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How to Create a Real Economic Stimulus

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Earlier this year, former U.S. Treasury Secretary Larry Summers expressed doubts about the Federal Reserve's quantitative easing policy of buying $85 billion a month of government bonds and other long-term assets. His skepticism antagonized some Fed insiders and liberal Democrats, who recently opposed his consideration by President Obama as the next Fed chairman.

When Mr. Summers on Sunday withdrew his candidacy for the chairman's job, there was one immediate benefit: Now Larry Summers will be free to voice an even clearer and stronger critique of current policy.

The United States certainly needs a new strategy to increase economic growth and employment. The U.S. growth rate has fallen to less than 2%, and total employment is a smaller share of the population now than it was five years ago. The official unemployment rate has declined sharply (to 7.3% last month from 10% in October 2009) only because so many people have stopped looking for work or are working part-time.

The Fed's monetary policy is no longer effective in stimulating demand. The near-zero interest-rate policy and aggressive quantitative easing, it has become increasingly clear, create dangerous risks to future stability. The Fed's announcement in June that it will soon reduce the rate of buying long-term assets raised long-term rates, slowing the recovery in the housing market and other activity. And the unemployment rate is approaching the 6.5% threshold that could lead the Fed to raise short rates.

On the fiscal side, a replay of the $830 billion "stimulus" in 2009 is politically out of the question. That poorly designed package added more to the national debt than it did to aggregate spending. The national debt has increased from 37% of gross domestic product before the economic downturn to 75% now. The Congressional Budget Office warns that the debt will remain at that level for the coming decade and then rise rapidly as the aging population increases the cost of Social Security and Medicare. The large projected national debt is a drag on the economy, causing businesses and entrepreneurs to fear higher tax rates and a sharp rise in interest rates when the Fed stops its massive bond purchases.

A successful growth and employment strategy would combine substantial reductions in the relative size of the future national debt with immediate permanent tax-rate cuts and a multiyear program of infrastructure spending. The challenge is to reduce future government spending by enough to make the ratio of debt to GDP predictably lower a decade from now, despite the tax-rate cuts and near-term infrastructure spending.

Fortunately, a relatively small change in annual deficits would significantly shrink the debt ratio. With a national debt of 75% of GDP, a projected annual deficit of 4% of GDP would keep the debt rising to 100% of GDP. In contrast, a deficit of 1% would cause the debt ratio to decline year after year until it reaches 25% of GDP.

The only way to reduce future deficits without weakening incentives and growth is by cutting future government spending. The share of GDP devoted to defense and to nondefense discretionary programs

is already headed to its lowest level in the past half-century. Reducing spending therefore requires slowing the growth of the benefits of middle-class retirees and cutting the spending that is built into the tax code.

Raising the age for full benefits is a simple but powerful way to slow the cost of Social Security and Medicare. Thirty years ago, Congress voted to increase gradually the age for full benefits from 65 to 67. Since then, the life expectancy at age 67 has increased by an additional three years. Congress should vote now to continue raising the full benefit age from 67 to 70. When that is fully phased in, the annual cost of Social Security benefits would be reduced by about 20%, equivalent to a saving in 2020 of $200 billion or about 1% of GDP.

Gradually raising the age of Medicare eligibility in line with the age for full Social Security benefits would achieve a budget saving of more than 1% of GDP in 2020 and later years. Individuals between ages 65 and 70 could still enroll in Medicare by paying a fair premium.

Limiting the tax breaks built into the tax code would also help. The combination of tax credits, deductions and exclusions increases the annual budget deficit by hundreds of billions of dollars. Those tax breaks are really subsidies that should be seen as government spending.

While many of the smaller tax subsidies should simply be eliminated, it would be politically impossible to eliminate such popular features as the deduction for mortgage interest or the exclusion of employer payments for health insurance. A better alternative would be to allow individuals to keep all of these tax benefits but to limit the amount by which individuals can reduce their tax liabilities in this way to 2% of adjusted gross income. This one change to the tax code would reduce the 2013 federal deficit by $140 billion or nearly 1% of GDP even if the deduction for charitable contributions was fully retained.

Slower entitlement growth and reduced tax expenditures should be phased in slowly to avoid weakening the recovery. But by 2020 they could be producing annual savings equal to more than 3% of GDP.

With the future debt under control, it would be fiscally responsible to enact permanent tax-rate reductions and an effective short-term program of infrastructure investment in things like bridges, airports and other projects that will boost demand. Each dollar spent on a well-designed infrastructure program would increase GDP by a dollar or more, unlike the 2009 "stimulus" program that spent its funds on transfer payments, temporary tax cuts and other programs that did little to raise total spending.

Lower personal tax rates would raise GDP by increasing incentives for additional earning and increased entrepreneurial activity. Bringing the U.S. corporate tax rate (35%) in line with the tax rates in other industrial countries (closer to 25%) would spur investment and production.

At the same time, U.S. corporations operating overseas should be taxed on a "territorial" system (as are their competitors in Australia, Canada, the U.K., France, Germany and Japan) that doesn't tax corporate earnings when remitted back home.

Entitlement reforms and a limit on tax expenditures are the keys to creating the framework for the tax-rate reductions and infrastructure spending that can stimulate growth and employment while gradually shrinking the relative size of the national debt. Without such a program, the U.S. economy will continue to limp along with slow growth, declining earnings and weak employment.

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