

## **A Framework for Economic Policy**

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Ronald Reagan Presidential Library  
February 15, 2002

My objective today is to discuss the framework for economic policymaking in the United States. Admittedly, a “framework” talk runs the risk of lacking the drama of current events. But in an era in which we wage a war on terrorism abroad, and a war against sub-par economic growth at home, there is value to stepping back from the front lines and evaluating the overall battle plan.

### *A Brief History of “Rebellion”*

It is time again to rebel against the prevailing orthodoxy. The Reagan Library is an appropriate setting for such a thought. The economic policies of the Reagan Administration represented a rebellion against the prevailing orthodoxy that viewed the Federal government as the key decisionmaker in the economy – necessary to steer the economy between the shoals of unemployment and inflation, central to deciding which industries should expand, and ever-more involved in the economic decisions of American families. Against this backdrop, President Reagan stressed the centrality of private markets in superior economic performance, their ability to drive innovation and growth, and the importance of maintaining vigilance against impaired market incentives.

The deregulation of our economy triggered by this vision was and is a tremendous source of economic flexibility and success in generating resources for our economy. Deregulation of several key sectors of our economy during the 1970s and 1980s brought substantial benefits to

consumers and our economy. One study estimates the combined economic benefit of deregulating airlines, motor carriers, and railroads to be about 0.5 percent of GDP per year.

Deregulation, reductions in marginal tax rates, and victory in the Cold War fueled a long boom in the United States that was interrupted only briefly during the early 1990s. The post-1995 boom in productivity growth in the United States stands out from other industrial economies. Productivity growth does not arrive from the heavens, and businesses around the world can all buy the same technology – the United States’ 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.

### *The New Orthodoxy*

Despite the success of the long boom, a new orthodoxy took root in Washington. Ostensibly adherent to market principles, it nevertheless is at odds with the fundamental strengths of reliance on the private sector. What are the features of this new orthodoxy?

*First*, the government is once again confused to be at the center of good economic performance. A recent manifestation of this orientation has been the focus on accumulating government budget surpluses as the key, at times to the exclusion, of good economic performance. Despite essentially no evidence that surpluses are related to long-term interest rates – a finding that would stand in defiance of the increasing integration of world capital markets – proponents of this view argue that increasing the budget surplus is the key to faster growth. In reality, these concepts are linked. However, the prevailing orthodoxy has the tail wagging the dog – a stronger economy produces higher revenue and larger surpluses. It is remarkable that the prevailing orthodoxy has taken hold during the long boom.

It is even more remarkable that we hear it suggested that tax relief might be making matters worse, and some urge its repeal. Economic growth is a direct consequence of millions of individual decisions to produce, save, and invest. Any added tax burden today would throw the economy back into reverse. To invoke the wisdom of Alan Greenspan: “All taxes are a drag on the economy. It’s only a question of degree.”

*Second*, the new orthodoxy revolves around an economy of guarantees. In this view, for example, the objective of health policy is to “guarantee” access to health insurance and medical care regardless of need, desire, or price. Alternatively, each worker must be endowed with a “right” to a “good job” – including a government-determined wage and guarantees of benefits.

The mix of these two elements of the orthodoxy can produce especially ill-conceived policies. Consider, for example, “guaranteeing” Social Security despite its well-demonstrated long-run financial imbalance. Any even-handed assessment of the current Social Security program recognizes that to continue business as usual will place us in the situation of facing radically higher payroll taxes or striking benefit reductions in the foreseeable future. Put differently, either Social Security retirees, or workers, or both are placed as substantial political risk by the “guarantees” to continue the current system.

For this reason, the only real guarantee of retirement security is to place it in the hands of Americans. Considerable evidence from experience with employer pensions show that workers who own assets in accounts bearing their name are more likely to save than workers who can only hope to receive a fixed payment each month. After a fruitful series of meetings and valuable analyses, the President’s Commission on Strengthening Social Security has endorsed personal accounts and advocated a year of national debate and discussion. Regardless of the specifics of the path chosen in the future, the message of the Commission stands in stark contrast to the orthodoxy of guarantees.

Or, consider again the new orthodoxy approach to health care and its steady march of “guaranteed access” to existing technologies and treatments, a march that is a costly death spiral. The best guarantee is to empower each American to regain control of his or her health care and to build a market to let a new breed of empowered consumers shop aggressively and force insurance to both hold providers accountable for their care.

The orthodox mixture of costly guarantees and the tax burdens required to sustain them breeds as well a class-warfare mentality that undervalues the dynamism of the economy and

handcuffs the ability to undertake beneficial, pro-growth policies. In the hands of class warriors, the telling question “are you better off than you were four years ago?” becomes the mantra of short-sighted redistribution.

### *Lessons and the Path Forward*

What lessons can be drawn from this experience? First, when economic growth is rapid and sustained, it is easy to lose sight of the importance of basics. A good analogy is the fact that many of us – myself included, sadly – put on a few extra pounds every now and then. When the wind is at your back, or the path slopes down, the weight matters little. But when a headwind kicks up or you face a steep climb, the weight becomes an severe impediment to reaching your goals.

The sustained growth over the past two decades has disguised the real burden of letting tax rates creep up, tax complexity expand, oversight of regulation slip, and government promises expand. Just like those few extra pounds, it is important to lighten the burden we have placed on the private sector.

Let me stretch the metaphor a bit further to draw out a second lesson. Sometimes the key to keeping the weight off is not just to eat less, but to eat right. In economic policy, the demands for regulations and guarantees may stem from a deeper source. For example, Americans have a genuine, deep concern over the quality of the health care system that in part feeds the political incentives for ill-conceived controls, mandates, and guarantees. In this setting, an appeal to market incentives may not be enough. Instead, we must embed support for markets and their incentives deep within the policy process, ensuring that markets *work* well.

What, then, should be our goals for economic policy. *We must begin by recognizing that we live in a dynamic economy and that growth and change are central to its success.* After stagnating during the 1970s and early 1980s, the rate of patents issued has dramatically increased – triple the rate of the 1950s and 1960s. These innovations include visible changes in technology such as computers but also management or business practices, such as the introduction of the hub-and-spoke system for express package delivery by Federal Express. These innovations form

the foundation of “perennial gale of creative destruction” – a term due to Joseph Schumpeter – that leads to dramatic economic changes and enormous benefits to society.

Computer processors today are more than 250 times more powerful than those produced in 1980 and twice as powerful as those produced two years ago. New drugs have vastly improved our ability to treat various illnesses. The list could go on, and the benefits could be enumerated.

With growth and change comes risk, however. In the computer industry during the 1990s, at least ten percent of firms had sales fall to zero, and more than half of the firms experienced negative sales growth over the period. Only 25 percent of firms experienced total sales growth of greater than seven percent during the entire period, and just one percent experienced growth of greater than 130 percent.

Entrepreneurs must have reason to expect that, taking into account the likelihood of failure, the profits from any successful innovations that do result from their efforts will be large enough to justify the initial investment. We guiding rule for policy design should be that it enhances the ability of the private sector to assess risk, capture the return to risk-taking, and efficiently shift risks to those most willing to bear it. For example, the President has convened his Working Group on Financial Markets to review the need for, and recommend changes to increase incentives for, greater disclosure of information useful for evaluating risks.

Workers face greater risks and changes as well. Over the last 20 years, the chances of staying in the same job for a decade, or even two decades, has fallen. For example, in 1979 fully 62 percent of prime-age workers in transportation, communications and public utilities industries had been in their jobs for more than 10 years; 46 percent for 20 years. By 1996, the fractions had fallen to 47 percent and 32 percent, respectively. A similar story applies elsewhere in the economy and underscores the basic point: Risks are central feature of a dynamic economy. In designing policy, we should not ignore or avoid risk, but incorporate its presence into the policy framework.

A lesson is that policy should not be envisioned in static terms – small versus big business; employed versus unemployed workers; or rich versus poor. Consider, for example, the new orthodoxy view of the estate tax – an opportunity to move wealth accumulation from the rich to the poor. Unfortunately, this ignores the fact that nearly one-half of those who can expect to pay the estate tax are entrepreneurs – even though entrepreneurs are less than 10 percent of the population – and that the looming specter of an estate tax affects their effort, hiring, and capital accumulation. Traditional analysis of estate taxation ignores the dynamics of entrepreneurial planning. More generally, policy should be about the *process* of growth, the evolution of firms, the constant re-balancing of priorities, and the efforts of Americans.

### *Raise the Ladder of Growth on a Firm Foundation*

The framework for policy design should begin with recognition that growth requires an investment in the basics: capital, technologies, and skills. I will have more to say about the role of removing impediments to capital accumulation in the tax system. The importance of research, innovation, and improved technologies, however, cannot be underestimated.

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 21<sup>st</sup> century. We must not only invest in basic research, but also ensure that the intellectual property of innovators is secure at home and abroad.

Research suggests that the rate of return to research and development is quite high – somewhere in the vicinity of 30 percent. To ensure that incentives are sufficient the President has supported a permanent extension of the Research and Experimentation tax credit.

### *Faster Growth: Raising A Taller Ladder*

In a dynamic economy, the greatest poverty is the poverty of opportunity. We must enhance our efforts to increase the long-run rate of economic growth, building a continued reliance on markets. “Increasing the long-run rate of growth” is a phrase that nobody finds objectionable. At the same time, it is my experience that it is easy to lose sight of the importance of even small changes.

To take an example, the final Clinton Administration economic forecast showed the economy with a long-run (potential) growth rate of 2.9 percent. In part due to economic policies that move toward the framework I am suggesting, the Administration forecast contains a corresponding number of 3.1 percent. What difference does this small increase make? Real GDP in the United States is roughly \$10.2 trillion. Growing at a 3.1 percent rate for 10 years increases GDP to \$13.8 trillion, whereas a 2.9 percent rate over the same period yields only \$13.6 trillion. The difference – \$266 billion – is roughly \$1,000 for every man, woman and child in America today.

Put differently, the difference is \$1,000 of opportunity for everyone. How can bring these opportunities to Americans?

*Expanding the Scope and Durability of Market Incentives*

We can begin by expanding the scope of markets through a 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 2001, the United States exported more than \$1 trillion in goods and services – or about 10 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.

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.

*Formal* trade agreements are the key here. We're seeing this today in the success of NAFTA. America strongly supports a new round of global trade negotiations. We're also working with nations in Central and South America to establish a Free Trade Area of the



Americas by January of 2005. And we have made great progress toward completing a free trade agreement with Chile this year.

Still, out of 130 free trade agreements in the world today, the United States is party to only three. All of our efforts to open new markets around the world will depend on Trade Promotion Authority – the ability of a President to negotiate a trade agreement on behalf of the United States, and submit it to Congress for an up or down vote. The House has already given approval. It remains only for the Senate to pass Trade Promotion Authority, and the signs are good.

Similarly, among our trading partners, a commitment to open trade represents a commitment to sound economic policy. This serves their self-interest, our foreign policy objectives, and global development objectives. To make the case for global trade, we can point to our own history, which demonstrates the link between trade liberalization and faster economic growth.

The scope of market incentives should be expanded in a second way as well: into non-market settings. It is now widely recognized that market incentives can serve our environmental interests. However, by crafting a suitable institutional framework for these incentives, we can foster 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. 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.

The President unveiled Thursday a new climate change mitigation goal for the United States and outlined the basic steps to get us there. The President identified greenhouse gas *intensity*, the ratio of emissions to economic activity, as a better way to measure progress, and set a serious but reasonable goal of reducing our greenhouse gas intensity by 18 percent over the next decade. He challenged industries to voluntarily commit to reduce emissions, promised businesses that their investments in emissions reductions today would not be penalized by future policy decisions, and announced that these reductions, once registered, could be traded. Finally, he established a check at the end of this ten-year period to determine whether further measures were necessary, including the possibility of a broad, market-based program in the future.

The President's plan builds on private incentives by first establishing a convincing goal, then allowing *businesses* to figure out innovative ways to measure and record their reductions—with government on the sideline to ensure integrity. It protects those reductions from future climate policies, so firms acting in good faith to contribute to the national goal are not penalized by any future policy. And, it lets firms transfer the reduction credits to other firms, so even those without immediate reduction opportunities can contribute as well as hedge against future climate policies. This creates an incentive, encourages a flexible response, but does not take economic risks. From the perspective of expanding the scope of market incentives, it also encourages the development of useful institutions regardless of the course we pursue in the future.

### *Better Markets for Better Growth*

In addition to expanding the scope of markets in a permanent way, we can make our markets work better. Our economy remains very flexible and able to generate new and higher-paying jobs. We must resist regulatory impulses such as those seen in Western Europe. The OECD has looked into the reason why productivity growth is consistently higher in the U.S. than in Western Europe. The answer, in part, lies in our higher level of job mobility and

entrepreneurship, a well-developed market for venture capital, and quicker resolution of bankruptcies.

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.

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. 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.

Another 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.

The rule of law is central to efficient markets. This has been one of the central lessons of our efforts to spread markets across the globe. At home, however, frivolous lawsuits and the lure of windfall recoveries are 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. Indeed, it is useful to remember that – like a tax – the unnecessary tort costs are spread throughout the economy as firms must raise prices faster, reduce the growth of wages and benefits, or cut dividends to cover their legal bills. As a rough guide, reducing this wasteful distortion could be as large as cutting 2.5 percentage points off the payroll tax – surely a good reason to address the incentives that lead to unnecessary torts and unreasonably large settlements.

#### *The First Step: Getting People on the Ladder*

The President has said “The same economy that is a miracle for millions of Americans is a mystery for millions as well.” We will not be successful in ensuring reliance on private markets until we remove the mystery. In contrast to the orthodoxy of guarantees, an entry-level job should not be an end in itself, but should lead to real economic progress.

For the economy as a whole and individual workers alike, modern studies of economic growth have emphasized the importance of human capital – the education, training, and skills of workers. We must ensure a strong foundation in this area as well. In the new orthodoxy, basic education was a “guarantee,” and a “good” education was guaranteed by mandates on the dollars spent.

A more fruitful framework is a results-oriented, flexible approach. When the focus is on results – student achievement – rather than process – how schools spend the money – the education system is empowered to choose the most effective means to achieve goals. The Administration’s approach to “leaving no child behind” follows a framework that strengthens the institutions that allow local education markets to work, that allow school districts cater to the diverse needs of their population, and that empower parents to choose what is best for their children.

Results matter. College graduates can expect to earn more than twice as much per year as high school drop-outs. In 1999, the average high school drop-out earned \$16,000; the average college graduate earned almost \$44,000. We must make every effort to ensure that policies generate results leading to the acquisition of skills. We must also make sure that individual incentives to acquire and use these skills are not impaired by high marginal tax rates on low-income Americans.

### *Keeping the Next Rung in Sight*

Reliance on markets in a dynamic economy is strengthened by a policy framework that anticipates the need for structural adjustment. As the past year has made vivid, the United States economy is subject to a variety of external events – “shocks” to the system. Shared macroeconomic shocks common to all industries and families should be addressed by an appropriate combination of monetary and fiscal policies that look *forward* toward maintaining low, stable inflation and rapid economic growth.

Some shocks, however, disproportionately affect one industry, or one area, or one occupation. We should design our “security system” to support growth by not living in the past. A failed enterprise should be closed. A bad job should be quit. Our policies should acknowledge these realities. For firms, bankruptcy protection is about the hope for tomorrow in midst of the failure of today. Restructured firms can be more productive and contribute to our growth.

But what of our workers? A common example derives from international trade. The gains from more open trade are larger when more of the economy's resources – its capital, technologies, and especially workers – are shifted toward the more productive markets. But these shifts take time and require adjustment. In recognition of this fact, the United States provides trade adjustment assistance to ease these transitions.

In thinking about policy toward worker adjustment it seems sensible to emphasize a few features. First, it should be *forward-looking*. Adjustment should not be about maintaining the *status quo*. For displaced workers, we must not set the goal to be government support comparable to their previous jobs. An American worker is a valuable, skilled contributor to economic progress who should not be left idle or underutilized. Aid for displaced workers should focus on incentives for getting workers back to work, and quickly. Resources should be devoted flexibly to basic needs and retraining, without an incentive for unnecessarily long spells between jobs, a “tax” (in the form of lost benefits) for taking a new job.

Policy should not be piecemeal. Adjustment from “trade” looks the same as adjustment from domestic competition, and is little different from adjustment due to poor management, or sub-competitive productivity. In short, all sorts of restructuring look the same in the eye of the worker. For this reason a piecemeal approach to adjustment – Trade Adjustment Assistance, Workforce Investment Act, *etc.* – can be improved by anticipating the need for structural adjustment in a comprehensive way.

Not surprisingly, because adjustment *is* a market phenomenon, a reliance on individuals is the best adjustment policy. Individuals know what they need most – support to make ends meet, health insurance, or a bit of training to move up in their next job.

A structural adjustment policy is not about compensating individuals' losses. It is about investing – and investing involves risks. Think about an individual's decision to undertake a new career, switch jobs, volunteer for a new project, or work some overtime or otherwise stretch the margins is a risk – under any circumstances. We need to reward this common, quiet entrepreneurship in the same way that we create an environment for visible entrepreneurs emerge.

We must keep marginal taxes rates low, regulations to their necessary minimum, and responsibility invested in the private sector.

*The Way Forward: A Summary*

In the aftermath of September 11, it has become nearly commonplace to argue that America stands at an historical divide, and I do not want to join the ranks of those who tie their concerns to this moment. At the same time, *ideas* matter and I believe that we must wage a strong campaign for the President's vision of economic policy. Two decades ago the Reagan Administration delivered a decisive victory. We can build on this legacy by returning to the lessons of the long boom and its reliance on markets. But we should not be satisfied by this alone. The Administration believes that we should cement the policy foundations of market mechanisms by anticipating the demands created by market dynamics, expand the scope of and reach of market incentives, and systematically remove those remaining obstacles to faster growth.