America's Challenge

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Thank you. I am very honored by this award and by the opportunity to deliver this year's Irving Kristol lecture.

I knew Irving for over 30 years and admired him as a public intellectual who was devoted to the development of ideas that could shape public policy in favorable ways.

Irving played an important part in my own life. I met him when I was a first year assistant professor at Harvard. Someone had told him I had some novel ideas about reforming health insurance and he encouraged me to write about them for the Public Interest. Over the years, the Public Interest had a small but influential group of readers who shaped conservative thinking and action about domestic policies. We should all be grateful to Irving for

[1] Professor of Economics, Harvard University. These remarks were delivered as the Irving Kristol Lecture of the American Enterprise Institute on May 3, 2011. A longer version is available at http://www.aei.org/docLib/Feldstein-speech-2011-Kristol.pdf

creating the Public Interest and for his devotion to maintaining its relevance and its impact.

I am also honored to be standing here tonight because of my admiration for the American Enterprise Institute. Many years ago, at a time when conservative ideas were scarce, particularly in the academic community, AEI brought rigorous debate to public policy issues. I saw many of those ideas come to fruition when I was in the Reagan White House. AEI continues to be a major contributor to public policy. We are all better off because of what AEI has done and what it continues to do.

China's Rise

Let me begin with an important – and to many people disturbing -- economic fact: sometime in the next 15 years China's economy will be bigger than that of the United States. That presents a major economic challenge, military challenge, and political challenge. Those challenges and America's response are my subject this evening.

China is still a poor country with real per capita income less than one-sixth of the U.S. level. But China's population of 1.3 billion people is more than four times ours and its per capita income is growing rapidly. That makes it inevitable that the real value of China's GDP -- the total value of goods and services produced in China (adjusted to US prices) -- will soon exceed America's.

China's real GDP is now about two-thirds of ours. Over the past three decades, China has been growing at a 10 percent real rate while we have been growing at about 3 percent. If that continues, China's GDP will exceed ours within just six years. But even if China's growth rate slows substantially while ours accelerates, China's GDP will catch up within 15 years. So China's future place as the world's largest economy is virtually inevitable.

I would not have believed that when I first visited China 30 years ago. China was then a desperately poor country in which the heavy hand of its communist government reduced productivity and prevented growth. It was illegal to hire employees or to own production equipment. Agriculture was still collectivized. But all of that was about to change as the Chinese government began to recognize property rights and to welcome entrepreneurship.

Today's China is a strange mixture of entrepreneurial capitalism and state owned enterprises. China's real GDP is now about 20 times what it was when I visited there in 1982. The Chinese people have taken seriously the advice of Deng Xiaoping when he said "To get rich is glorious."

Too bad that sentiment is not shared by some of our own senior political leaders.

But here is the important point: China's imminent overtaking of America's GDP does not diminish our ability to grow and to raise our standard of living. Even when China's total GDP catches up to ours, our per capita income will be much higher than China's. And the United States can continue to have the highest standard of living in the world if we pursue sound policies here at home.

But China's total GDP does have important implications for America's military and trade policies.

The Military Challenge

The United States and China now have relatively good political relations and China is not a current military threat. Today's leaders in China are focused on achieving economic growth, raising domestic living standards, and preserving internal stability. Tensions over Taiwan, Tibet and the South China Sea are being dealt with diplomatically.

But China is building a serious military capability. China is already a nuclear power, developing a navy with global reach, acquiring an aircraft carrier, has anti-ship missiles, has demonstrated a stealth fighter plane, and clearly has sophisticated skills in cyberspace.

The strength and quality of China's military are not currently up to U.S. standards. But no one doubts that China's defense budget will grow with its GDP. While the U.S. political system has forced defense spending to shrink from nine percent of GDP in the Kennedy years to less than five percent now, China doesn't face the same political limits on its defense spending.

What are the implications for America's defense policy? The key is to focus on the future generations of Chinese civilian and military leaders. The United States should maintain a military capability such that no future generation of Chinese leaders will consider a military challenge to the United States or consider using military force to intimidate the United States or our allies.

China's future military spending and weapons development will depend on China's perception of what the U.S. is doing and what we will do. If we show a determination to remain invincible, China will not waste resources on challenging us in an arms race.

It is important that our Asian friends like Japan, Korea, Singapore, and Australia see the commitment of the United States to remain strong and to remain present in Asia. Their relations with China and with us depend on what they can expect of America's future military strength.

The navy has a particularly Important role to play, including the navy's presence to enforce freedom of the seas, naval visits to Asian ports, and joint exercises with other navies.

We cannot postpone implementing a policy of future military superiority. We have to work now to develop the weapon systems of the future. We have to maintain the industrial and technological capacity to produce those weapons. We have to make it clear by our budgets and by our actions that we are <u>the</u> global force now and will continue to be that in the future.

While reducing fiscal deficits is very important, that task should not deflect the federal government from achieving its primary responsibility of defending this country and our global interests, both now and in the future.

President Obama's proposal to shrink defense spending to less than four percent of GDP in the current decade threatens our capabilities and sends the wrong message about our future strength.

And as we think about our military role in Asia and elsewhere, we have to ask ourselves whether we have a moral obligation to defend our allies. Or is our appropriate military policy just limited to protecting our trade, our foreign investments, and our access to oil?

There are those who say the United States should not be the global policeman. But if not us, who? As the only democratic superpower with the ability to defend and to punish, do we not have a moral obligation to be willing to use that power?

There are also those who say we cannot afford to be the global policeman. But should we really be deterred when the cost of our entire military budget -- including the actions in Iraq and Afghanistan -- is now less than five percent of our GDP? There is no danger of bankrupting ourselves by so-called “imperial overreach” when we spend less than five percent of GDP on defense.

While there is certainly waste in military procurement, that is inherent in the Congressional appropriation process. Cutting the defense budget would reduce our military capabilities rather than just removing waste.

The Challenge to Trade and Investment Policy

Let me turn now from military issues to comment on the challenge that China's growth poses for America's trade and investment policies.

China has become the major customer for companies around the world. It's a striking fact that General Motors now sells more vehicles in China than it does in the United States.

Global companies also want to produce in China, to be close to potential buyers and also to hire employees at more favorable wages than they can in the United States, Europe, or Japan. This will remain true even though rising wages in China will erode some of that cost advantage.

The increasing size of the Chinese market creates a challenge for U.S. trade policy and our related foreign policy. China will inevitably want to leverage its trade and investment relations with other countries in pursuit of its political, economic, and military aims. The best way to prevent Asia becoming a closed trading block and a China-centered political coalition is for the United States to expand free trade agreements and other trade arrangements with the countries of Asia.

Recent experience shows some of the risks that could lie ahead for American firms in China. One example is the Chinese policy to require foreign firms manufacturing in China to transfer their technology to a Chinese partner. American CEOs with whom I spoke about this were outraged but felt they had no choice since they want to produce and sell in China. Pressure from the United States and other governments eventually caused a modification of this policy, but it is not clear how this will evolve.

Although China is bound by WTO rules, policies of limiting market access for government purchases and requiring technology sharing are not technically prevented. As China flexes its economic muscles, the United States and other countries will have to develop a strategy to protect the lrights of our firms in China.

The Challenge at Home: Raising America's Standard of Living

I turn now to the challenge at home. At the beginning of my remarks I emphasized that China's eventual overtaking of U.S. total GDP does not diminish America's ability to grow and to remain the greatest economy in the world, the country to which people around the world want to come, and the country that is the global leader in science and culture and creative industry.

Our growth and our standard of living depend on what we do and not on what the Chinese do.

Although our economy has its cyclical ups and downs, our 2.3 percent growth of real per capita income during my life has been enough to raise real per capita income more than five fold during those years. In today's prices, per capita GDP rose from just over $9,000 in 1939 to more than $47,000 last year. The challenge is to maintain that rate of growth into the future or to raise it even higher.

Small differences in the growth rate can mean a great deal. If the average growth rate of GDP per capita had been one percent less during my lifetime, our income level today would be only half what it actually is. And if we could have grown at one percent more per year, our incomes now would have twice today's buying power. So preserving or increasing our economic growth will have a powerful effect on our nation's future.

I fear that the current policy path will not permit strong future growth. If we want to achieve satisfactory growth, we need to shift to more pro-growth policies.

The key to our standard of living is productivity – the quantity of goods and services produced per hour of employee work. The faster the growth of productivity, the faster will be the rise in real incomes and in our standard of living.

The growth of productivity depends on the quality of our workforce, the growth of our capital stock, the effectiveness of management, and the introduction of new technology and new products. Each of these is influenced by government policies -- by taxes, regulation, government programs, and fiscal deficits.

While government policies cannot produce the creative drive that generates exciting new products -- products that make American ingenuity the envy of the world -- bad government policies can stifle that creativity and make it more difficult to convert new ideas into real products at prices that millions of people around the world can enjoy.

You may have noticed that I have not said anything about international “competitiveness”. That wasn’t an oversight. Our nation’s ability to export and to replace imports with American made goods and services doesn’t raise our standard of living unless it is the result of higher productivity. Productivity is fundamental, not competitiveness.

Indeed, raising America’s competitiveness can actually depress our standard of living if it is the result of a weaker dollar. If the Chinese raise the value of the renminbi, as the current and previous administrations have urged, that would increase our ability to compete with China both at home and abroad. But the rise in the renminbi would increase the real cost of everything we buy from China. For the American public as a whole, a stronger renminbi would mean a lower standard of living. So let’s stop focusing on competitiveness and focus instead on raising our productivity -- the amount that we produce per worker.

A fundamental source of American productivity is the quality of our workforce and education is key to that quality. American higher education is very good. That reflects our tradition of independent private universities and the national market in higher education in which those institutions compete for students and faculty.

The real problem with our education system is the primary and secondary schools. The problem is not just in poor neighborhoods in central cities. American students as a whole do poorly on standardized international tests of science and mathematics.

We know the primary reasons for this failure -- the lack of choice for students and their parents and the monopoly power of teachers' unions. The result is that teaching does not attract talented college graduates and that schools do not weed out poor teachers. Let's hope that the accumulating evidence on the positive effects of school choice and the changes that computer technology will make possible in education will bring the needed reforms.

Our productivity growth also reflects the way that government policies, especially tax policies, influence what students do when they leave school. High tax rates affect the occupations they choose, the effort they make on the job, their decisions to change jobs in pursuit of better opportunities, and their willingness to take risks in pursuit of a good idea. The entrepreneurial drive is strong in America but it can be suppressed by high tax rates and complex regulations.

Marginal tax rates on incremental earnings are too high. A middle income couple making $80,000 a year now faces a marginal tax rate of 45 percent on every extra dollar they earn because of the combination of the federal income tax, the payroll tax and state taxes. But while 45 percent is a typical marginal tax rate, all personal taxes combined collect less than 15 percent of GDP.

The reason we have such high marginal tax rates to collect 15 percent of GDP is that the tax code is full of special features that reduce tax revenue. Those features are really forms of government spending that have been built into the tax code.

If Congress wants to reduce government spending, it has to look beyond the outlay side of the budget to the spending that is imbedded in the tax code.

Tax credits for buying hybrid cars or solar panels are just like government spending to subsidize their purchase. The exclusion from employees' taxable incomes of employer payments for health insurance is just like government spending to subsidize health insurance.

These special features -- known as tax expenditures -- add more to the deficit each year than all the non-defense discretionary spending in the budget. Once enacted, tax expenditures do not face annual review as part of the appropriation process.

Although limiting the use of tax expenditures would produce additional tax revenue, it is very different from other revenue increases. It doesn't raise marginal tax rates, doesn't discourage work or entrepreneurship, and doesn't tax saving and risk taking. It is really a reduction in government spending, not a tax increase.

It is clear that we need tax reform to lower marginal tax rates and improve incentives for saving and investment. Just one example is the tax on capital gains.(I discuss other aspects of tax reform in the printed version of these remarks that will be distributed at the end of the evening.) The capital gains tax not only discourages saving and risk taking but also locks investors into existing investments rather than freeing their capital to invest in new ventures. It is an unfair tax: a double tax on retained earnings that have already been taxed at the corporate level, a tax on nominal gains that reflect inflation, and a tax on all gains without allowing a full deduction for losses.

Reforming our tax system should be combined with bringing our budget deficits under control. The unprecedented deficits now projected for the current decade and beyond will absorb most of private saving, crowding out productive investment and keeping the U.S. dependent on unreliable capital inflows from abroad.

We cannot eliminate those deficits and the resulting explosion of the national debt by faster economic growth or by inflation. We have to slow the growth of spending, particularly the so-called entitlement programs for the future aged. The right solution is to provide a basic level of tax-financed social security pensions and medical care for retirees and to encourage individuals to supplement those benefits by saving more in their preretirement years.

Reducing spending also means cutting the spending done through the tax code. Limiting those tax expenditures would allow raising revenue to reduce the budget deficit while lowering marginal tax rates at the same time. All of this is a tough political agenda. But it is doable.

It is worth remembering that after World War II we reduced our national debt from 109 percent of GDP in 1946 to 46 percent of GDP in 1960. We did this by avoiding any growth of the government's debt during those years -- that is, by balancing deficit years with surplus years. The combination of real growth and moderate inflation was then enough to halve the ratio of debt to GDP in 15 years. We did that then and we can do it again.

And we should insist that reducing poverty, not limiting inequality, is an appropriate goal of government policy. While a fair distribution of tax burdens is important, we should reject the spiteful egalitarianism of those who would use high tax rates to reduce income inequality.

A Picture of Success

If we do the things that need to be done -- improving education, reforming taxes, reducing government deficits, stabilizing the government debt, and eliminating damaging regulations – if we do these things, we will unleash the rising incomes that American creativity and a free enterprise system can produce.

Kate and I have a new grandson, born just six months ago. So I think about what life could be like when young Otto is 30 years old. Just maintaining the historic 2.3 percent a year growth of per capita income would -- in just those 30 years -- double the level of individual real incomes in America. And when Otto is as old as I am now, real incomes would be five times what they are today. The average per capita GDP of about $45,000 today would be

$90,000 in today's prices after 30 years and more than $200,000 in today's prices after 70 years.

Those income levels would make so many things possible that are not possible today. Otto and his generation would be able to take advantage of the remarkable improvements in health care that science will bring, spending a larger share of income on health care while still having very large amounts left to spend on everything else. They would be able to devote much more income to education, to cultural activities, to the environment, to maintaining America's security, and to virtually eliminating poverty.

But all of that will only happen if we act now to make it so. That is America's challenge.

Thank you.

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