business cycle. Our national habit of looking for federal help at signs of economic weakness has had a significant result: It has made government bigger. Today, as budget deficits mount, the federal government is rapidly moving toward 25 to 30 percent of the economy. That compares with the 20 percent that was the rule just a decade or so ago.

But our dependence on government has not given us what we were really asking for: strong growth. This is because, as the authors point out, reliance triggers a destructive dynamic. To finance our excessive government spending, the U.S. Treasury must issue substantial new debt. Foreigners and foreign governments like to lend to

the United States. But the extent of our borrowing will eventually make us look risky. Though they may be lower now, interest rates will inevitably rise. Equally inevitably, higher rates will crowd out business investment. This crowding out in turn will decrease our ability to invest in essential functions such as defense, research, and education.

The last and final trouble is our trade deficit. As Hubbard and Navarro astutely illustrate, our trade imbalances are the result of several factors: that skewed tax system, which also puts exports at a disadvantage, our energy dependence, and those protectionist walls and deals that do exist already. It is time to set aside trade favoritism and develop constructive multilateral trade reform.

If these simple suggestions truly are "seeds of prosperity," why haven't others before Hubbard and Navarro recognized them? The first reason is the tendency of Congress and the White House to treat America like an emergency room. Next to other things it must manage—war, a Katrina, or a BP disaster—slowing growth does not look like an emergency. That slow growth, therefore, gets overlooked by politicians eager to play the hero by ministering to direr cases. Lawmakers' triage is understandable because crises have the rare capacity to catalyze our sluggish legislative bodies and voters into action. "Never waste a crisis," as Rahm Emanuel told an interviewer just after President Obama's election. But what the lawmakers forget is that even a gradual disease can be fatal. The sluggishness they despair of in their political conversations is a symptom of an economic slowdown.

There is a more profound reason for the American delay in addressing the causes of slow growth. In the postwar period, our textbooks have been called Keynesian, after the British economist John Maynard Keynes. Keynesianism, as it has been taught for the past half century, tends to neglect innovations, investments, and investors in

favor of the consumer and shopper. Keynesianism likes the kind of growth it knows, home buying or factory work.

Keynesian principles have so penetrated our thinking that they determine our lexicon. When a television commentator tells viewers that consumer activity represents 70 percent of the economy—and the commentators do that often—the commentator is quantifying the economy using Keynesian measures. The very meters we trust to tell us how to invest are Keynesian—the Consumer Confidence Index, for example. Such meters are fine and good. But they do not capture producers' anxieties or hopes. When we hear that "strong jobs numbers may lead to inflation," the speaker is assuming, as Keynesians do, that there is always a trade off between unemployment and inflation. This is not the case. We have had decades with strong growth and low inflation, and we have had a decade where growth slowed and inflation took off. "Stagflation," the 1970s dynamic, is itself a contradiction of the Keynesian trade off.

Our national inability to see outside the Keynesian construct in fact contributed to the recent financial implosion. For decades, the message to Americans from politicians of both parties was that spending was good—especially spending on housing. The tax structure reinforced this first with that home mortgage interest deduction but then also with the numerous home credits available over the years for lower earners and tax-subsidized federal loans. Had Americans invested that money on new ideas and new companies, growth overall would have been stronger and more genuine. The exotic mortgages that vulnerable families began to sign up for were tacitly sanctioned by the rest of us out of the Keynesian habit of believing in housing.

Unfortunately, politicians from both parties seem these days content to muddle forward in Keynesian fashion. Due to budgeting rules, the tax codes that Hubbard coauthored are due to expire this year or

next. The White House and many members of Congress have adopted a passive–aggressive approach to this process. Rather than extend the tax cuts, lawmakers and administration officials seem to be willing to let all or most of them expire. In addition, of course, Washington is blithely laying on new taxes, such as the health care planned 3.8 percent tax on so-called "unearned income." This last addition is itself a mighty burden, for it targets precisely those engines of growth described above. The result is to skew our tax system yet more against job creation. The total effect of the 2010 tax changes, even before any further increases are passed, is to impose the biggest tax increase on the country since World War II, and that in a time when the economy is still fragile. Lord Keynes himself, far wiser than today's Keynesians, would have been the first to point out the folly of that. In other words, at the present time, the United States truly is planting seeds of destruction, just as the title of this book suggests.

The good news is that scholars like Hubbard and Navarro do supply us with not only a new plan, but also a language for talking about that plan. Once voters can find the lexicon they need, they are ready to discuss, and eventually support, policies that will bring the progress for which we wax nostalgic. We will again enjoy that elusive thing that made the 1950s feel so good—not the union cards, not the music, not the lifestyle, but the growth.

—Amity Shlaes
Amity Shlaes is a Senior Fellow in Economic History at the Council on Foreign Relations, a Bloomberg columnist, and author of The Forgotten Man: A New History of the Great Depression.

chapter one

America's Four Growth Drivers Stall and Our Economy Stagnates

> *"For most of the past 70 years, the U.S. economy has grown at a steady clip, generating perpetually higher incomes and wealth for American households. But since 2000, the story is starkly different. The past decade was the worst for the U.S. economy in modern times, a sharp reversal from a long period of prosperity that is leading economists and policymakers to fundamentally rethink the underpinnings of the nation's growth."*
>
> *Washington Post* (January 2010)[1]

America has the largest and most productive economy in the world. Yet something feels terribly wrong.

It's not just that millions of Americans remain out of work. It's also that income and wage growth have been stagnant for many for much of the last decade, while our job security seems far more uncertain and our job opportunities seem more limited.

Amid these labor market uncertainties, our capital markets have likewise been in crisis. It's not just that millions of American stock market investors have lost trillions of dollars. It's also that our faith in our financial markets and institutions has been shaken to the core—even as the financial crisis cost many innocent bystanders their jobs.

The past decade has been particularly unsettling for a generation of Americans raised on Wall Street's doctrine of "buy and hold." Indeed, our financial advisors assured us that all we had to do was buy and hold a portfolio of stocks representing the broad U.S. stock market, and we would have more than enough to retire on. Yet an American dollar invested in a mutual fund holding the Standard & Poor's 500 stock market index at the beginning of the appropriately named "nought decade" of the 2000s was worth only 90 cents at the end of the decade.

In these unsettling times, the central conundrum we now face is that America's once-robust and vibrant economy appears to many to depend on an unprecedented, massive, and totally unsustainable monetary and fiscal stimulus just to achieve modest growth rates and relatively small reductions in a persistently high unemployment rate. One very clear and present danger is that these massive stimuli—and the massive government debts that come with them—will force us down the road to confront very unpleasant choices and trade-offs among fiscal priorities ranging from education and national defense to Medicare, Social Security, homeland security, and the provision of critical infrastructure. These massive stimuli may also possibly reignite inflation in the midst of America's underperforming growth rate.

Under this cloud of uncertainty, the central policy question now facing the nation is this: How can America reharness the vibrant productivity growth of the private sector and resume its journey on the path of long-term prosperity? In order to answer this question—and thereby make things right—we first need a much better understanding of just what has gone wrong.

The first diagnostic tool we will use is the GDP Growth Drivers equation, which is a simple but very powerful representation of how all nations grow their economies. Using this diagnostic tool, we will

see that after more than a decade of failure of our fiscal, monetary, and trade policies, the American economy has been saddled with major structural imbalances in all four of its growth drivers that are now stalling our economy. We as a nation are simply saving too little and therefore are investing too little in the primary engine of job creation—the private sector. We as a nation are also spending far too much of our wealth on government while chronic trade imbalances have left us severely weakened.

The GDP Growth Drivers Equation

The *Gross Domestic Product*, or GDP, is what economists use to measure the growth of any nation. The beauty and simplicity of the GDP Growth Drivers equation is that it illustrates that a nation's economic growth is driven by only four factors. It may be written like this:

GDP =
Consumption + Business investment + Government spending + Net exports

In this equation, "net exports" represents the difference between what a country exports to, and imports from, the rest of the world. It is important to understand up front that by the simple arithmetic of this equation, if a country such as the United States runs a trade deficit, its net exports will be negative, and its rate of GDP growth will be lower than it otherwise would be.

More broadly, using the construct of the GDP Growth Drivers equation allows us to very precisely diagnose why America is now facing a decade of slow growth and high unemployment. As we will see, all four American drivers of GDP growth have effectively run off the road—or, perhaps more accurately, been stalled by policy failures. Let's start our diagnosis, then, with a brief overview of the GDP itself.

GDP Growth Has Been Well Below Potential Growth

The 2007–2009 crash produced the worst recession since the Great Depression. However, the even bigger problem with the decade of the 2000s was that the U.S. economy performed well below its historical average and potential growth rate.

This concept of "potential growth rate" is particularly critical to both understanding and diagnosing America's economic woes. Any nation's potential growth rate (also called "potential output") measures the highest GDP growth rate a country can sustain over time without generating significant inflation. When the American GDP is growing at an annual rate consistent with its potential growth rate, our economy is creating as many jobs as it can in a sustainable fashion. However, if the American economy grows at a rate significantly below its potential growth rate for any sustained period of time, such as it did during the 2000s, millions of jobs that would otherwise be created are lost—and are very difficult to recover.

Exhibit 1.1 illustrates this problem of slow, below-potential growth by comparing the average annual, inflation-adjusted GDP growth rate during the 2000s to that of a historical benchmark based on the postwar period of 1946 to 1999.

Exhibit 1.1 The 2000s: A Decade of Underperformance

	Average Annual GDP Growth Rate
1946–1999	3.2%
2000–2009	2.4%

Source: Department of Commerce

During the benchmark period, the American economy grew at an average annual rate of 3.2%. What this benchmark number tells us

with more than 50 years of data is that the potential growth rate of the American economy is achieved when the GDP grows a little over 3% a year.

What Exhibit 1.1 also tells us, however, is that during the nought decade of the 2000s, the American economy substantially underperformed that potential. It averaged a 2.4% GDP growth rate[2]—0.8% below the historical average.

You may think that a difference of only 0.8% in the GDP growth rate is a small number. However, this 0.8% gap makes an *enormous* difference in terms of the ability of the American economy to create new jobs and income growth.

The rough rule of thumb is that every 1 percentage point of GDP growth creates about a million jobs. This means that on a cumulative basis, a 0.8% underperformance in growth over the course of a decade translates to close to ten million jobs our economy failed to create. This is a stunning finding, because if we had created those jobs in the nought decade, the American economy would be much closer to full employment than it is today. If the American economy continues to perform well below its full potential growth rate, this will mean continued persistent high unemployment, downward pressure on wages and income, and a stagnant or perhaps even falling standard of living.

To understand why the American economy grew below its potential in the 2000s—and why it is likely to perform below its potential growth rate in this new decade unless something is done—we need to turn to our diagnosis of the ills afflicting each of the four GDP growth drivers.

To set up this diagnosis, look at Exhibit 1.2. It compares the percentage contributions of each of the four GDP growth drivers in our benchmark period of 1946 to 1999 to those contributions in the decade of the 2000s.

Exhibit 1.2 Structural Imbalances in the U.S. Economy Emerge in the Nought Decade

	1946–1999	2000–2009
Consumption	64%	70%
Business investment	16%	16%
Government spending	20%	19%
Net exports	0%	–5%

We first see that in the postwar period from 1946 to 1999, consumption expenditures accounted for an average of 64%, or just shy of two-thirds, of America's GDP growth rate. That's a share of the GDP that is consistent with most developed economies.

However, we also see that the share of consumption jumped significantly in the nought decade of the 2000s—specifically, to 70%. As we will discuss further, this is a signpost of America's overconsumption during that decade, which helped lead us first to a housing bubble and then to a housing bust.

The second statistical comparison that really leaps out from Exhibit 1.2 has to do with net exports. In our benchmark period from 1946 to 1999, American trade with the rest of the world had virtually no net negative impact on GDP growth—net exports were near 0%. However, during the 2000s, as our trade deficit more than doubled and grew to record proportions, the net negative impact of net exports on total annual GDP jumped to fully *minus* 5%. In doing so, this negative net export effect may have reduced our annual GDP growth rate by as much as half a percent—with the collateral loss in millions of jobs that might otherwise have been created.

As a final statistical comparison, Exhibit 1.2 shows that government expenditures as a percentage of GDP were actually slightly lower than the historical average during the nought decade. This

means that at least during the nought decade, a bloated government sector does not appear to have been a significant brake on growth.

In this new decade, however, the problem we have going forward is a huge one.

As we will illustrate and discuss further, government expenditures are projected to zoom to as high as 30% of GDP under the impetus of massive fiscal and monetary stimuli and rapidly ballooning entitlement programs. Note particularly how the future projected deficits dwarf the current ones—which are historically large. Prospectively, the GDP Growth Driver equation therefore faces a significant worsening of its government spending problem—and a new and massive structural imbalance in its economy.

With these observations as background, let's turn to a more detailed analysis of each of the individual drivers of the GDP growth rate, starting with consumption.

The American Consumer's Roller Coaster

As previously shown in Exhibit 1.1, the American consumer is by far the largest driver in the GDP Growth Equation. In fact, in developed countries such as the United States, the European nations, and Japan, personal consumption expenditures typically account for fully two-thirds of economic activity. That's why a strong consumer with robust purchasing power is critical to any long-term American recovery.

Right now, the American consumer is anything but strong and robust. A large part of the problem is a frayed and tattered household "balance sheet" that remains as a leftover from overconsumption during much of the last decade. It was precisely this pattern of overconsumption (and a collateral low level of saving) that helped fuel America's housing bubble and eventually helped trigger the consumer-led 2007–2009 crash.

In fact, much of the overconsumption that occurred during the past decade was driven not by rising income and wages but rather by rapid home price appreciation. As housing prices rose during the bubble years, millions of Americans relied more and more on the black magic of mortgage refinancing for their spending needs rather than on rising wages and income.

By refinancing their mortgages and removing equity from their homes in the form of cash payouts, consumers effectively turned their homes into automatic teller machines. Collectively, this "house as an ATM" phenomenon provided a tremendous short-term consumption boost to the economy.

However, with consumers spending beyond their means and stretching their balance sheets, that kind of economic boom would inevitably go bust. Once the housing bubble burst, the "house as an ATM" consumption stimulus for the economy went into reverse, and consumption spending slowed dramatically.

Today, as the American economy attempts to resume its robust long-term growth pattern, a big brake on that growth remains a chastened consumer being squeezed on at least four fronts.

First, with housing prices stagnant and foreclosures an ongoing problem, the houses of many consumers are worth less than their mortgages. This "negative equity" problem puts a severe crimp on spending, and using one's home as an ATM is no longer an option.

Second, persistently high unemployment constrains future GDP growth in both an obvious and subtle way. Most obviously, all the people in unemployment lines, who aren't bringing home a paycheck, are by definition spending far less than they otherwise would. More subtly, a high unemployment rate puts strong downward pressure on the wages of those who are employed, further suppressing consumption.

In still a third dimension of the problem, inflation has vitiating effects on America's purchasing power. Not only are oil and gasoline

prices in a long-term upward trend, but so are the prices of imported goods ranging from foreign cars to toys and electronics as the value of the American dollar declines.

Finally, income growth has actually been *negative* since the beginning of the nought decade—in contrast to very robust growth in the preceding two decades. This is illustrated in Exhibit 1.3 using one of the best measures of income growth—real, inflation-adjusted average median household income.

Exhibit 1.3 Real Median Household Income Over the Past Three Decades

Decade	Total Growth Rate for the Period	Average Annual Growth
1980–1989	18%	1.8%
1990–1999	16%	1.6%
2000–2008	−1.4%	−0.014%

You can see that during the 1980s, real median household income grew a total of 18% over the decade, or 1.8% annually. Similarly, during the 1990s, the total growth rate was 16%, or 1.6% annually. However, during the nought decade through 2008, income growth actually went negative—to a growth-vitiating *minus* 1.4% over the nine-year period.[3] As we shall explain, there are at least two reasons for this—one obvious and one more subtle.

The problem is not so much one of insufficient productivity growth, though an increasingly hostile tax, trade, and regulatory environment is harmful to income growth. A more subtle part of the problem, however, is rapidly rising health care costs. These out of control costs (which we squarely address in Chapter 9, "Why ObamaCare Makes Our Economy Sick") have taken an ever increasing share out of the total compensation paid to workers by employers in our employer-based health care system.

It follows from these observations that restoring the strength of the American consumer as an important driver of long-term economic growth is a complex and multidimensional task. Any broad rebalancing solution will incorporate at least five components.

First and foremost, it will mean putting unemployed Americans back to work. Second, it will mean stabilizing the housing market and housing prices. Third, it will mean more rapidly increasing the productivity of the American worker and making U.S. industry more competitive in international markets so that wage and income growth can once again boost purchasing power. Fourth, it will mean reducing America's dependence on increasingly expensive oil. Finally, it will mean creating a strong and stable dollar so that our import bill remains manageable.

*　　*　　*

Two final points on the consumption driver in the GDP Growth Driver equation are worth noting. First, nothing we have said about the falloff of consumer spending in this new decade should be construed as exhorting consumers to "go to the mall and help spend their way to prosperity." We tried that strategy in the 2000s, and what we got was initially a housing bubble, and then a housing bust, and then a bad balance sheet hangover.

Second, nothing we have said about the 2000s being a decade of overconsumption should be construed as an anticonsumption, moralistic judgment. Quite the contrary: We advocate a strong and robust consumer who generates sufficient income and wealth to enjoy a rising standard of living without going deeply into debt. Only with such a strong and robust consumer will we regain our path to prosperity.

Where Has All the Business Investment Gone?

Although consumption makes up more than two-thirds of America's GDP Growth Driver equation, business investment historically has accounted for a little over 15% of U.S. economic growth. What business investment lacks in size, however, it more than makes up for in volatility.

The recessionary fact of the matter is that business executives can reduce capital investment rapidly and thereby trigger a downturn. In fact, this is precisely what happened leading into the March 2001 investment-led recession.

One reason why business investment is so volatile has to do with what Depression-era economist John Maynard Keynes once called the "animal spirits" of entrepreneurs and business executives. At the first hint of recessionary trouble, executives often cut back on business investment—ironically sometimes making a recession a self-fulfilling prophecy.

Today, business investment in America has a lot more than a mere psychological problem. Since the 2001 recession, American business executives have chronically underinvested not just in new plants, equipment, and production facilities, but also in basic research and development (R&D).

Part of America's business investment problem has to do with the 2007–2009 crash and its aftermath. Since that crash, many businesses have continued to face a severe credit and liquidity problem. The paradox is that even as the federal government has driven down interest rates to near-zero levels, and even as the Federal Reserve has created

over $1 trillion in new money, credit remains constrained—particularly for small businesses. Meanwhile, many households are still unable to obtain sufficient credit to purchase big-ticket, interest-rate-sensitive items such as houses and cars.

Not just a credit and liquidity problem plagues American businesses. With its mishandling of issues ranging from "cap and trade," health care reform, and tax hikes, the Obama administration has created tremendous uncertainty within the American business community—and attendant risk and uncertainty. The particularly dangerous nature of these "Seeds of Destruction" is this: In the presence of so much uncertainty and risk, business executives have been unable to accurately calculate projected rates of return on new investment. As a result, many corporations have invested less than they otherwise would. Combine this cloud of risk and uncertainty with a lack of access to credit, and you wind up with the financial equivalent of a black hole that sucks the life out of domestic business investment.

It would be a big mistake, however, to assume that the lack of adequate business investment in America is simply a short-term problem driven by a lack of adequate credit and liquidity and rising uncertainty over regulatory and tax policies. This continued "sand and grit" in America's financial system certainly helps account for the short-term, cyclical downtrend in business investment during the 2007–2009 crash. However, the harsh reality we must also confront is that domestic business investment in new industrial capacity has been in a longer-term decline since at least 2001.

A big part of the problem, as evidenced by the falloff in industrial production and the loss of six million manufacturing jobs during the nought decade, is the phenomenon of offshoring. Over much of the past decade and continuing into this new decade, American business executives have increasingly chosen to transfer much of their production, along with much of their R&D and many of their other operations, to foreign countries.

Debates over offshoring and its possible negative effects on domestic investment and growth in America make it tempting to blame the rise of free trade and wave the bloody shirt of "cheap foreign labor." Such an explanation, however, is far too simplistic. As we will explain in the next chapter when we discuss our Ten Levers of Growth, free trade is an essential component of global economic growth and stability.

The real problem American business executives face is not free trade *per se*. Rather, it is that in today's global marketplace, American corporations often fight the free-trade wars with both hands tied behind their backs.

One hand is tied behind the backs of American business executives because of the greater regulatory and tax burdens that are imposed on American soil relative to the burdens competitors face in other countries.

The second hand which is tied behind the backs of American business executives relates to the tendency of several of our key trading partners to engage in both mercantilist and protectionist policies that make it almost impossible for American companies operating on American soil to compete freely and fairly.

Accordingly, increasing business investment again in America will require a comprehensive overhaul of three critical policy areas: regulation, tax, and trade.

There's Too Much Government Spending

Let's stop now and take stock of where we are so far in this chapter. We know that two major constraints on America's long-term economic recovery are overconsumption in the consumption driver of the GDP Growth Driver equation and underinvestment in the business investment driver.

The third major constraint on America's long-term economic recovery presents us with a seeming paradox. That constraint is *overspending* by the federal government.

We saw in Exhibit 1.2 that excess government spending was not a significant constraint on GDP growth throughout much of the nought decade. The problem lay more in structural imbalances in the consumption, business investment, and net exports growth drivers.

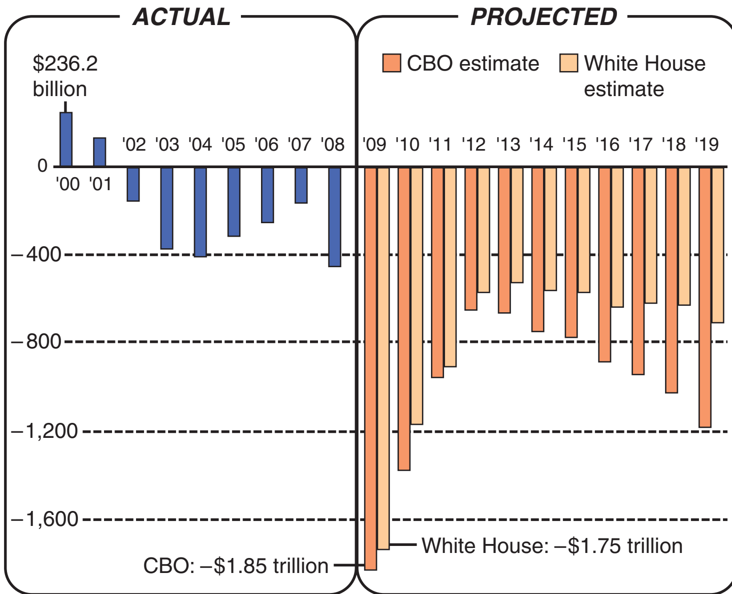
This current decade, however, is likely to witness explosive and sustained growth in government expenditures. That such overspending by the federal government might actually slow down America's growth prospects would seem to be a paradox, because according to the GDP Growth Driver equation, if government spending goes up, so must the GDP.

That "stimulus effect" may be true in the short run. However, over the longer term, large and chronic budget deficits represent one of the worst seeds of economic stagnation that any White House and Congress can plant because of their negative impacts on all three *other* drivers in the GDP growth equation. Before we come to understand why this harm is done, let's take a further look at the deficit and public debt numbers.

Exhibit 1.4 compares the actual budget deficits run in the 2000s to the projected budget deficit picture in the 2010s. In reviewing this exhibit, it is important first to understand that the deficits that occurred during the Bush administration, particularly during the second term of George W. Bush, were historically large in absolute terms. That said, you can see that the Obama deficits projected by the CBO dwarf the Bush deficits.

There are several reasons why the Obama deficits are likely to significantly choke growth—and why the CBO estimates that America's real GDP will grow by only 2.4% annually from 2015 to 2020 once the stimulus effects wear off.

Exhibit 1.4 The Daunting Budget Deficits of Our Future



The first reason is the simplest to understand. A rapidly rising debt burden for the federal government means that more and more of our tax dollars must be paid to service interest on that debt. With foreigners holding over half of our public debt not held by the Federal Reserve and other government institutions, payments on debt flow right out of America and right out of the GDP Growth Driver equation.

The second problem is slightly more complex. It has to do with how America's budget deficits are actually financed—and whether the financing instrument chosen will be either inflationary or contractionary.

To finance its budget deficits, the American government has two basic options. It can either raise taxes or sell U.S. Treasury bonds. If

the Obama administration raises taxes, as it has shown a propensity to do, that will be contractionary for the economy. This is because higher taxes take money out of consumer pocketbooks and thereby reduce consumption in the GDP Growth Driver equation. Higher taxes also take money out of corporate budgets that might otherwise be used to invest in new plants, equipment, and facilities.

Alternatively, if the Obama administration chooses to sell Treasury bonds to finance its deficits, the ultimate effect will be either higher interest rates or higher inflation—depending on who actually buys the bonds.

One possible bond buyer is the general public. In this financing scenario, the Treasury Department sells the bonds on the open market. However, in order to do so, the Treasury Department typically must offer higher interest rates on its bonds as the economy recovers. These higher interest rates, in turn, spill over into the corporate bond market.

In this way, the higher interest rates caused by deficit spending are said to "crowd out" business investment in the GDP Growth Driver equation, thereby slowing down GDP growth.

If the Treasury Department wants to avoid this crowding-out effect, it can sell its bonds to another possible buyer instead—the U.S. Federal Reserve. This type of deficit financing is called Fed "accommodation," and it happens when the Fed is willing to buy the Treasury bonds before they are put on the open market at the prevailing interest rate.

The problem with this type of bond financing and "Fed accommodation" is that it is inflationary. Inflation occurs because the Federal Reserve is simply printing new money to buy the bonds.

Of course, once inflation begins to rise rapidly, the Fed must raise interest rates to control inflation. At this point, you get the same

growth-killing, crowding-out effect on business investment as well as on consumer spending for interest-rate-sensitive, big-ticket items such as houses and autos.

The bottom line of this diagnosis is a lesson apparently not understood by the Obama administration. Massive budget deficits are totally incompatible with long-term economic recovery. By definition, they plant some of the most potent seeds of economic destruction of any government policy—higher taxes, higher interest rates, and higher inflation.

Net Exports Are a Net Negative

In an age of globalization and in an increasingly flat world, the long-term growth rate of any nation's economy often is ultimately determined by the strength or weakness of a country's net exports—the difference between what a country sells to the rest of the world and what it buys.

On the plus side, a nation's exports make a positive contribution to economic growth by creating domestic jobs. On the negative side, however, when the United States buys foreign oil from countries such as Saudi Arabia and Venezuela or foreign steel or electronic goods from countries such as Germany and China, these other countries enjoy the benefits of increased jobs, wages, and GDP growth.

Of course, when a country such as the United States imports more than it exports, it is running a trade deficit, and its net exports are negative in the GDP Growth Driver equation. That's precisely the problem we observed in Exhibit 1.1. Although America kept its trade balance at close to even throughout much of the postwar period leading up to 2000, it has run significantly larger trade deficits since the beginning of the nought decade. By the simple arithmetic of the GDP growth equation—and like a crooked college hoopster—these negative

net exports shave critical growth points off America's economic growth rate.

To be clear, we're not implying that imports *per se* are in any way negative for a nation. Imported goods provide consumers with much more choice while helping lower prices in markets around the world. Rather, the problem comes when America runs large trade deficits over a much extended period.

In fact, America's chronic deficits have three primary sources. The first is the anticompetitive nature of our corporate tax system. Not only must American exporters contend with the second-highest corporate tax burden of all the major economies in the world, but they also face a "double taxation" on anything they earn abroad.

The second source of America's trade deficits is what former President George W. Bush once called America's addiction to foreign oil. America depends on foreign oil imports for over half of its oil needs, and America's petroleum import bill accounts for over 40% of the total U.S. trade deficit.

These expenditures on foreign oil effectively act as a "tax" on both American consumers and American businesses. When American consumers pay more to foreign oil producers to heat their homes and fill their gas tanks, that's money lost that could otherwise go into driving the domestic economy. By the same token, when American businesses pay more for their energy needs, this drives up production costs, reduces the competitiveness of American businesses, and leads to lower output and fewer jobs.

The third source of America's chronic trade deficits is the mercantilist and protectionist trade policies of our major trading partners—particularly our largest trading partner, China. This has resulted in a related structural imbalance between savings and consumption, in which Asia saves too much and the United States consumes too much.

Reducing the U.S.–China trade and savings imbalances is particularly important in America's long-term economic recovery. This is because Chinese exports to the United States constitute fully 45% of America's trade deficit and 75% when petroleum imports are excluded.

Conclusion

This chapter has used the GDP Growth Driver equation to diagnose a variety of ills afflicting the four drivers of America's economic growth—consumption, investment, government spending, and net exports. Our diagnosis tells us that we face yet another decade of slow growth and high unemployment if we continue down the path of a low savings rate and lack of adequate business investment coupled with too much government spending and large and chronic trade deficits.

The next chapter introduces the Ten Levers of Growth to explore more fully how we can turn around the sluggish American economy. In this way, we will finish building the foundation for our Seeds of Prosperity analysis and policy blueprint.

Endnotes

1. Neil Irwin, "Aughts were a lost decade for U.S. economy, workers," *Washington Post* (January 2, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/01/01/AR2010010101196.html.
2. Omits last quarter of 2009, which was unavailable at the time of this writing.
3. At the time of this writing, the Bureau of Labor Statistics only provided data through 2008.

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