An Agenda for Economic Security
The Robert Weintraub Memorial Lecture
Baruch College

R. Glenn Hubbard
Chairman, Council of Economic Advisers
December 14, 2001

Introduction

The events of this year have brought us a simple lesson: We cannot be complacent about the security of American lives. We will and must fight a war against terrorism abroad and at home. This is a long battle, requiring commitment, endurance, and focus.

So we cannot be complacent about our rate of economic growth, our gains in productivity, and our successes in the international marketplace. The war against terrorism raises the demands on our economy. We must seek every opportunity to build an economic force sufficient to meet this challenge-- removing obstacles and welding together our workers and their skills, new technologies, entrepreneurs, financial markets, and small businesses to yield faster growth. We must also extend this integration abroad, eliminating the economic roots of terrorism and securing the gains from worldwide markets in goods and capital. This is the economic challenge, requiring commitment, endurance, and focus.

As we all know, the National Bureau of Economic Research recently made its official declaration that the United States is in recession. Although the NBER pointed to the events of September 11 as a key contributing factor, it dated the cyclical peak in March of 2001.
This is not news. Prior to September 11, growth rates were much below their potential levels, and were recognized as unacceptably low. Accordingly, monetary and fiscal policy had already moved decisively to reverse recessionary pressures. Since September 11, the Federal Reserve,

the Administration and Congress have undertaken numerous efforts to provide insurance against the economic consequences of the attacks. This work is far from complete, but it is not the focus of my remarks today.

1. An Agenda for the Future

While it is important to have a cyclical recovery around the world, for example it is even more essential to raise the long-run rates of economic growth. Over the 1990s, U.S. GDP grew at an average annual rate of 3.7 percent, much faster than the 2.0 percent in the Eurozone or the 1.2 percent in Japan.

In the United States, the long-term rate of productivity growth is more rapid than in other major industrialized economies, between 2.0 and 2.5 percent, and supports a long-term GDP growth rate in excess of 3 percent. Where productivity growth is concerned, a difference of 0.5 percentage point is enormous. Over ten years, this difference in growth cumulates to almost 6.5 percent greater output – about $700 billion additional dollars in an economy of our size. In the same way that in recent years the United States has produced a better growth record than our trading partners, we must pursue opportunities to produce a better growth record in the future.

Growth, of course, is not an end in itself. Economic growth raises standards of living – "consumption" in the language of economists. It also provides resources that may be devoted to a variety of non-market activities. Growth can fund environmental protection, charitable organizations, and a wide variety of non-market goods that are of interest to the United States, other industrialized economies, and developing economies alike.

2. Engineering Faster Growth: Foundations

Behind any successful growth episode lies improvements in productivity. Productivity growth in the United States accelerated during the second half of the 1990s relative to growth during the previous two decades. Economists generally believe that much of this higher rate of productivity growth is permanent. Information technology investment is likely to remain strong in the long run. Another source of gain is better ways of doing business. Only a fraction of possible improvements have been made. It is essential that we reap the benefits of the remainder.

The post-1995 boom in productivity growth in the United States stands out from other industrial economies. We are all well aware that productivity growth does not arrive from the heavens, and because businesses around the world can all buy the same technology, the U.S. advantage must be elsewhere. New technologies, process innovations, and other aspects of private-sector productivity gains are the result of investment, effort, testing, and implementation. Put differently, the important economic outcome – productivity growth – hinges on the structure of economic incentives. A recent OECD study documents the relative advantage of the United States in job markets, entrepreneurial activity, venture capital, compensation practices, and corporate governance. The lesson of U. S. experience is that private markets are resilient, efficient, and flexible in meeting new challenges. We need to take steps in public policy to make sure that we get the maximum productivity possible in our economy to fund the many important priorities facing our nation.

Maintaining and Improving Growth: Next Steps

To build upon our past success and rise up to our new challenges we must remove impediments to growth. We need to revisit our policies in trade, technology, taxes, legal foundations, and rules for market conduct. How can we best lay the foundation for a stronger economy?

1. Drawing Resources Together: Expanding the Gains from Trade

One of the President's top priorities is the U.S.-led effort for more open global trade. The large contribution of reduced trade barriers to growth in our standard of living has long been recognized. In 2000, the United States exported $1.1 trillion in goods and services – or 11 percent of GDP.

Trade between nations is simply the international extension of trade among states, or even trade among households. It is a two-way street in which the United States exports its specialties (such as aircraft, industrial machinery, and agricultural commodities) in exchange for products produced efficiently abroad (such as coffee, crude oil, automobiles, and shoes). Trade raises the productivity of Americans, and productivity is the ultimate determinant of our standard of living.

The United States has the opportunity to reap significant gains from the future trade agreements. A recent study finds that a new World Trade Organization (WTO) round that lowers barriers to services and reduces tariffs by one-third on agricultural and industrial products would yield gains roughly equivalent to a $2,500 permanent increase in the annual income of the average family of four. An agreement on the Free Trade Area for the Americas that removes bilateral tariffs would generate about an $800 permanent increase in the annual income of a family of four.

These are important benefits for the average American household. Trade is sometimes portrayed as a threat to lower-income individuals. This is not the case. To take one example, in 1997, $18 billion in tariffs was paid, with nearly one-half on clothes and textiles. Who pays those tariffs? Measured as a fraction of their income, tariffs paid by the lowest-income quintile of households, was roughly three times that of the highest-income quintile.

This is an example of the benefits of trade. Trade itself – not just either exports or imports in isolation – is the key. Trade helps our domestic productivity. Expanding global trade allows the most efficient producers to grow because selling goods in the competitive international marketplace demands higher productivity. Imports also provide competitive stimulus to improve domestic productivity growth.

Gains to the United States from trade would be enhanced by the granting to the President of Trade Promotion Authority (TPA). The case for TPA rests on three legs. First, an open world trading system plays a significant role in aiding productivity and standards of living.

Second, formal trade agreements contribute to the architecture of our trading system. Since World War II, a bipartisan consensus in the United States has supported the idea that multilateral trade negotiations should establish rules for world trade and should free that trade from artificial barriers imposed by governments. The freeing of world trade would not just benefit the U.S. economy, but would also strengthen the world economy, thereby serving the nation’s foreign policy interests.

Third, Trade Promotion Authority would allow the President to submit a negotiated trade agreement to Congress for a simple up or down vote, without amendment and modification. Obviously, Congress still has its final, rightful say on whether the United States signs any trade agreement. TPA, though, provides the President with maximum flexibility and gives the United States additional credibility in the international community. It enhances our bargaining power in these negotiations. It also ensures that trade agreements will maintain a focus on trade, as intended by the negotiating parties. TPA sends a signal to other countries that the United States is united in active engagement in trade negotiations that will benefit all participating countries.

2. Fueling Growth: Research, Innovation, and Improved Technologies

Science and technology fuel U.S. economic growth. As an example, although information technology producing industries represent only eight percent of all enterprises in our economy, they produce 29 percent of U.S. exports, generate some of the best and highest paying new jobs in our nation, and contribute strongly to our productivity growth.

Technology also improves our quality of life. Agricultural technologies are increasing crop yields while reducing the need to spray herbicides and insecticides on our foods and into our environment. According to the United Nations, the recent mapping of the rice genome could halve world hunger within a generation, while the genetic addition of vitamin A to rice harvests promises to prevent millions of childhood deaths and incidences of blindness each year. Pharmaceutical and biotechnologies are generating new cures and treatments that help us live longer and healthier lives. Advances in health care have increased life expectancies, while CAT scans and MRIs, laser scalpels, endoscopes, and blood-cleaning technologies make surgery safer, less invasive, and more precise.

Looking forward, we must ensure that incentives are in place to ensure a continued growth in innovation and the new technologies that will define the 21st century. We must not only invest in basic research, but also ensure that the intellectual property of innovators is secure at home and abroad.

3. Reducing the Drag on Growth: Tax Reform

A key element of getting the most out of our economy's resources is to avoid costs--in lower economic growth and waste—associated with our tax code. The entire tax system would benefit from fundamental changes to address existing complexity and inefficiency. With the President's leadership, we have made progress with the individual income tax by reducing marginal tax rates and improving tax fairness. Much more needs to be done to help the economy generate resources and increase productivity.

The current income tax is biased against saving, investment, and entrepreneurship—activities critical to our economic security. While many avenues for tax reform are possible, they should share the principle that income be taxed no more than once. The current tax code generates multiple layers of taxation generating substantial costs to our economy of about 0.5 percent of GDP each year, according to the Treasury Department. In addition, tax complexity is much more than an irritant on April 15. Complexity imposes real costs on taxpayers and the economy. Taxpayers bear the cost in terms of the billions of dollars they spend trying to comply. The economy suffers because the tax complexity raises the uncertainty surrounding business decisions and generates, wasted resources, reduced international competitiveness, and lower productivity. The combined costs associated with complexity could exceed a hundred billion dollars per year.

These costs produce no benefits. They are also unnecessary. To get the most out of our economy, we must investigate options for tax reform.

4. Lowering the Lawsuit Tax: Tort Reform

The rule of law is central to efficient markets. Today, however, frivolous lawsuits and the lure of windfall recoveries is transforming America from a lawful society to a litigious one. The litigation explosion imposes a variety of costs on all of and damages our prospects for growth. One study estimates the costs to be roughly 1.5 percent of GDP. Inefficiencies in our tort system are a waste, an unnecessary tax on our attempts to grow faster. To reduce this wasteful distortion, we must address the incentives that lead to unnecessary torts and unreasonably large settlements.

We must reduce the number of lawsuits. First, we can help to protect the innocent by deterring frivolous litigation. We can also make litigation the last resort by encouraging timely, good faith settlements. One way to do so is to make sure that if plaintiffs turn down a settlement offer, they pay the defendant's costs if they lose.

We must make sure the lawsuits are made on their merits. We must reduce "forum shopping," in which lawsuits are tailored to the jurisdiction most favorable to the cause. We must make sure that unreasonably high legal fees do not siphon resources from productive uses. These measures will reduce the costs of fees and the drain on our economy.

5. Supporting Flexible Markets

Our success in achieving high productivity growth in the past stems from the ability of market incentives to guide us flexibly to new opportunities and innovations. This feature of our economy must be protected against unintended interference and extended to new spheres.

Competition Policies At Home and Abroad. Competition and incentives to compete are at the core of exploiting opportunities to achieve faster growth. Competition policy –antitrust policy and pricing laws—should serve to promote efficient resource allocation and consumer interests.

Competition policy seeks to promote competition and improve consumers' well-being. Such policy faces a challenge, though. Efforts to prevent changes in the behavior and organization of firms that are harmful to competition may inadvertently keep firms from taking steps that could lower their costs or improve their products and thereby benefit consumers.

The recent past has witnessed a remarkable shift in the landscape of firms. Mergers, acquisitions, joint ventures, and partial equity interests reshape the organization of firms and the nature of competition. Our competition policy must be flexible enough to acknowledge the efficiencies in these changes, while thwarting efforts to restrain competition.

In light of the increasingly global markets in which firms compete, the international nature of competition and firms' operations is one part of the motivations for changes in their organization. Our policy should reflect these incentives. But national competition policies now cross international borders, so inefficient competition policies in any nation may impose costs on firms and consumers worldwide. To grow, we must integrate, both at home and abroad. The United States should pursue harmonization that brings best-practice, efficient competition policy worldwide.

Regulatory Reform. The deregulation of our economy over the past twenty-five years represents a tremendous source of economic flexibility and success in generating resources for our economy. We must build on that success. Deregulation of several key sectors of our economy during the 1970s and 1980s has brought substantial benefits to consumers and our economy. In the twenty years following the beginning of airline deregulation, average fares declined 33 percent. Rates for long-distance telecommunications dropped 40 to 47 percent in the ten years following deregulation of that market. In addition, the quality and variety of services in deregulated industries has grown markedly. Partly due to increased competition arising from reductions in banking regulations, banks have greatly expanded the scope of financial services they offer customers, including important new tools for diversifying risk. These price declines and quality improvements have yielded substantial economic benefits. One study estimates the combined economic benefit of deregulating airlines, motor carriers, and railroads to be about 0.5

percent of GDP per year. Moreover, the time period over which these benefits were realized suggests we should be patient in evaluating the success of more recent deregulation initiatives in, for example, electricity markets.

Market Efficiency for Non-Market Challenges. Our nation and the world face an opportunity to craft an important new institutional framework that supports the desire for faster, sustainable growth. Each of you is familiar, I am sure, with the debate over the appropriate policies toward global climate change. Certainly this debate will be with us for the foreseeable future, and along with the need to analyze international agreements and institutions. President Bush's statement in June on the administration's ongoing review of climate-change policy offers a wise departure from the current debate over the Kyoto Protocol and a welcome emphasis on science, the environment, and economics. As the President observed, a sound policy requires a global effort to protect the earth from long-term climate damage while simultaneously avoiding damage to our prosperity and economic resources.

The ultimate goal of a sound climate change policy is long-term stabilization of atmospheric greenhouse gas concentrations at levels that avoid costly environmental or economic damage. However, this complicated problem requires a gradualist approach: Emphasize long-term goals, but focus short-term efforts on developing durable domestic and international policy architectures to learn about the benefits and costs of alternative strategies. We need to develop institutions to seek out and exploit the lowest-cost abatement opportunities wherever they are in the world. This is a tall order, but one should not pretend that they need to be developed right away. In contrast to a premature, Kyoto-style agreement, the conversation should become broader and deeper over time, much like the fifty-year effort for the General Agreement on Tariffs and Trade/World Trade Organization.

For example, the President has proposed additional budget resources for advancing science and technology research. We should also move away from the mantra of fixed emission targets that threaten economic growth toward more realistic and gradual goals -- for example, linking greenhouse gas emission growth to a percentage of economic growth. This could be viewed as a first step in a trajectory that would eventually stabilize and then reduce emissions, in turn stabilizing concentrations – at a lower cost to our economy than under the Kyoto Protocol.

Outcomes, Not Outlays: Getting the Most Out of Government

Getting the most out of the economy will require an emphasis on efficiency in government as well. If government spending grows without discipline, dollars will be siphoned away from private sector innovation, taxes will rise, and growth will suffer. Perhaps for this reason, many view government and markets to be in inevitable conflict. This is too narrow a view, as the power of incentives can be used to improve government. The President's Management Agenda, for example, seeks to shift toward an emphasis on results, not process. It aims to replace a hierarchy with a flatter, more responsive management, structure and it seeks a performance-based system.

The management agenda aims to infuse the federal government with the attributes of economic success – institutions that respond flexibly to unexpected needs in uncertain world, a constant search for ways to lower artificial barrier to avenues for improvement, and the matching of rewards to performance.

These attributes, however, should be reflected in the design of government programs, and not just the management of these programs. We must keep this less in mind as we address pressing policy challenges.

1. Integrating the Safety Net: Displaced Workers

The slow descent toward recession that began in mid-2000 bled jobs from the economy. The lightning strike of the attacks of September 11 destroyed hundreds of thousands more. In an era in which the value of economic growth is at a premium, we must develop policies that anticipate the possibility of displaced workers from unexpected causes. Of course, safety-net policies must meet individuals' basic needs. But that is not enough. An American worker is a valuable, skilled contributor to economic progress who should not be left idle or underutilized.

Aid for displaced workers exists under our trade policies – Trade Adjustment Assistance (TAA) and NAFTA-TAA—in our Workforce Investment Act, and elsewhere. We should think comprehensively about these policies with a focus on incentives for getting workers back to work, and quickly. Resources should be devoted flexibly to basic needs and re-training, without an incentive for unnecessarily long spells between jobs, a "tax" (in the form of lost benefits) for taking a new job.

2. Enhancing Skills for the Future: Efficiency in Education

Experience and a broad array of research has shown that education, training, the acquisition of skills and human capital more generally is at the heart of successful productivity growth. Although federal spending is far from the dominant source of investment in human capital, the President's focus on getting results from school spending is an example of growth-oriented spending policies. The focus is not on process – the federal government should not dictate how local and state school budgets are spent. The focus should be on outcomes. The goal of the No Child Left Behind education reform bill is better accountability and increased flexibility in school spending decisions. Schools and localities will have more freedom and control, reducing bureaucratic red tape and giving parents more choices. But flexibility will be matched by accountability and rewards paired with performance. Schools must show through rigorous testing not only overall achievements, but a shrinking of race and gender achievement gaps.

By creating incentives for long-term performance improvement, creating incentives for a flexible education system that responds broadly to the needs of an increasingly diverse population, and by creating incentives for even more skilled and better-educated workers in the future, we can avoid lost opportunities for growth in the future.

3. Promoting Work: Progress of Welfare Reform

Welfare reform is a success story. Since the introduction of Temporary Assistance for Needy Families in 1996, thousands of families have moved from welfare to work, ending the cycle of dependence that has been passed from generation to generation. How was this transformation accomplished? Not by dictating to states the form of their assistance to low-income families should take and how those families. Not by mandating how those families should be moved into the workforce. Not by simply spending more money. The focus is on outcomes and flexibility. Welfare reform gave states the flexibility to provide the kind of assistance that was needed for their particular situation and rewarded them for getting recipients into jobs. Some states provided child care assistance, others provided transportation. In fact, states have been so successful at moving families from welfare to work altogether that they now have extra resources.

An efficient system provides incentives for such surpluses. At the same time, it should reward the stewardship of these dollars so as to respond effectively to variations in the need for assistance in response to adverse shock. As in other areas, our need to respond to external events need not be at odds with promoting economic growth to shoulder additional burdens.

4. Improving Health Care: Focus on Outcomes.

While the accomplishments of the American health care sector are nothing short of remarkable, some of the resources devoted to health care are much more productive than others. We can help ensure that we buy as much health and longevity as possible for our investment in resources in several ways.

Health care is the largest sector of the American economy, and also one of the most vibrant. Biomedical research has led to dramatic advances in our understanding of the human genome, basic biology, and mechanisms of disease, and in our ability to diagnose and treat illness. New diagnostic and imaging tools have improved our understanding of diseases, our diagnostic ability, and our ability to diagnose illnesses quickly and accurately. New drugs and devices have dramatically improved the treatment of a wide range of illnesses. New information systems, including those relying on the internet, have made it possible for health care providers to work more effectively with their patients to manage illnesses and avoid complications. These advances testify to the success of our system in encouraging discovery and innovation. Recent discoveries coupled with a strong tradition of professional care hold even more potential for the future.

Although our health care system has clearly had many innovations, its cost has risen dramatically with the scope and quality of medical treatments available. We now spend 13.3 percent of our gross domestic product on healthcare, a figure predicted to rise to 16 percent by 2010. The high and rising level of per capital expenditure on healthcare is reflected in the cost of health insurance—private insurance and government-sponsored insurance.

Having health insurance is associated with receiving better health care, and thus increasing insurance rates is an important policy goal. But there are reasons for concerns about the cost of health insurance. Even though Americans are receiving high-value care overall, they often do not get high-value treatments for their health problems. Whether it is the underuse of basic preventive services, of low-value medical procedures, or the misuse of treatments because of preventable complications or because of insufficient patient participation and lack of competition, there is tremendous potential to improve the quality of health care in the United States. This potential for improving the quality of care also provides opportunities to improve the use of resources, with substantial cost savings available for other priorities.

U.S. health care policy is again at a crossroads, with fresh policy directions needed to support innovative health care coverage for the future: We need to foster a health care system that enables patients working with dedicated health care professionals to get the care that best meets their needs in the face of rising health care costs. Patient-centered care requires more flexibility and innovation in health care coverage; it also requires more patient responsibility—rather than reliance on third-party payers or government regulators—to help avoid wasteful costs. To achieve more patient-centered health care by encouraging innovations in the financing and delivery of services in this dynamic sector of the economy, three broad objectives should be pursued: (1) develop flexible, market-based approaches to providing health care coverage for all Americans; (2) support efforts by health care providers and patients to improve the quality and efficiency of care; and (3) provide better support for biomedical research.

This is not an exhaustive list of programs that merit our attention. We will need to focus on the challenge of raising the "outcome per dollar" in Social Security by introducing personal accounts. And we will face the challenge of raising the "quality per dollar" in the Medicare budget. At each step, we must focus our government programs on performance -- on outcomes and not outlays.

Conclusion

The future holds many surprises, but the certainty of a struggle against terrorism. We must harden our economy to be resilient against unforseen adversity, while lifting the rate of growth sufficiently to fund the nation's needs. We must seek every opportunity to build stronger economic growth by removing obstacles to efficiency, integrating our internal and external markets, improving the performance of our government programs. This is our central economic challenge.

Thank you.