Heritage Lectures

Published by The Heritage Foundation

No. 1014
Delivered March 19, 2007

April 30, 2007

Promoting Stronger Economic Growth: What Public Policy Can Do to Improve Productivity

Edward P. Lazear, Ph.D.

I am delighted to speak at the Heritage Foundation, an organization that ardently supports the principles of free enterprise, limited government, and individual freedom.

The flexibility of the American economy has allowed it to continue growing despite a number of headwinds, the most obvious of which are high energy costs and a housing sector that saw a significant decline over the past year.

Economic Overview

The growth of our economy traces back to seeds that were sown well before I became the President's economic adviser. The President believes that the economy is best served by policies of limited government and low taxes, and he took actions early in his first term to reduce tax rates on wage income and on dividends and capital gains. Those policies paid off with high rates of economic growth, high levels of productivity improvements, high profits, and the strong labor market we now enjoy with rising real wages.

Despite last year's high energy prices and housing sector declines, the economy continued to grow at a solid pace last year. GDP grew 3.1 percent during 2006—roughly the same pace as during 2005, which is impressive given that residential investment subtracted 0.8 percentage point from growth over 2006. And it is all the more remarkable since we are well into the current business cycle expansion. Some economic headwinds will persist in 2007, but we expect the

Talking Points

- Ensuring economic growth requires keeping marginal tax rates low, because the most important way to encourage growth is to maintain the smallest possible difference between the before-tax and after-tax rates of return to investments, and encouraging investment in human capital, because the economy depends to a large extent on capital embodied in people through their skills.
- It also requires maintaining America's openness to trade and its long tradition of allowing investment to flow freely into the economy.
- The greatest long-run fiscal challenge is likely to be Medicare. The projected long-term growth in entitlement spending is unsustainable because growing mandatory spending puts budgetary pressure on discretionary spending.
- It is therefore crucial that entitlement program reforms preserve protections against financial risk without having negative effects on the economy.

This paper, in its entirety, can be found at:
www.heritage.org/research/economy/hl1014.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

economy to show similar resiliency as it continues its expansion.

Equally compelling is the large increase in tax receipts flowing to the government the past couple of years as a result of the growing economy. That revenue, combined with some spending restraint, has allowed the government to achieve the goal of reducing the budget deficit ahead of schedule. The President in his FY 2008 budget has called for balancing the budget in 2012 with spending restraint and without increasing taxes. I believe that increasing taxes, as some have proposed, would be counterproductive for the economy.

There are two trends that are most important when looking at the economic scene as we move into 2007.

First, the labor market has been very strong. The unemployment rate fell from 5 percent in late 2005 to 4.5 percent in February. The economy added 2 million payroll jobs over the past 12 months, and most impressive is that wages grew at an after-inflation rate of 1.8 percent, which is higher than the average rate during the second half of the 1990s. Jobs are available, employers are searching for talent, layoff rates are at a low point, and the gains that businesses have enjoyed during the past few years are now spreading to the average worker.

Second, part of our healthy economy has been fueled by demand for American goods abroad. In 2006, exports grew nearly 12.7 percent while imports grew 10.5 percent. This was the first time in nine years that exports grew faster than imports. Export demand has increased significantly, and export growth has been an important factor in pushing the American economy forward during a period when many were predicting a slowdown. Real export growth outpaced import growth in all four quarters of 2006. With consistent and open economic policies, these trends should continue through 2007 and into the next year.

Economic Report of the President

For CEA's part, we recently released our annual *Economic Report of the President*. The most visible output of the Council of Economic Advisers, the *Report* discusses a variety of key economic policy issues. It is written to be accessible and useful to both economists and non-economists alike.

The *Report* begins with a review of the macroeconomy in 2006 and discusses the Administration's forecast for the years ahead. Having reached a high level of resource utilization by year-end 2006, we expect that growth will slow a bit in 2007 but will continue at a solid pace, with GDP growing in the high 2 percent range.

Because tax policy is so important to the economy, the *Report* discusses pro-growth tax policy and how we can reduce tax distortions that hamper economic growth. The current tax code contains provisions that discourage investment and create impediments to efficiency that affect the level, distribution, and financing of capital investment. Estimates from research suggest that removing these tax distortions could increase real GDP by as much as 8 percent in the long run.

Looking to the long run, our greatest fiscal challenge is likely to be Medicare, another policy that the *Report* discusses. The projected long-term growth in entitlement spending is unsustainable because of the pressure it puts on future federal budgets, and we feel it already. Each year, growing mandatory spending puts budgetary pressure on discretionary spending. It is crucial that reforms to entitlement programs preserve protections against financial risk without having negative effects on the economy.

The events of 9/11 and hurricanes of 2005 have taught us that no one—young or old—is immune to the risk of large-scale disasters. The *Report* examines catastrophic risk insurance as a method of insuring against such events. In particular, the *Report* looks at the effect government policies may have on individual decision-making. Sometimes, well-intentioned backstop policies create adverse incentives that put people in harm's way and increase the cost to the American taxpayer.

The President has made clear his view that diversified energy sources are important for national security and to ensure that the U.S. economy is less vulnerable to the acts of others on whom we may not be able to rely. The *Report* looks at the details of these issues.

The final three chapters in the *Report* focus on the role of flexible and open markets in an efficient economy. One chapter provides an overview of currency markets, the thickest and deepest and most liquid of capital markets. The chapter discusses the different kinds of currency markets and how they work.

A discussion of international trade and investment follows the currency discussion. Both Americans and others find investment opportunities in the U.S. worthwhile. We are able to attract outside foreign direct investment and other investment because of the strength of our economy and prospects for the future. Looking ahead, international trade liberalization in services presents significant opportunities for U.S. workers, firms, and consumers.

In addition to attracting foreign investment, the U.S. attracts foreign workers. The *Report* looks at international migration and comprehensive U.S. immigration reform.

The theme of productivity growth underlies much of this year's *Report*. Policymakers face a challenge: Productivity growth is important for economic growth and many of the underlying issues that they are trying to solve, but there is no single cause of productivity and no single policy to spur its growth. Tax policy can be structured to encourage productivity growth. Entitlement programs, on the other hand, may weigh indirectly on productivity growth if not reformed. Open commerce and financial markets allow productivity to flourish. Productivity growth is a common thread that ties the positive macroeconomic news together and plays a central role in our international competitiveness.

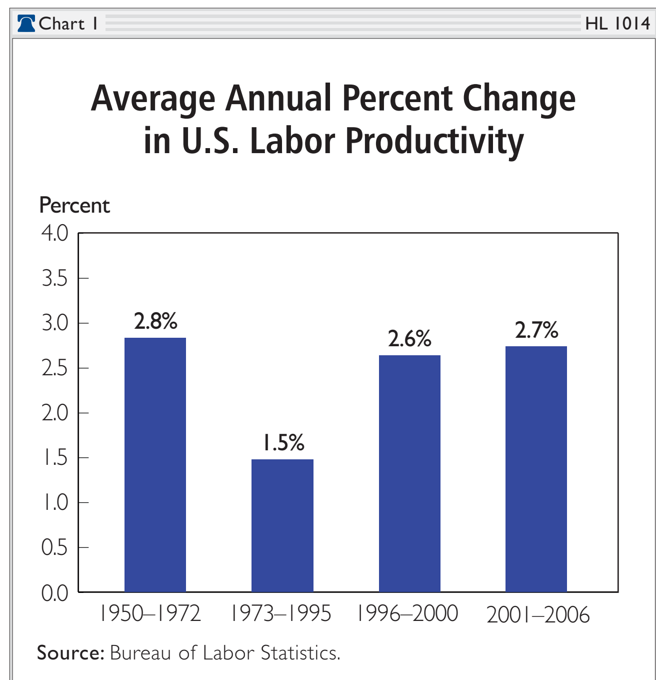
Productivity Growth

Productivity growth is closely tied to economic growth. It helps to keep inflationary pressures moderate and has proven to be both one of our nation's most important economic fundamentals and a defining characteristic of our international competitiveness. In addition, although economists discuss productivity growth using macroeconomic data, its most important result is an increase in individual Americans' standards of living.

The United States is the most productive large economy in the world. Output per capita is approximately 30 percent higher here than output in the developed European countries and Japan.

U.S. productivity growth and output per hour worked are among the highest in the world. Growth in American productivity has been impressive in recent years. The Bureau of Labor Statistics reports that U.S. productivity growth since the end of 2000 has been 2.7 percent per year, outpacing the 2.6 percent average from 1996 to 2000. The current growth rate is substantially above that for the period between 1973 and 1995, when productivity growth averaged only 1.5 percent.

Chart 1 HL 1014

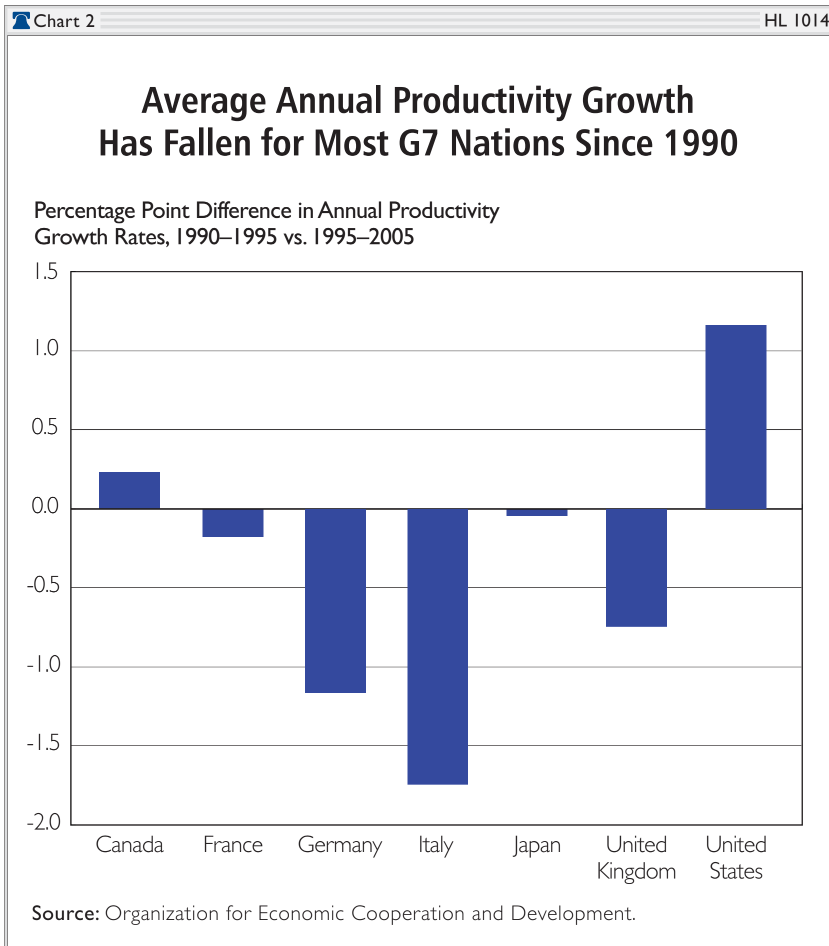


Source: Bureau of Labor Statistics.

Notice the marked increase between the 1973–1995 period and the two most recent periods in Chart 1. This productivity growth rate is remarkable for a country that is already at the top of the productivity pyramid. Raising productivity would seem to be easier for countries that can learn from technological improvements made by other countries, but for the country that leads the world in productivity, a high growth rate is even more impressive.

The impressive nature of American productivity growth stands out even more when we look at productivity growth rates for G-7 countries since 1990.

As seen in Chart 2, the U.S. increased its productivity growth rate over a period in which the productivity growth of most G-7 countries decreased.



Source: Organization for Economic Cooperation and Development.

What makes productivity grow? Labor becomes more productive either because it becomes more skilled, because it has more and better capital to work with, or because we come up with new and better ways to combine labor and capital. Thus, an environment that fosters growth in human capital, physical capital, and innovation is key to both our past growth and the growth we need for our future.

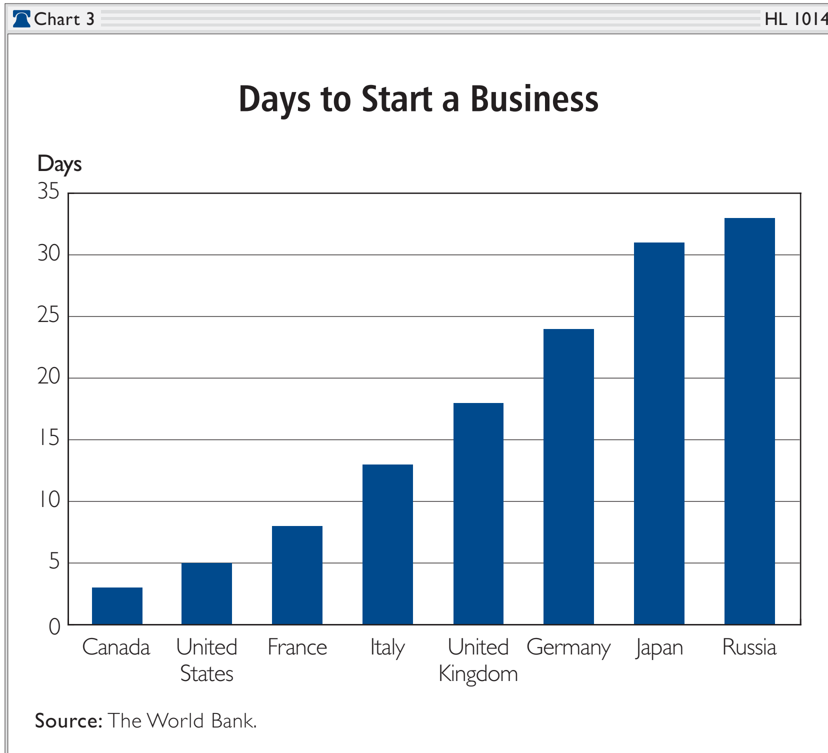
There have been a number of potential explanations for the productivity differences between the United States and other countries. The leading candidates include labor market flexibility and high levels of investment in both physical and human capital. A number of observers believe that low marginal tax rates on work, high incentives to invest in physical capital, and a climate of employment at will have been major contributors. Job security provisions pervasive in Europe and less prevalent in the United States are primary suspects for output limitations found in Europe.

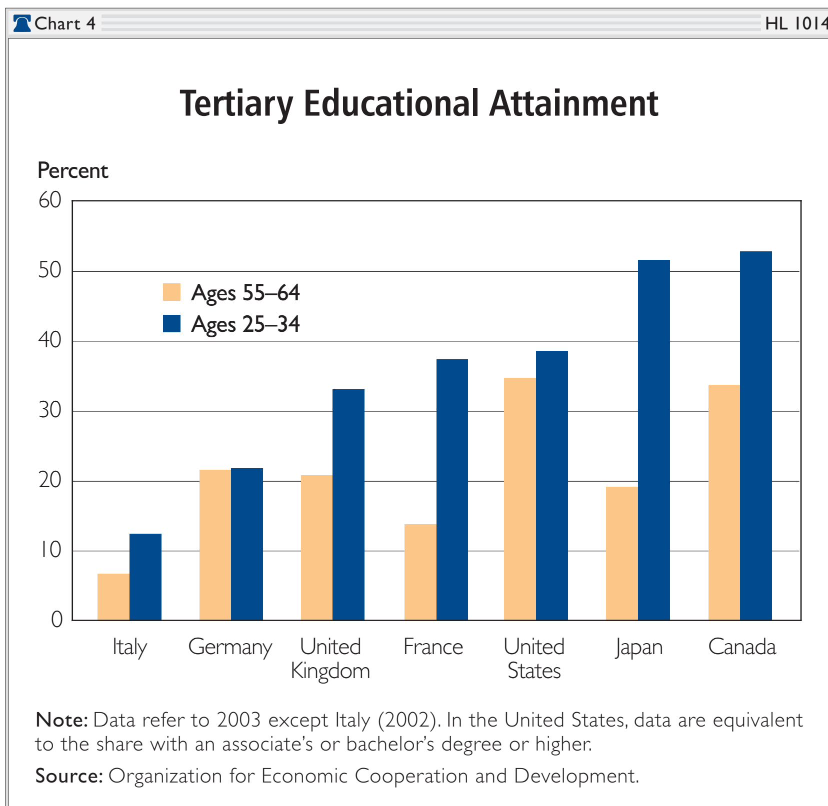
In addition to having a free and mobile labor market, the U.S. also encourages entrepreneurship and business formation. By almost any measure, the U.S. is one of the leading nations in terms of the ease with which individuals can start a new business. Chart 3 shows that Canada and the U.S. lead the G-8 in the ease with which businesses can be initiated.

As important as physical investment is to American productivity, human capital is a key driver of productivity growth in any country. Historically, the United States has led the G-7 in tertiary educational attainment. In Chart 4, the lighter bar for the U.S., which depicts tertiary educational attainment among the cohort of individuals currently aged 55 to 64, is the highest among G-7 countries.

But it is also important to note that while our tertiary educational attainment has gone up, we have lost ground relative to the other G-7 countries—most notably Japan, Canada, and France. The darker bars, which show educational attainment among more recent cohorts, reveal that the U.S. is no longer the leader in educational attainment. In order to maintain our edge in the future, it will be necessary to ensure that we do not allow our investment in human capital to slip.

Another ingredient of economic growth is that individuals believe they have the ability to succeed in this society. When young people do not believe that they have a chance to attain levels of success commensurate with their effort, they cease trying, but the United States has always been a place where



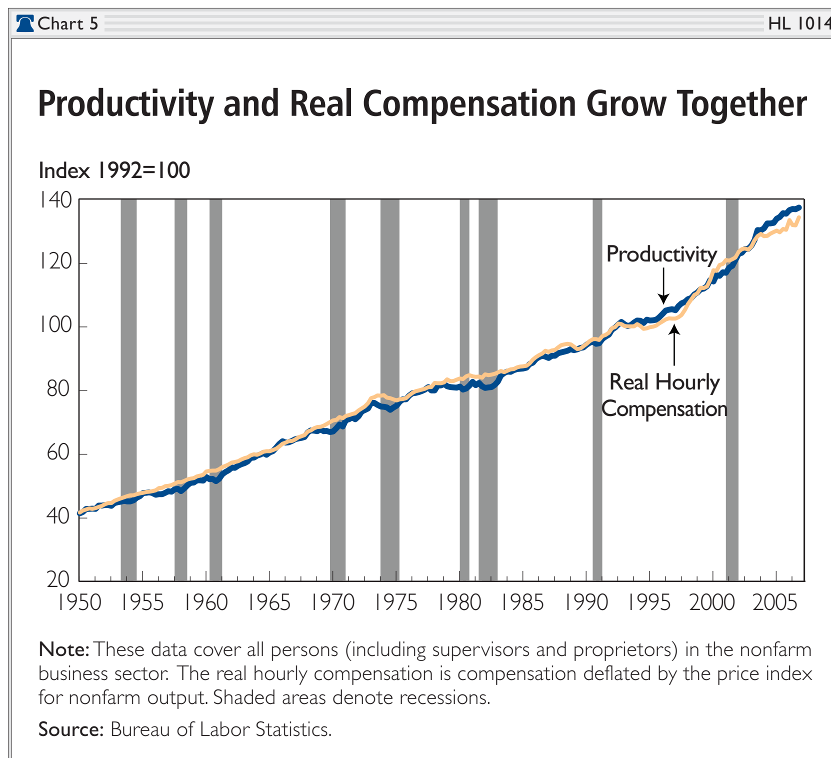


opportunities to move up are widespread. This is best illustrated by looking at the earnings of immigrants. First-generation immigrants in 2003 had median incomes of about $27,000. Second-generation immigrants had median incomes of about $38,000, which exceeds the median income of Americans from third and higher generations. Thus, in one generation, immigrants go from being below the median to above the median.

While output and productivity are of interest in and of themselves, they are of particular importance because wages and workers' standards of living depend on productivity, even over the relatively short run. Over the longer run, hourly compensation and productivity grow together one-for-one.

Chart 5 demonstrates the very strong correlation between productivity increases and real hourly compensation. Notice how closely the lines trace each other. While there are periods during which the two series diverge, they tend to catch up to one another. In particular, wage growth sometimes lags productivity growth—especially coming out of recessions. That was the case coming out of the recession in the early 1990s, where hourly compensation lagged productivity in the mid-'90s and caught up only during the late '90s. It was also true after the recession that occurred in 2001.

In 2006, we saw significant increases in nominal wages above the levels of past years. Real hourly compensation also increased at a solid rate. These trends have helped real wages to begin to catch up with earlier productivity gains, despite high energy prices.



Recent experience illustrates that wages and productivity do not always move together over the very short run. It is also true that hourly wage growth is lower than compensation growth because benefits have been growing over time. Some of this is a real increase in worker well-being, but some may reflect rising costs of providing the same level of benefits.

Wage growth lagged productivity growth in the early parts of this recovery, but profits have enjoyed high rates of growth. This has raised the question of whether profits have displaced wages in our economy. Two points are relevant to this question.

First, corporate profits are more volatile than is employee compensation.

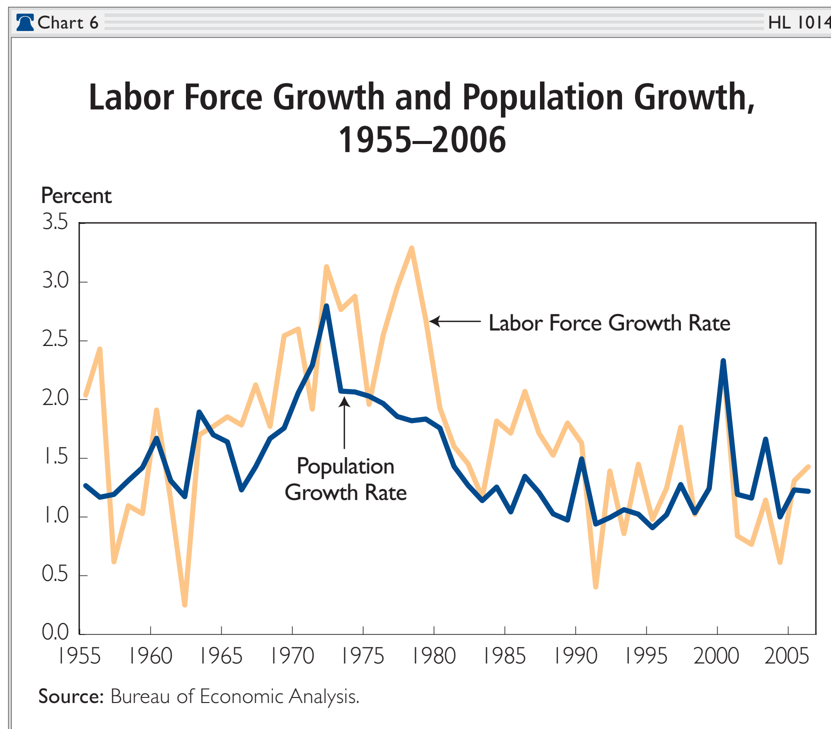
Second, profits and wages follow a distinct pattern over the business cycle: After a recession, productivity growth increases, and wages tend to remain flat. As a result, costs stay low and profits rise. As the labor market gets tight, wages increase and eat into profits, and the profit rate declines.

The last three years have seen high profitability commensurate with high levels of productivity growth. Now wages are rising, and our forecast is that profit rates will decline in the future, bringing them back to more normal levels. Normal profit levels should be sufficient to sustain incentives for business investment going forward.

Productivity gains have been an important component of recent output growth, but employment gains have also contributed to that growth. As we go into the future, unemployment rates are now sufficiently low that it is unrealistic to expect to see huge gains in output from increased labor. That is true even more so as we move into the distant future, because the slowing growth of the population and the aging of baby boomers will mean a smaller supply of workers to support the economic engine.

By far the single most important determinant of jobs in the economy is population. In Chart 6, it is apparent that there is a high correlation between population growth rates and labor force growth rates. It is also clear that population growth has slowed relative to the high rates that we experienced about one generation ago. In order to sustain growth in output, it will be necessary, therefore, to ensure that productivity increases.

To put this in historical perspective, note that the U.S. working-age population increased by 84 percent between 1950 and 2000. Between 2000 and 2050, the working-age population is projected to increase by only 34 percent, while the elderly population is projected to more than double. And our situation, incidentally, is less problematic than that facing other countries. For example, Japan's working-age population is expected to decline by 39 percent over that same period, and Italy's working-age population will decline by 33 percent. All of these trends increase the dependency ratio and make productivity



Source: Bureau of Economic Analysis.

growth even more important to maintaining our standard of living.

What We Can Do

What can we do specifically to ensure that we continue to grow at high rates?

First, we must make sure that marginal tax rates stay low. The most important way to encourage growth in an economy is to maintain the smallest possible difference between the before-tax and the after-tax rates of return to investments, both in physical and human capital. Raising the level of capital per worker makes workers more productive and leads to higher wages in the long run.

Second, we must ensure that we do not discourage investment in human capital. The strength of our economy depends to a large extent on the capital that is embodied in people through their skills. If individuals see little return to investments in their skills because of high tax rates on moderate to high wage earners, the incentives to invest in human capital will be dampened.

The President has outlined a competitiveness initiative to make sure that Americans have the skills to compete in the modern world. We must continue to push for reform in K–12 education, which has been the weakest component of our human capital investment structure. Fortunately, our colleges and graduate schools are the best in the world, but we must also make sure that those Americans who do not go on to college also get the skills that allow them to compete in a modern American economy. Strengthening K–12 education, reducing our dropout rates, and ensuring that all of our young citizens receive high-quality education will be important not only in the near future, but for the rest of the 21st century.

Third, we must remain open to trade. Countries that have closed their borders in attempts to shelter domestic industries have suffered in productivity growth, which has cost their citizens dearly in terms of their living standards. It is important to ensure that those who are adversely affected by trade have a safety net available to them, but we must not use the losses of some as a justification for protectionist policies that will harm us and our children.

Finally, foreign investment has been an important source of capital for the United States. Openness to foreign capital has given the United States the flexibility it needs to deepen its capital stock and improve its productivity. We must make sure that we maintain our long tradition of allowing investment to flow freely into our economy.

Conclusion

In conclusion, productivity grows as a result of investment in physical and human capital, which leads to new technologies. The American economy is relatively unimpeded by restrictions that hinder productivity growth in other countries. We need to maintain the incentives to invest in physical and human capital to ensure that productivity growth will continue to generate improvements in the typical worker's standard of living.

Questions and Answers

QUESTION: Joanne Morrison with Reuters. You talked about the health of the economy, and I know in the past you've mentioned that the housing marketing decline isn't likely to move into other areas. We have seen some weakness, and as of late we have had this shock with the sub-prime market; many of the loans written last year were sub-prime loans. I was wondering if you could address that and see if there might actually be a risk of some sort of contagion elsewhere in the economy.

DR. LAZEAR: The housing market obviously has had a significant negative effect on economic growth. You mentioned the shock in the sub-prime market. I don't think I would label it a "shock." I think what we see in the sub-prime market is the continuation of a trend that started a few months back, even a year back. It's not an unexplained trend; obviously, when you see interest rates going up, that's going to put pressure on adjustable rate mortgages, and we tended to see it in that sector first.

I think the more important question, or the issue I would focus on, is not so much whether it's going to spread. I don't think many people believe that it's going to spread; it's simply too small a part of the total economy for it to spread. The issue is whether it's symptomatic of some more general underlying phenomenon that's just showing up first in the sub-prime market. I think the answer to that is, probably not. The evidence that we've seen is that the banking sector is actually very strong, better capitalized now than it was a year or two ago, so that sector looks like it's in very good shape.

We do know that the housing market will have an impact on GDP at least for the next six months, because there's a lag. So if you see housing starts down in the second half of 2006, we know that's going to play out during the first half of 2007. I think most people are expecting that to turn around, hopefully in the near future because sooner is better than later. But we are expecting growth in the second half of 2007 to be along the lines of the growth that we saw last year, somewhere in the 3 percent range, so our forecast is still that 2007 will be a good year, kind of in the high twos.

QUESTION: My name is Ed Powers, no affiliation. You briefly mentioned entitlement programs as a factor: Medicare, Social Security, Medicaid. It seems like those are the "looming monster" things to deal with in the future, and it doesn't seem like much is happening at the present time. It appears that it has to be a catastrophe before Congress will do something about it. How do you see that as impacting the economy in the near and longer terms, and what really can we do about it?

DR. LAZEAR: We see those impacts already because when you have entitlement spending increasing, it crowds out other kinds of investment. That's not to say that Medicare isn't an important program, that Social Security isn't an important program; I think everybody recognizes that those have been important and have been positive contributors to the social fabric of the United States. But they have to compete with other good programs as well, and investment in education is a clear case in point. So when we think about discretionary expenditures, like investment in education programs, it seems to me that the major short-run pressure is crowding out other kinds of investment that would enhance the human capital stock of the United States and would increase economic growth.

Whether we have to wait for a disaster or not remains to be seen. As you know, the President has been pushing very hard on this. Treasury Secretary Hank Paulson's been going to Congress, trying to persuade people to come to the table, to come to talk to us. We want to make some headway on this. It doesn't necessarily mean we're going to solve everything in the next year, but any movement in that direction is positive, and we'd like to get started on that. The Administration would welcome having the Democrats in Congress come talk. There are no conditions, no preconditions. Let's get together; let's start moving on this. There are surely some areas where we can make some progress, and any progress on this would be positive.

So I hope we don't have to wait for a disaster. I hope that's not the case. But it is tough, and I think we all recognize that it is tough to make progress in this area.

QUESTION: Alison Acosta Fraser, The Heritage Foundation. I don't think we need to wait for a disaster; I certainly hope not. I know that there are many institutions, including The Heritage Founda-

tion, here in Washington and beyond who are working to make sure that that's not the case, including setting up good dialogues with the country and among lawmakers, so they can do that with the President in a very bipartisan way.

The President also has a number of proposals on the health care front that you may care to comment on. Two of them, I think, are especially important. One of them is the tax treatment of health care insurance. I think that's important because it changes the incentives for purchase of health insurance and also really equalizes the playing field. The second is a number of proposals for Medicare that will really rein in by a quarter, I believe, the long-term costs of the Medicare $32 trillion unfunded obligation.

DR. LAZEAR: Let me focus on the first one, because I think that's probably the one that's most important in terms of long-run success of the health program. We think of that initiative as being one that can really change in a very dramatic way and a very positive way the nature of health care in the United States. The program, just to elaborate a little bit on what it is, is to move to a $15,000 standard deduction on taxes and do that as a replacement for the current deductibility of health care at the employer level.

As Alison mentioned, there are a couple of reasons for doing that. One is that there is currently a distortion; it's both a distortion and unfair in the way it treats employer contributions to health care versus non-employer contributions to health care. But I think more important is that it provides the right incentive on the margin for people to take their health care expenditures into account. Right now, people are not rewarded appropriately for saving money on their health care plan, so they buy a Cadillac plan, a significant portion of which is covered by the government.

This plan would move away from that. You would get your $15,000 exclusion irrespective of the plan that you bought, as long as it was a qualifying plan. Then if you want to have a better plan, you have that choice. If you want to have a plan that doesn't give you first dollar coverage, you also have that choice.

That provides better incentives on the margin, and it also deals with the uninsured. The reason that it deals with the uninsured problem is that it gives people, even at the very bottom of the working income distribution, a pretty significant amount of money—something on the order of $2,000 to people earning $15,000 a year.

Just think about when you're home at night, how many calls you get from telemarketers. Well, you've got an opportunity here. There's $2,500 lying on the table; think about how many insurance companies are going to be calling these people and saying, "Guess what? We can give you a health insurance policy that will cost you $1,500, but you'll get $2,500 from the government. You can net the $1,000 and then still have the $1,000. We'll take care of the whole thing; you don't have to do anything." I think it's just a significant opportunity. I think it could really have a very large effect on transforming our health care.

It also meshes nicely with the second point that you mentioned, which is the reform of Medicare. One of the problems that we've had in the health care sector is that costs have been rising much more rapidly than inflation, and that's been going on for a pretty significant number of years now. Again, a part of that is a result of people not having control over their own expenditures and not having to face the incentives associated with their own expenditures. This will give people better incentives in health care and, we believe, will bring about additional efficiency and cost saving in that sector.

So we think it's a fabulous plan. I've talked to people on both sides of the political spectrum in terms of both politics and economics. I've talked to a number of Democrats, influential Democratic economists, and there is a lot of enthusiasm for this. So I really hope that this thing gets some legs and that we can actually move it forward. I think it would be terrific for the country and terrific for the health care industry as well. I think it would rationalize things and make things much more productive.

—Edward P. Lazear, Ph.D., is chairman of the President's Council of Economic Advisers.