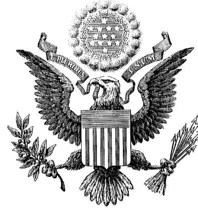
ASSESSING THE CURRENT EXPANSION



Vice Chairman Jim Saxton (R-NJ)

Joint Economic Committee
United States Congress

February 2000

Executive Summary

The current economic expansion is remarkably resilient, sustained and has set longevity records. One of the remarkable features of the expansion is the simultaneous achievement of low rates of inflation and unemployment together with relatively robust rates of economic growth.

A key reason for the durability of the expansion owes to the maintenance of macroeconomic policies promoting long-run efficiency and growth without inflation. Appropriate macroeconomic policies evolved from the gradual recognition that monetary and fiscal policies should be directed at different and independent objectives; monetary policy should focus on achieving price stability whereas fiscal policy should focus on open market, growth-promoting tax and spending restraint policies encouraging entrepreneurial activity (i.e., policies promoting aggregate supply).

More specific reasons for the economy's remarkable sustainability all promote growth without inflation and include the following:

- The growth-enhancing effects of a gradual, credible anti-inflationary Federal Reserve monetary policy.
- The growth-promoting effects of credible government spending restraint.
- The long-term growth effects of an efficiency-promoting incentive structure embedded in the tax code.
- The effects on aggregate supply and capacity of substantial investment in equipment as well as in productivity-enhancing new technologies.
- The specialization and efficiency-promoting effects of increased international integration and open markets (globalization).

The Administration offers an alternative explanation. It contends that its 1993 policy of raising tax rates worked to reduce budget deficits and interest rates and thus fostered sustained recovery. This view proves inadequate for a number of reasons including the following:

- Raising taxes does not promote economic growth without inflation.
- The current expansion began well before President Clinton's inauguration.
- The budget deficit began contracting well before Clinton Administration policy could have been implemented.
- The timing of interest rate movements contradicts the Administration's explanation.
- The Clinton Administration's own economic projections were not consistent with its after-the-fact explanation.
- The Clinton Administration provides an inaccurate explanation of the disappearance of budget deficits.

The prospects for continued expansion look favorable so long as appropriate macroeconomic policies are maintained and no serious policy errors are made.

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ASSESSING THE CURRENT EXPANSION

INTRODUCTION

After briefly summarizing recent macroeconomic developments as well as the salient features of the current expansion, this paper outlines the reasons for the expansion's sustainability. A key reason for this remarkable longevity relates to the pursuit of appropriate macroeconomic policy, in particular, to the maintenance or adoption of those policies promoting long-run efficiency and growth without inflation. More specifically, proper policies evolved from the gradual recognition that monetary and fiscal policies should be directed at different and independent objectives. Monetary policy should focus on achieving price stability objectives by gradually reining in aggregate demand, whereas fiscal strategies should be focused on open market, growth-promoting tax and spending-restraint policies encouraging entrepreneurial activity: i.e., policies promoting aggregate supply.

More detailed reasons for the economy's remarkable sustainability include the following:

- The many growth-enhancing effects of a gradual and credible anti-inflationary monetary policy.
- The growth-promoting effects of credible government spending restraint together with an accompanying less intrusive role of government in the economy.
- The long-term growth effects of an efficiency-promoting incentive structure embedded in the tax code, as epitomized by marginal income tax rates that remain lower than those of the 1950s, 1960s, and 1970s.
- The effects on aggregate supply and capacity of substantial investment in equipment as well as in productivity-enhancing new technologies.
- The specialization and efficiency-promoting effects of increased international integration and open markets, or globalization.

These reasons for the expansion's remarkable sustainability have common elements. In particular, they all foster economic growth while at the same time reducing pressures on price inflation; they all promote growth without inflation.

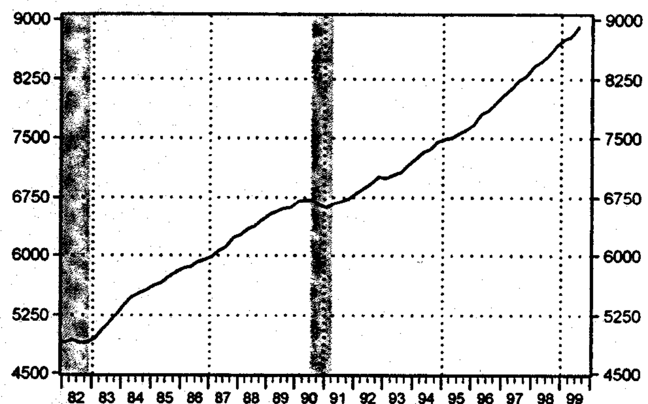
In addition to explaining the sustainability of the U.S. expansion, the paper examines an alternative "explanation." In particular, the Administration's claim that its policies of raising tax rates to reduce the budget deficit and interest rates brought about the current sustained recovery prove inadequate for a number of reasons. Raising taxes, for example, does not promote economic growth without inflation. The economic recovery began almost two years before Clinton was inaugurated and the budget deficit began falling well before Administration policies could have been implemented. The timing of interest rate movements is decidedly inconsistent with the Administration's arguments. In addition, Administration officials as well as Democratic-controlled Congressional committees are on record recognizing the contractionary nature of such

policy. Finally, the Administration provides an inaccurate explanation of the disappearance of budget deficits.

CHARACTERISTICS OF THE CURRENT EXPANSION: THE RECORD, A SUSTAINED RECOVERY

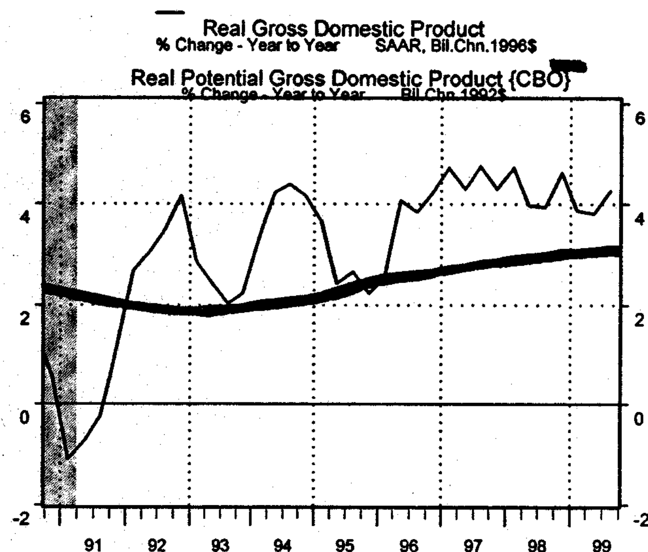
The current economic expansion is now approaching its ninth birthday and is the longest expansion on record. Furthermore, this sustained expansion is expected to continue into the foreseeable future since few obvious major cyclical imbalances are evident that have disrupted earlier recoveries.[1] Notably, this expansion followed the 1980s expansion (see Figure 1)[2], which is the second longest peacetime expansions on record (92 months). In short, the U.S. is experiencing back-to-back the first and second longest peacetime expansions in American history. And the brief, mild recession that occurred between these record-breaking expansions was exceptionally short (8 months).

Figure 1



For much of this recent expansion, GDP growth has exceeded conventional estimates of "potential" GDP growth as calculated, for example, by the Congressional Budget Office (CBO). (See Figure 2.)

Figure 2



While most private-sector GDP components have shared in this expansion's growth, a few sectors have made notable, healthy contributions. Consumption, investment spending, and exports, for example, have all been key,

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[1] In particular, factors such as inventory imbalances, corporate or bank balance sheet distortions, overbuilding in the construction industry, resurgencies of inflation, or sharp interest rates increases are for the most part neither evident nor expected.

[2] The source for all graphs, unless otherwise stated, is Haver Analytics.

leading sectors for most of this expansion, generally growing at rates exceeding that of aggregate GDP. Accompanying figures show that both investment and exports have grown as a percentage of GDP. Investment in business equipment (and information processing investment) especially contributed to this advance. (See Figure 3.) Inventory investment, however, has been increasingly better managed as evidenced by significantly lower inventory/sales ratios. This development enhances the likelihood of continued economic expansion since it minimizes the likelihood of important inventory corrections.

For most of this expansion, exports have also made a significant contribution. For the most part, export growth has exceeded GDP growth, and thus the export sector's GDP share has steadily grown during this expansion. (See Figure 4.)

One sector that has not grown as rapidly as GDP during this expansion is federal government spending. The accompanying chart shows that federal government spending as a percentage of GDP has fallen continually during this sustained expansion. (See Figure 5.)

The Labor Market

Employment gains have also continued to mount during much of this expansion. In fact, more than 21 million jobs have been added to non-farm payrolls since the recovery began in the early 1990s.

Figure 3

Real Gross Private Domestic Investment as a percentage of Real GDP

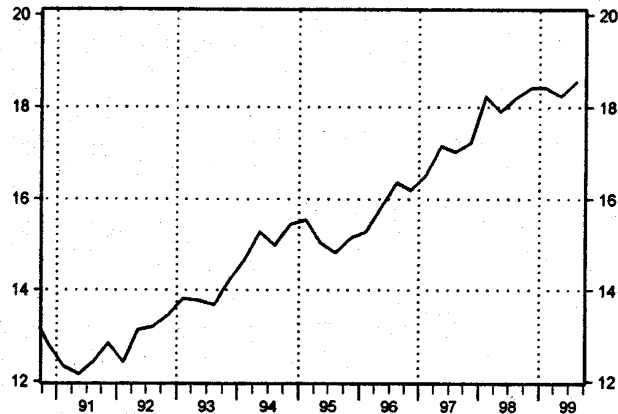


Figure 4

Real Exports as a percentage of Real GDP

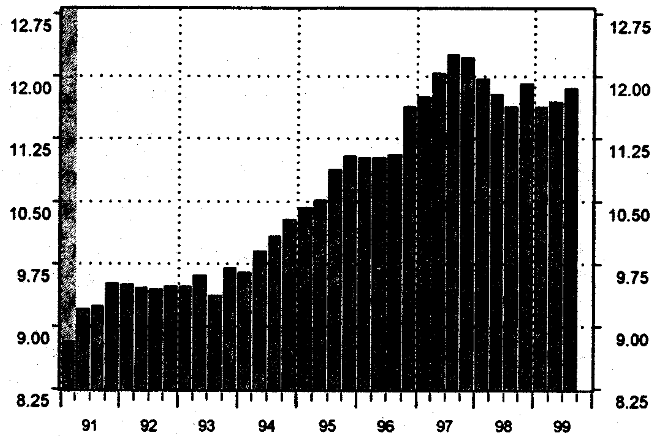
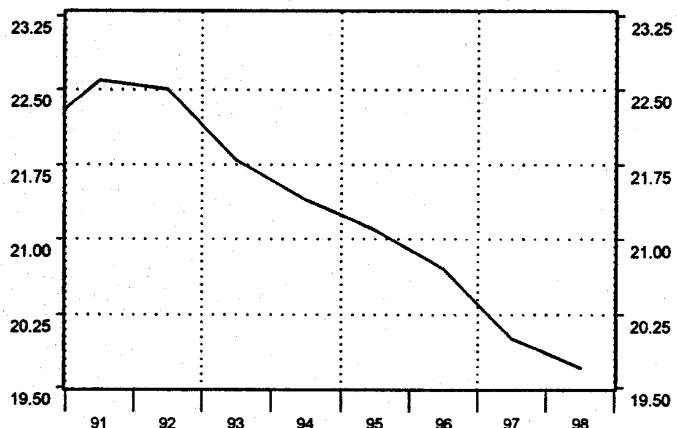


Figure 5

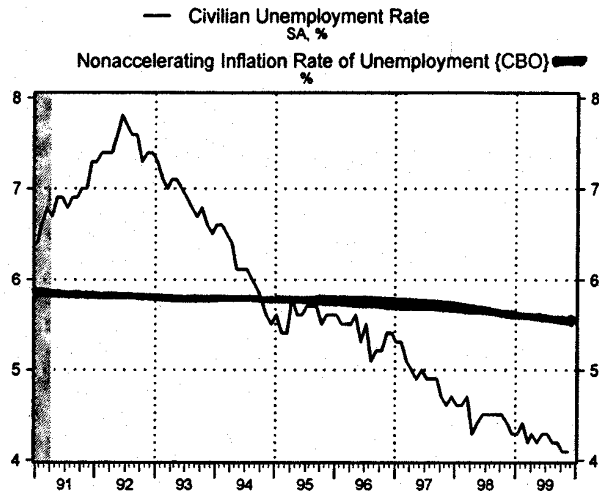
Federal Outlays as a Percentage of GDP

%, NSA



The civilian unemployment rate has fallen well below estimates of the non-accelerating inflation rate of unemployment (NAIRU) and to the lowest rates since the early 1970s. (See Figure 6.)

Figure 6

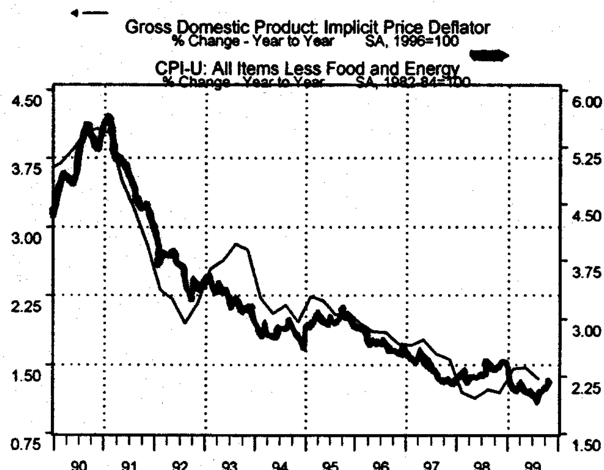


Similarly, both the employment/population ratio and the labor participation rate have increased during this expansion and remain close to their all-time highs. The high employment-to-population ratio indicates that a higher proportion of the population has jobs now than in the past. The high participation rate means that more people are participating in the labor force (i.e., either have jobs or are seeking work) now than in the past. Both measures suggest that the labor market is tight relative to historical norms. In short, then, this expansion has been characterized by significant increases in the inputs of both capital and labor.

Lower, More Stable Inflation

Another important characteristic of this expansion is the notable absence of inflationary pressures that have often plagued previous recoveries. Most broad-based measures of inflation such as GDP deflators or the core Consumer Price Index (all items less food and energy) have been remarkably well behaved. (See Figure 7.)

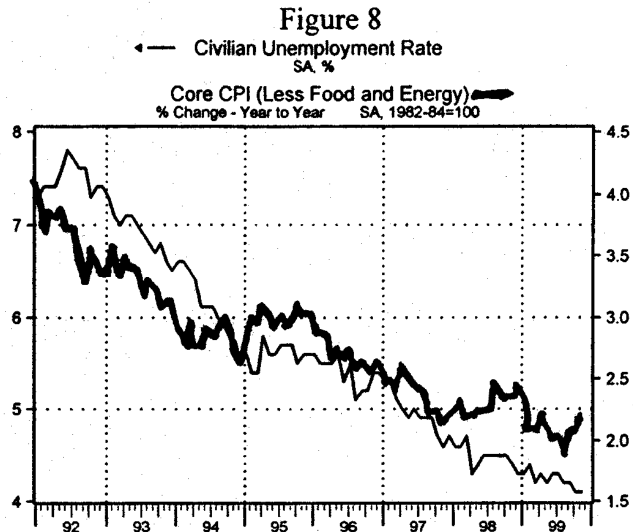
Figure 7



Similarly, wage costs remain relatively tame despite unemployment rates remaining below those levels sometimes associated with rising price and wage pressures. Furthermore, forward-looking market price indices (such as commodity price indicators), which in the past have accurately signaled rising expectations of future inflation, currently remain relatively well-behaved, although they have increased in recent months.

One of the remarkable features of this expansion, therefore, is the simultaneous achievement of low rates of inflation and unemployment together with relatively robust rates of economic growth. More generally, the U.S. has experienced the phenomena of sustained growth and lower inflation for an extended period. As Figure 8 shows, for the most part inflation and unemployment have fallen together for nearly eight years. This phenomenon was clearly not predicted by conventional (demand-side) macroeconomic models, which embody a trade-off between the rates of unemployment and inflation.

Figure 8



REASONS FOR THIS EXCELLENT PERFORMANCE

The primary reason for this excellent sustained performance relates to the operation of a number of well-established policies, which promote efficiency and growth without inflation. These policies fell into place as a result of the gradual recognition that monetary and fiscal policies should be directed at different and independent objectives; that is, monetary policy should focus on achieving price stability objectives by gradually reining in aggregate demand, whereas fiscal strategies should be focused on the longer-term benefits of open market, growth-promoting tax and spending-restraint policies encouraging entrepreneurial activity, i.e., policies promoting aggregate supply that, in fact, were in large part initiated in the 1980s. The common element of all these policies is that they foster efficiency and growth without inflation; these policies promote more growth, lower inflation, or both.

Notably, the record of sustained growth together with lower inflation registered during this expansion was not predicted by conventional Keynesian macroeconomic analysis. Such analysis, after all, downplays the capacity-enhancing and output effects that foster growth while lessening pressures on price inflation. Further, this conventional analysis also downplays the many growth-enhancing effects of price stability.

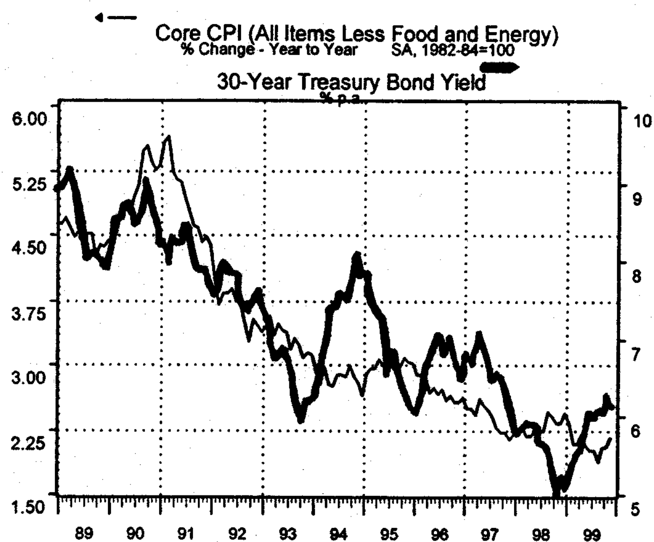
Key policies that explain the economy's excellent, sustained performance include (1) the growth-enhancing effects of a gradual and credible price stabilizing monetary policy, (2) the growth-promoting effects of credible, government spending restraint, (3) the long-term effects of an efficiency-promoting incentive structure embedded in the tax code, (4) the output effects of substantial investment in business equipment as well as in productivity-enhancing new

technologies, and (5) the efficiency-promoting effects of increased international integration, open markets, or globalization.

- **The growth-enhancing effects of a gradual, credible price-stabilizing monetary policy.**

A key ingredient of recent Federal Reserve monetary policy has been a persistent emphasis on price stability as a key policy objective. Federal Reserve officials have embraced this objective in the form of policy statements as well as in policy action. As a result, Federal Reserve inflation-fighting credibility has become established and most broad-based measures of inflation have generally continued to moderate during this expansion. Indeed, the sustained downtrend in inflation has brought some broad-based inflation measures to their lowest rates in decades with few signs of any meaningful resurgence.

Figure 9



This credible, sustained reduction in inflation has important growth-promoting implications related to the durability of the expansion. In particular, lower inflation:

(1) Lowers interest rates: This credible, sustained reduction in inflation has gradually lowered expectations of future inflation. Accordingly, the inflation expectation component of interest rates dissipated from the structure of both short- and long-term interest rates; interest rates are lower as a result. Figure 9 depicts the relationship between inflation and long-term interest rates.

(2) Stabilizes financial markets and interest sensitive sectors: As inflation diminishes, the variability of inflation is reduced. Lower inflation is associated with lower volatility of inflation. Accordingly, financial markets have less tendency to over- or undershoot their fundamental values. This lower volatility has the effect of reducing uncertainty premiums of interest rates; financial markets tend to become more stable and predictable. In short, lower inflation stabilizes financial markets.

As a result, market participants tend to become more confident and more willing to invest, take risk, and innovate. Businesses are able to better plan, coordinate, and control inventories, thereby improving efficiency. Furthermore, this enhanced financial stability

works to stabilize various interest-rate sensitive sectors of the economy and, therefore, the macroeconomy as well.

(3) Enhances the workings of the price system: Lower inflation is associated with lower (relative) price dispersion. Lower inflation lowers the variability between individual prices or reduces the noise and distortions in the price system. As a result, the price system can better serve its information and allocative functions. Consequently, the economy operates more efficiently and, therefore, grows faster.

(4) Acts like a tax cut: Lower inflation is analogous to a tax cut in several important ways. Lower inflation removes distortions in the price system and also minimizes those interactions of inflation with existing non-indexed portions of the tax code that effectively result in higher taxation.[3]

In short, credible disinflation and price stability work to lower interest rates, stabilize financial markets and interest-sensitive sectors of the economy, promote efficient operation of the price system, and effectively lower taxation. All of these effects contribute to promoting the sustainability of the expansion.

- **The growth-enhancing effects of government spending restraint.**

Another key policy, which helps to explain the economy's excellent sustained performance, relates to the long-term growth-promoting effects of government spending restraint. Empirical evidence suggests that beyond some point, an increasing share of government spending has a negative effect on economic growth.[4] As government expands and increasingly provides goods and services that the private sector is better suited to supply, inefficiencies and diminishing returns mount. The disincentives of financing such increased spending mount and growth inevitably suffers.

Government spending as a share of GDP, however, has actually declined during much of this expansion, and is smaller in the U.S. than in many other countries. This smaller share of government enables more economic resources to be allocated and utilized more efficiently and productively in the private sector, allowing more growth to occur without upward pressures on price inflation. Congressional efforts to restrain government spending have aided significantly on this score.

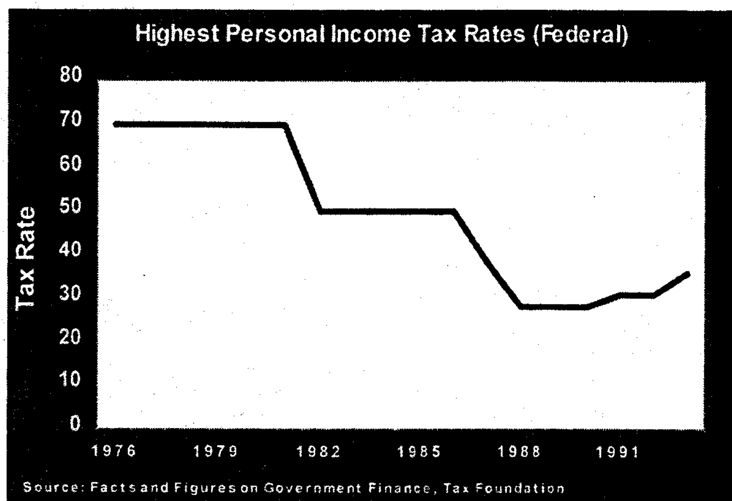
[3] Remaining portions of the tax code that are not indexed, for example, include capital gains taxation, estate taxation, and forms of corporate taxation.

[4] See, for example, James Gwartney, Robert Lawson, and Randall Holcombe, "The Size and Functions of Government and Economic Growth," Joint Economic Committee, April 1998.

- **<u>The long-term effects of an efficiency-promoting incentive structure embedded in the tax code.</u>**

Tax policy is also central to any explanation of this long-term, record-setting, back-to-back expansion and sustained growth of recent years. In particular, the substantial marginal income tax rate reductions in the 1980s embedded into the tax code an incentive structure that has encouraged and fostered steady and long-run improvements in work effort, investment, innovation, and entrepreneurial activity that recent years have witnessed. Because such tax cuts encourage the supply of labor and capital as well as innovation and entrepreneurial activity, they impact aggregate supply and increases in the capacity of the economy to grow: i.e., such tax cuts foster economic growth. While some backsliding has occurred with the rate increases in some brackets in 1990 and 1993, most marginal rates still remain lower than comparable rates which existed in the 1950s, 1960s, and 1970s. (See Figure 10.) Thus, these lower rates continue to provide the basis for an efficiency-promoting incentive structure conducive to the increased innovation, entrepreneurship, labor supply, and investment observed during this expansion. Since this structure fosters aggregate supply and capacity, all other things equal, it also helps to lessen pressure on price inflation and thus helps to explain the recent phenomenon of sustained economic growth without inflation.

Figure 10



- **<u>The effects on aggregate supply of substantial investment in business equipment and productivity-enhancing new technologies.</u>**

Another key event that necessarily plays a prominent role in any explanation of the sustained, low inflation expansion is the substantial increase in technological innovation and in the resultant investment boom that has occurred in recent years. Investment clearly has been a leading sector in this expansion and has grown substantially as a percentage of GDP. Such investment has not only grown substantially faster than GDP but has added significantly to business capacity. Computer equipment and software are major components of this advance. Since such investment increases capacity and therefore bolsters aggregate supply as well as aggregate demand, it helps to explain the observed sustained economic growth without inflation. Some of the impetus for such strong investment, of course, was provided by tax cuts as well as the technological advances of recent years.

This rapid investment and technological improvement have been associated with greater-than-expected productivity gains in recent years. These gains have allowed sizable wage increases to occur without inflation consequences, providing further support to this explanation of the sustained, low inflation expansion.

- **The efficiency and growth-promoting effects of increased international integration, open markets, and globalization.**

A final policy dimension helping to explain the economy's excellent sustained, low inflation performance relates to the efficiency or growth-promoting effects of increased international integration (globalization) and open markets. Pro-trade policy initiatives working to lower tariff (tax) barriers -- dating at least from the early 1980s -- have worked to encourage growth in both exports and imports. The U.S. economy, for example, has become increasingly open as measured by the fraction of GDP accounted for by the sum of what is exported and imported. Moreover, export growth has generally exceeded GDP growth in most years of the current expansion; for the most part, exports have been a leading sector in the expansion.

These trends have enabled the U.S. economy to take advantage of larger markets and to become more specialized and therefore more efficient, productive, and competitive than earlier was the case. In short, these trends enable the economy to produce more goods with the same or less input at the same or lower prices: i.e., to grow faster while promoting competition and lower prices.

The explanations presented here help to explain how the economy has persistently grown at a healthy pace without higher inflation. These explanations have a common element: they all indicate how aggregate supply or efficiency can be promoted so as to foster growth without inflation.

Invalid Explanations of this Sustained Performance

The Clinton Administration has argued that economic policies it sponsored in large part "explain" the robust economic performance witnessed in recent years. The *1999 Economic Report of the President*, for example, argues that the recent economic successes "are the result of an economic strategy that we have pursued since 1993... Our new economic strategy was rooted first and foremost in fiscal discipline ...the market responded by lowering long-term interest rates."[5] The centerpiece of the Administration's 1993 "fiscal discipline" was increased tax rates. These tax increases, or tight fiscal policy, purportedly reduced the budget deficit, and from a Keynesian perspective, lowered aggregate demand by draining spending power. This restrictive (lower budget deficit) policy, in turn, lowered interest rates, thereby eventually stimulating the

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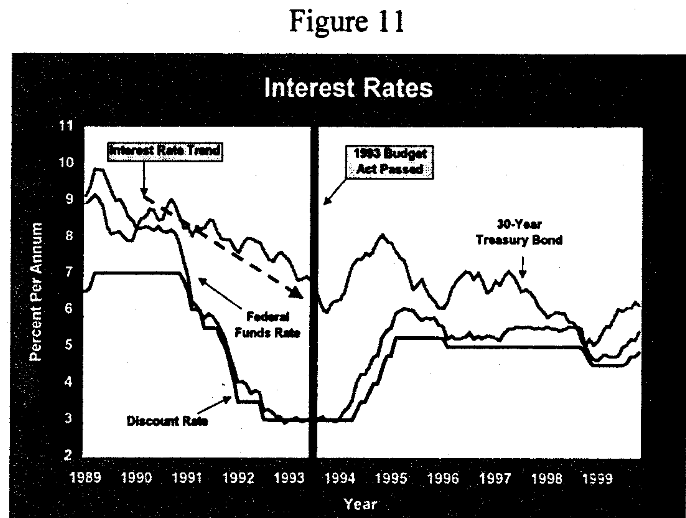
[5] *1999 Economic Report of the President*, U.S. GPO, Washington DC, 1999, p.3.

economy.[6] Some argue that this new "tight" fiscal policy was consciously accompanied by an "easy" monetary policy. This explanation has been often repeated by Administration officials in testimony, speeches, or press interviews.

There are a number of problems with this explanation. Some key inconsistencies of the explanation, for example, include the following:

- The timing of interest rate movements is decidedly inconsistent with the Administration's explanation. According to the Clinton Administration, the passage of the Budget Act in 1993 was followed by a decline in interest rates. Yet movements in both short-term and long-term interest rates contradict the Administration explanation. First, for example, both long-term and short-term interest rates fell for several years prior to the enactment of the *1993 Budget Act* (see figure 11).[7] Clearly, these interest rate declines had nothing to do with Clinton Administration fiscal policy. Second, both short-term and long-term interest rates substantially increased rather than decreased after the *1993 Budget Act* was passed. Thus, the Budget Act did not cause a fall in interest rates as claimed by the President or other Clinton Administration officials. Moreover, the substantial increase in short-term interest rates after the Budget Act was enacted demonstrates that the Federal Reserve did not adopt an easier policy at that time. Additionally, both short- and long-term interest rates for the most part remained above summer 1993 interest rate levels for years after the Act's passage. In

Figure 11



[6] In the words of the President's *Economic Report*, "The market responded (to the Administration's policy) by lowering long-term interest rates. Lower interest rates in turn helped more people buy homes and borrow for college..." ibid, p.3 (parenthesis added).

[7] Since the *Budget Act of 1993* passed Congress by the narrowest of margins, explanations of interest rate movements prior to enactment that rely on expectations of future passage make little sense.

sum, interest rate movements clearly are inconsistent with the Administration's oft-voiced explanation.[8]

- The factors underlying the Administration's explanation do not foster economic growth without inflation. Logical explanations as to why economic growth has persisted for years without inflation increasing in a meaningful way presumably should be based on forces promoting aggregate supply or increased efficiency that do not foster inflation. The explanations presented earlier in this paper have this element in common. The Administration's explanation, however, does not; raising tax rates promotes neither economic growth nor lessened pressures on price increases.

- The current expansion was not initiated by Clinton Administration policy. The economic expansion began in early 1991, almost two years before Clinton's inauguration. Clearly, the expansion itself was not initiated by any policy action of the Clinton Administration.

- The federal budget deficit actually began contracting well before Clinton Administration policies were implemented. Actual budget deficit figures indicate that the budget deficit began declining in a significant way after FY 1992 (i.e., by the start of FY 1993 in October 1992). In particular, the budget deficit fell from $290 billion in FY 1992 to $255 billion in FY 1993, a drop of $35 billion. Since Clinton Administration budget policies were not implemented until (at the earliest) the fall of 1993, they could not have materially impacted budget numbers until FY 1994. Thus, budget deficit declines experienced during this expansion could not have been initiated by the Clinton Administration.

- The Clinton Administration's own economic projections at the time were not consistent with its after-the-fact (ex-post) explanation. Shortly after the enactment of the tax increase in August of 1993, for example, the Administration revised its own growth assumptions downward for 1993 and 1994. This downward adjustment was in accord with the period's contemporary conventional wisdom about the economic effects of the Clinton plan. According to the Democratic majority of the Joint Economic Committee at the time, the Clinton plan "will continue to exert downward pressure on economic activity through the next five years."[9] Furthermore, Administration budget forecasts have consistently understated the economy's performance in recent years, suggesting

[8] Notably, the empirical relationship between interest rates and budget deficits is neither strong nor particularly reliable. During periods of the 1980s, for example, budget deficits widened while interest rates fell. During other periods during the same decade, deficits narrowed as interest rates fell. For a survey of the budget deficit interest rate relationship, see George Iden and John Sturrock, "Deficits and Interest Rates: Theoretical Issues and Empirical Evidence," Staff Working Papers, Congressional Budget Office, January 1989.

[9] See *1993 Joint Economic Report* (Washington, DC, Government Printing Office, 1996) p.10. Also see Christopher Frenze, "Whither the Budget Deficit?," Joint Economic Committee Study, July 1996, p.2.

that even Clinton Administration officials did not believe the Clinton policy was stimulative.

- The Clinton Administration's explanation of the recovery ignores the growth-enhancing effects of a gradualist, price-stabilizing monetary policy. As described above, such monetary policy, by gradually lowering inflation, contributed significantly to the sustainability of the expansion in a number of ways. Many of these beneficial effects are unrecognized by the Administration. Since monetary policy, not fiscal policy, dominates movements in aggregate demand, it cannot be ignored in interpretations of this period's macroeconomic performance.[10]

- The Clinton Administration provides an inaccurate explanation of the disappearance of budget deficits. The Administration's explanation -- that tax rate increases worked to erase the deficit -- ignored the well-documented fact that budget deficits are importantly endogenous (or largely determined by economic factors). In fact, the significant deficit reduction witnessed in recent years is in large part the result of the strong economic expansion together with other economically driven factors such as low interest rates and sizable capital gain realizations.[11] As the economy expands, tax revenue from income, payroll, and other revenue sources increase whereas several forms of government spending (e.g. welfare payments, unemployment insurance) decrease, causing the budget deficit to shrink. In short, the reduced deficit is importantly the result of these economically driven factors rather than the cause of them. This has been documented during the current expansion by studies including, for example, Frenze.[12]

  Data from CBO also support this contention although they may understate the positive fiscal impact of the expansion.[13] In particular, about two-thirds of the fall in the budget deficit projected by CBO over this expansion is accounted for by economic and technical factors rather than legislative changes.[14] To be more specific, in 1993 CBO projected the FY 1998 baseline deficit would be $357 billion. The actual 1998 "deficit" turned out to be a surplus of $69 billion. The $426 billion difference between the projected and actual deficit for 1998 can be explained largely by economic and

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[10] Articles reviewing the argument that monetary policy dominates fiscal policy as a determinant of aggregate spending include, for example, Bennet T. McCallum, "Monetary Versus Fiscal Policy Effects: A Review of the Debate," in *The Monetary Versus Fiscal Policy Debate: Lessons From Two Decades*, edited by R.W. Hafer, Rowman & Allanheld Publishers, Totown, NJ, 1986 (see esp. pp. 10, 23-24); and Lawrence Meyer and Robert Rasche, "Empirical Evidence on the Effects of Stabilization Policy," in *Stabilization Policies: Lessons From the '70's and Implications for the '80's*, Center for the Study of American Business, 1980 (see pp. 51,54).

[11] Tax rate increases may not work to meaningfully reduce budget deficits since such increases can slow economic growth.

[12] Christopher Frenze, "Whither the Budget Deficit?," Joint Economic Committee Study, July 1996.

[13] The data were provided by CBO (Table 1 in letter of August, 1999).

[14] Technical factors include economically driven factors such as capital gains realizations.

technical factors, which account for 70 percent of the difference. The next most important explanation is changes in legislated outlays (which account for 19 percent of the difference). The least important explanatory factor is legislated revenue changes, which account for just 11 percent of the difference. Endogenous or non-legislated factors, therefore, explain the bulk of this deficit decline. The Clinton Administration's interpretation ignores these important endogenous or economic factors which involve causation running counter to their explanation.

In sum, there are a number of serious inconsistencies in the Administration's narrow explanation of the reasons for the current sustained expansion.

Longer-term Prospects for Continued Expansion

The current expansion is expected to persist into the foreseeable future. In part, this expansion relates to the absence of substantial existing imbalances in the economy. In particular, inventory imbalances, corporate or bank balance sheet distortions, overbuilding in the construction industry, serious resurgences of inflation, or substantial interest rate increases are neither evident nor expected. This expectation also relates to the expected continuation of those policies outlined earlier in this paper. More specifically, a price-stabilizing monetary policy, an incentive structure involving low tax rates built into the existing tax code, a policy of government spending restraint, and promotion of open markets and international integration are all expected to be maintained.

As long as no policy errors occur involving efforts to reverse the above-mentioned policies, the economic expansion should continue. That is, so long as the Federal Reserve keeps inflation at bay, substantial tax rate increases or budget-busting increases in government spending are avoided, restrictive trade practices, capital controls, or policies shackling new technologies are not embraced, the recovery should persist and establish new longevity records.

SUMMARY AND CONCLUSIONS

The current economic expansion is remarkably resilient and sustained. One of the remarkable features of the expansion is the simultaneous achievement of low rates of inflation and unemployment together with relatively robust rates of economic growth.

A key reason for the durability of the expansion owes to the maintenance of macroeconomic policies promoting long-run efficiency and growth without inflation. Appropriate macroeconomic policies evolved from the gradual recognition that monetary and fiscal policies should be directed at different and independent objectives; monetary policy should focus on achieving price stability whereas fiscal policy should focus on open market, growth-promoting tax and spending restraint policies encouraging entrepreneurial activity (i.e., policies promoting aggregate supply).

More specific reasons for the economy's remarkable sustainability all promote growth without inflation and include the following:

- The many growth-enhancing effects of a gradual and credible anti-inflationary monetary policy.
- The growth-promoting effects of credible government spending restraint.
- The long-term growth effects of an efficiency-promoting incentive structure embedded in the tax code (as epitomized by marginal income tax rates that remain lower than those of the 1950s, 1960s, and 1970s).
- The effects on aggregate supply and capacity of substantial investment in equipment as well as in productivity-enhancing new technologies.
- The specialization and efficiency-promoting effects of increased international integration and open markets (globalization).

The Administration offers an alternative explanation. It contends that its 1993 policy of raising tax rates worked to reduce the budget deficit and interest rates and to foster sustained recovery. This view proves inadequate for a number of reasons including the following:

- Raising taxes does not promote economic growth without inflation.
- The current expansion began well before the inauguration of President Clinton, and thus could not have been initiated by Clinton Administration policies.
- The budget deficit began contracting well before Clinton Administration policy could have been implemented. Hence, the budget deficit reductions were not initiated by Clinton policy.
- The timing of interest rate movements is decidedly inconsistent with the Administration's explanation.
- The Clinton Administration's own economic projections were not consistent with its after-the-fact explanations.
- The Clinton Administration's explanation of the recovery ignores the growth-enhancing effects of a gradualist, price stabilizing monetary policy.
- The Clinton Administration provides an inaccurate explanation of the disappearance of budget deficits.

The prospects for continued expansion look favorable so long as appropriate macroeconomic policies are maintained and no serious policy errors are made.

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to the Vice Chairman