# POLICY CHALLENGES FACING THE NEXT PRESIDENT

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Whoever takes the oath of office as President of the United States on January 20, 2009 will face a staggering array of policy challenges. It is not surprising that few of these difficult issues are being taken up in the election campaign to date. Yet it is not too soon for the American public to start thinking about them.

Let us focus on developing a possible action agenda for January 2009 and beyond. The most pressing item is responding to the adverse developments in the national economy. The normal concerns about dealing with the downturn phase of the business cycle are aggravated by unusual stresses and strains in financial markets. My foggy crystal ball does not tell me whether getting the economy growing again will be a more urgent objective than dealing with rising inflation.

## Restoring Trust in Financial Markets

I do believe that restoring trust in financial markets should receive a very high priority. Too many investors were let down by the financial experts on whom they had been relying. Likewise, too many homeowners who qualified for conventional mortgages were pushed into more costly and complicated subprime mortgages.

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The most casual newspaper reader or television viewer has become aware of the shortcomings of the financial wizards who devised complex forms of securities embodying a bewildering array of underlying assets of often doubtful worth. The next presidential administration will have to undertake the difficult task of balancing the development of adequate protections for the public with the continuing desire to limit the arbitrary power of government over private decision-making.

The Federal Reserve System will continue to exercise major responsibility both as a regulator of the macroeconomy as well as of financial institutions. In its day-to-day operations, the Fed traditionally acts with a substantial degree of independence. That is essential in maintaining the credibility of monetary policy at home and abroad.

Consistent with the Fed's autonomy, the role of the President will be to signal to the nation that the new administration has developed an economic program that meets the needs of these challenging times. Surely, those of us who have engaged in the conduct of economic policy have learned that no administration should try to give the Fed "marching orders." Rather, good communication is developed in a variety of informal ways.

## Preparing the Federal Budget

Developing fiscal policy — in practice this means preparing the annual federal budget — is invariably a vital initial task of any new president. On the tax side, a key issue will be deciding whether or not to renew the tax cuts that expire on January 1, 2010. Of course, the president can recommend to Congress that they make some changes, such as modifying any extended tax reductions in order to provide revenues for important new priorities. The incoming administration, Republican or Democratic, will be chastened by the practical point that letting the tax cuts expire will be the equivalent of a large tax increase.

By the way, we hear the same criticism about tax cuts today that we heard during the Reagan presidency: the tax cuts are unfair because supposedly they are a giveaway to "the rich." In responding to this loaded point, I always find it useful to look at the factual data supplied by the Internal Revenue Service — not the self-serving stuff from any political committee.

When we array taxpayers according to their income — from the highest to the lowest — the IRS data show that the top half of taxpayers pay over 90 percent of the federal personal income tax and the bottom half less than 10 percent. Under the circumstances, I do not find it surprising or unfair that most of the tax cuts go to the people who pay most of the taxes.

One of the best kept secrets in Washington, DC — which I normally describe as a sieve — is that the federal income tax is progressive. On average, the higher your income, the larger the proportion of your income that goes to taxes.

After taking account of all the special provisions in the tax code, the data show that the average federal income tax burden on the top one percent of taxpayers is 28 percent. Each successive group of taxpayers pays a smaller percentage of income to IRS. The bottom one-half of the taxpaying population pays only 4 percent of their income as federal income tax. A little hard data do go a long way!

A pressing priority will involve dealing with the Alternative Minimum Tax (AMT). The history of the AMT provides a vivid reminder of the unintended side effects of hastily written legislation. The AMT was enacted to deal with millionaires who do not pay any federal income tax. In practice, however, the AMT covers a rapidly rising proportion of middle class taxpayers.

Another leftover problem on the revenue side of the budget is the federal inheritance tax (some call it the death tax). Under existing law, that tax is scheduled to go through strange contortions. It is supposed to go away in 2010 and then return full-blown in 2011. That is hardly an example of sensible policymaking on the part of Congress.

On the spending side of the budget, the challenge is to get ahead of the curve. The federal budget is now dominated, not by purchases of goods and services, military or civilian. Rather the largest portion of federal spending now goes to so-called entitlements, notably Social Security and Medicare.

Every actuarial report shows that Medicare is already operating in the red and that Social Security is not adequately funded either. It is sad to note that, despite all the talk about health care by every candidate, none of them has dared to mention the painful fact that Medicare is going broke. The expected date when the basic Medicare trust fund runs out of money is 2019.

The nation has more time in the case of Social Security. The actuaries estimate that the Social Security fund will not be exhausted until 2042. However, we are warned, in both cases, that the longer the nation waits to deal with the situation, the larger and more painful will be the required bailout.

Of course, both Medicare and Social Security will continue to receive new revenues from current taxpayers. Thus, the two programs can make partial payments to beneficiaries. Contrary to any “truth in labeling” law, both “entitlements” are also called social insurance.  If they were true insurance operations, they likely would be declared to be insolvent.

## National Security Spending

Another important area of financial decision making by the new president is national security spending.  Potential threats to the national security come from a wide variety of sources.  To help get a handle on the fiscal dimensions, let us make two optimistic assumptions:  1) that the involvement of the United States in Iraq will be reduced substantially and 2) that the American role in Afghanistan will be stabilized at about the current level.  That would only be the starting point for difficult decision making on the military budget.

The next president will have to face the painful fact that the overall military establishment has been stretched to the point where serious policy changes have to be made.  Depleted inventories of weapon systems and other equipment need to be rebuilt. The ranks of the armed forces need to be expanded in order to reduce the strain on those who have served repeated tours of duty in Iraq and Afghanistan.

More fundamentally, attention needs to be given to other potential threats to the nation's security.  Just as the strategy and equipment of the Cold War could not readily be transferred to Iraq and Afghanistan, so the strategy and equipment needed for the future also will likely be different.  For example, China has been arming steadily and rapidly.  Simultaneously, Russia under Putin has revised its interest in military strength. Thus, the longer-term trend of military spending in the United States is upward.

New Civilian Priorities

A variety of important civilian priorities have been postponed during the Iraq War. Most obvious are the repair and modernization of infrastructure, such as bridges, tunnels, highways, and the renovation of other transportation facilities. Many school buildings and sewage treatment facilities deteriorated as state budgets have been reallocated to cover new priorities, ranging from homeland security to environmental concerns.

Sadly, it usually is far easier to get approval of a new project than funding to fix up existing roads, buildings, and other deteriorating parts of the governmental capital stock.

The name of the legislator — or of a worthy constituent — can be placed on a bridge or in an airport. It is unlikely that any repair project will generate that sort of political side-benefit. Nevertheless, recent and dramatic examples of the disasters that can occur when existing infrastructure is neglected remind us of the large national repair bill that is overdue.

Less dramatic is the erosion of our lead in science and technology. It is widely known that American students do not do as well in standard tests in math or science as the young people in many Asian and European nations. Hence, it is not surprising — but it is sad — that relatively few Americans going to college major in math, science, or engineering. As an educator, I welcome the inflow of foreign students who help to fill out our classrooms and laboratories. But not too many are either interested or allowed to stay here to become productive members of the nation's high-tech workforce.

These issues cannot be solved quickly. They involve long-term investments in what economists call "human resources." That is jargon for people rather than machines. Clearly, another essential contributor to maintaining America's competitiveness in the global marketplace is the expansion of our technology base.

Also, on the international front, the rising concern over global warming and the variety of effects of climate change warrant a comprehensive response by the new administration. A related challenge is to reduce our growing reliance on foreign oil. Both issues are interrelated. Policy responses could result in pressures for increased subsidies to develop innovative domestic energy sources.

Turning back to current economic developments, housing is bound to get special attention. Congress is likely to take some initial action later this year to deal with the consequences of rapidly rising foreclosures of homes. In striking comparison to these pressing issues, the intermittent interest in restraining the tendency to expand wasteful congressional earmarks just seems like an anachronism. In olden times, these sops to special local interest were more accurately called the "pork barrel."

Candidates on the campaign trail love to talk about new priorities. On reflection, however, establishing priorities is much more difficult than merely identifying new or expanded areas for government spending. Any serious effort to change the nation's priorities must also deal with the far more difficult issue of what items become lower in priority. To put the matter bluntly, some existing expenditure programs must be curtailed or eliminated.

When it comes to cutting the budget, for too long we have been satisfied with cynical responses. Business and labor interests can be coaxed to support reductions in subsidies to farmers. Agriculture interests, likewise, can cheer the elimination of subsidies to business and urban areas. We will know that the advocates of economy in government are serious when they begin to support reducing subsidies across the board, including those that benefit their own interest groups.

In a burst of nonpartisanship, I would like to cite the words of my late friend and former colleague, Tom Eagleton: "Without some accommodation and compromise, our government cannot function and we will not be able to preserve the values we hold in common and in trust for future generations."

## An Upbeat Conclusion

Surely the new president will have no shortage of difficult issues to face. However, a traditional "honeymoon" period should provide the opportunity to take a broader view of the day-to-day issues that tend to occupy the time and energy of every presidential administration.

Thus, let us shift gears and turn to the bright side of economic developments. In the worst of times, new industries are created and some fortunes are made — and these are hardly the worst of times. For example, the U.S. biotechnology industry has gone from a handful of startups to a major sector of the economy with a market capitalization of $400 billion and a combined payroll of over 130,000 people — and those tend to be good jobs, above the average level of pay and compensation that prevails in the United States.

Thus, as the next president wrestles with the problems that arise from the increasing globalization of markets, the positive options available will be those that focus on enhancing American productivity and competitiveness. Restricting the flow of international commerce is a negative and ultimately self-defeating approach for a nation with the special capabilities of the United States.

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

#1. A strong entrepreneurial spirit. Americans are constantly starting up new enterprises. In contrast, Europeans tend to be satisfied with the status quo. Here is one obvious manifestation of this basic difference: They take much longer vacations — and resent our greater economic success.

#2. We have a substantial small cap stock market. That is unique. In no other country can a new business with a promising product idea raise substantial amounts of capital in the equity market. Elsewhere, a new small business is limited to bank loans and family wealth.

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

#4. High labor mobility. Yes, it is easier to lay off workers here than in Europe. But that is not the whole story. There is another side to the coin: American employers are far more likely to hire new workers. The overall result is striking: job stagnation and high unemployment in Western Europe, job growth and much lower unemployment here.

#5. World class higher education. Where do people in other countries send their youngsters to college, especially for advanced degrees? Not to Beijing University or Tokyo or Berlin or Riyadh universities. Parents who can afford to do so send their young people to American universities. Moreover, the research being performed at our major universities is a vital asset to our national growth and competitiveness. I will just cite one key indicator: the United States made a clean sweep in the 2006 Nobel prizes in the sciences.

Let me leave you with the forecast of my favorite economist, an economics major from Eureka College. It is the last sentence of the eloquent letter that Ronald Reagan wrote to the American people telling of his final illness: “I know that for America there will always be a bright dawn ahead.”