

BY ROBERT J. BARRO

WHY THE U.S. ECONOMY WILL RISE AGAIN



SAD TRUTH:
The war on terrorism will free the government to pursue deficit spending, as it should—and prevent a recession

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My objective here is to say some positive things about the fallout from the recent attacks on the World Trade Center and the Pentagon without in any way minimizing the costs in life and property. One silver lining from the attacks is that they probably signal the end of the near-recession we have been experiencing. Some early reactions from commentators and foreign financial markets suggest the opposite: that the U.S. would plunge into a full-fledged recession, which would drag down the world economy. But I think these views are wrong. In fact, the oft-mentioned parallel with Pearl Harbor is also apt in the economic realm.

The U.S. entrance into World War II at the end of 1941 was followed by a boom that shook off the remaining economic problems from the Great Depression. Of course, this economic expansion does not mean that World War II was a net benefit, and the same goes for the recent terror in New York, Washington, and Pennsylvania.

One favorable effect of the current emergency is the breaking of the nonsensical constraint on invading the Social Security surplus. The surplus, projected under one definition of Social Security to be roughly \$160 billion for 2001, corresponds to payroll taxes (contributions from workers and employers), plus interest earnings on the Social Security trust fund, minus benefit payments. From this definition, it is obvious that the Social Security surplus is independent of spending and taxing decisions taken by the rest of the government. Payroll taxes depend only on wage incomes and the given payroll tax rates. Interest earned and benefit payouts are also automatic.

Therefore, it is unclear in what sense the remainder of the federal surplus or deficit would invade or reinforce the Social Security surplus, which is the amount that feeds the trust fund. Hence, the policy that would keep the rest of the federal budget surplus above zero so that the total would remain above \$160 billion never made sense. However, the constraint was not a problem until the economic boom turned into a slow-down and, even more, when a new kind of terrorism brought us into war.

ROBBING PETER. Most economists, whether Keynesians or not, agree that government budget deficits should be large during temporary economic difficulties, of which the two most prominent examples are recessions and wars. Recessions are bad times to collect lots of taxes, and wars are times in which spending is sharply above normal. At present, we have both a recession (at least a near one) and a war (against

world terrorism), and we ought to and will have a federal deficit.

One source of the deficit will be a sharp increase in military, or military-related, spending. The federal government will, in addition, finance a significant part of the coming reconstruction in New York. Expenditures for a sharply altered domestic aviation system will also be substantial. These increased outlays, combined with expanded private investment in New York, are likely to prevent the recession.

The extra federal spending will tend to crowd out other candidates for new public spending, such as education, prescription drugs, and an array of social programs. Since I always regarded these programs as mistakes, I view the pressure to curtail them as a plus.

CUT NOW? There is a question about what to do on the tax side. The Bush tax-reduction package mostly had the virtue of eliminating federal revenues that the government would otherwise spend on programs of doubtful value. The tax-rate cuts will improve economic efficiency in the long run, but most of these changes won't take effect for years. Therefore, households and businesses would reasonably expect future tax rates to be lower than current ones and, hence, would be motivated to postpone work and production. A similar adverse incentive applied to the income-tax cut of 1981 and likely contributed to the 1982 recession. Since this year's tax rebate will have only a minor effect on consumer demand, the net effect of the tax-cut package in terms of countering the current recession threat is probably adverse.

Any further tax cuts should be aimed at motivating work and production, especially during a time of national emergency. Thus, there would be a rationale for immediate cuts in the marginal tax rates that affect households and businesses. These reductions could be accomplished by accelerating the planned cuts in individual income-tax rates, lowering corporate tax rates, and reducing tax rates on capital gains. However, the effective loss of at least part of the "peace dividend" from the end of the cold war may mean that some kinds of taxes will have to rise.

Another way in which the terrorist attack has eliminated harmful constraints is that it has freed the government politically to approach international terrorism as the war that it is. Probably this freedom will be the most important in the long run. But since I am supposed to have narrow expertise in economics, I will leave this subject to others.