

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 Kristol for more than 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 also 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 that I had some novel ideas about reforming health insurance and he encouraged me to write about them for the *Public Interest*. Over the years I found the *Public Interest* to be an excellent way to present ideas about a wide range of subjects to the relatively small but highly influential group of *Public Interest* readers who helped to shape conservative thinking and action about domestic policy. We should all be grateful to Irving for 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 in a wide range of areas. 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, political challenge, and psychological challenge. Those challenges are my subject this evening.

China is, of course, still a very poor country with a much lower average income than we enjoy in America. Real per-capita income in China is 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 U.S. prices)—will soon exceed America's GDP.

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China's GDP recently exceeded Japan's, making China the second-largest economy in the world. Although we remember Japan's industrial expansion in the 1980s, its relatively small population means that Japan's economy could never become as large as ours.

According to official U.S. government estimates, China's real GDP is now about two-thirds of America's GDP. Over the past three decades, China's GDP has been growing at a 10 percent real rate while the U.S. GDP has been growing at about 3 percent. If those growth rates continue, China's GDP will exceed ours within just six years. But even if China's growth rate slows to 7 percent a year while ours accelerates to 4 percent, China's GDP will catch up to ours by 2025. So China's future place as the largest economy in the world 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 then illegal for anyone 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. Anyone who now visits Beijing or Shanghai or dozens of other Chinese cities sees increasing prosperity and growth. 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." It's too bad that that sentiment is not advocated 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 very 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 the rapid growth of China's *total* GDP does have important implications for America's military and foreign policy and for our policies toward trade and foreign investment.

I'll begin my remarks by commenting on these military and trade challenges. I will then return to the challenge of achieving a strong rate of growth and a rising living standard here at home.

The Military Challenge

The United States and China now have relatively good political relations and China is not a current military threat to the United States. There are tensions over Taiwan and Tibet and the South China Sea but these are being dealt with diplomatically. Today's leaders in China are focused on achieving economic growth, raising domestic living standards, and preserving internal stability. They want to engage with the United States in a positive way by promoting trade and investment in China. American administrations and businesses are responding in a similar positive way.

But China is building a military capability that will grow in scale and force as its total GDP grows. China's military spending has been growing at double-digit rates for decades. China is already a nuclear power, is developing a navy that can have global reach, is acquiring an aircraft carrier, has anti-ship missiles, has demonstrated a stealth fighter plane, and clearly has sophisticated skills in cyberspace.

The quality of China's military force is not currently up to U.S. standards. The United States now clearly has the world's strongest military. But no one doubts that China's defense budget will grow with its GDP. And 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 of GDP now, China does not face the same political limits on the share of its GDP that it devotes to defense.

What are the implications of this for America's defense policy and defense spending? The key is to focus on the future and to recognize the virtual certainty of China's growing economic power.

Our focus should be 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 its weapons development will depend on China's perception of what the United States is doing and what we will do in the future. If we show a determination to remain invincible, China will not waste resources on trying to challenge us in an arms race.

China is in many ways a resource-poor country that depends on imports of oil, iron, and other raw materials as well as on imports of food to feed its people. That is not likely to change. China is therefore now buying oil in the ground around the world and arable land in Africa to grow food for the Chinese people. Some countries in the past have used military force to gain secure access to such materials. China's future leaders should not be tempted to follow that path.

It is important that our allies and friends like Japan and Korea and 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 in this, including the Navy's presence in international waters to enforce freedom of the seas, naval visits to Asian ports, and joint exercises with the navies of other governments.

We cannot postpone implementing a policy of future military superiority until some future year. 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 weapon systems. We have to make it clear by our budgets and by our actions that we are *the* global force now and will continue to be that in the future. While reducing fiscal deficits is very important, that task should not prevent the

federal government from achieving its primary responsibility of defending this country and our global interests, both now and in the future.

And while my remarks have been focused on China, the United States now faces current global threats that cannot be ignored. We need a strong military force now and a budget that is adequate for current operations as well as for preparing for the future. The president's proposal to shrink defense spending to less than 4 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? And as we think about our national interest, shouldn't we look ahead and consider how developments in any one country can eventually affect a broader geographic area?

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? Is anyone now proud of America's isolationism in the 1930s that prevented the United States from assisting European nations that were being overrun by Nazi Germany?

There are also those who say we cannot afford to be the global policeman. But should we really be deterred from that role when the cost of our entire military budget—including the actions in Iraq and Afghanistan—is now less than 5 percent of our GDP? There is no danger of bankrupting ourselves by so-called "imperial overreach" when we spend less than 5 percent of GDP on defense. And while there is no doubt waste in military budgets and military procurement, that is unfortunately 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 some brief comments on the challenge that China's economic growth poses for America's trade and investment policies.

China, with more than \$1.3 trillion of annual imports, has become the major customer for the exports of many companies and many countries. Many foreign firms also produce in China and sell to the Chinese market. It is a striking fact that General Motors now sells more vehicles in China than it does in the United States. The countries and companies that sell in China recognize that the size of China's market will continue to rise rapidly as China's GDP increases and its middle class grows. They want to continue to sell increasing amounts to those Chinese buyers.

Global companies also want to locate production facilities in China. They do that to be close to potential buyers but also to hire both low-skill and high-skill employees at more favorable wages than they can in the United States, Europe, or Japan. This will remain true even though rising wages and increasing property rents in China will erode some of the cost advantage of producing there.

The increasing size of the Chinese market creates a challenge for U.S. trade policy and for 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 a deterioration of Asia into 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.

The recent experience of U.S. manufacturers in China is an example of the risks that could lie ahead. Two years ago the Chinese government announced a policy that would allow only Chinese firms to sell products to the Chinese government and to all Chinese governmental entities. Moreover, the Chinese decree said that even U.S. firms that are producing in China would be classified as foreign and therefore not eligible to sell to government entities. Since so many Chinese firms—from state-owned enterprises to local hospitals—are technically government entities, this policy would exclude American firms from a large part of the Chinese market. Fortunately, in response to U.S. pressure, the Chinese government eventually revised the rules to treat American firms that are based in China as Chinese for the purpose of this restriction.

The Chinese government also declared a policy that would require foreign firms that want to manufacture in China to transfer their technology to a Chinese partner. American CEOs with whom I spoke about this were outraged but felt that they had no choice since they wanted to manufacture 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 in the future.

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

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

Let me now turn to the challenge at home. At the beginning of my remarks I emphasized that China's growth and its 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 had its cyclical ups and downs, the 2.3 percent average annual growth rate of real per-capita GDP that America has experienced 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 \$9,070 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 1 percent less during my lifetime, our income level today would be only half of what it actually is. And if we could have grown at 1 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 policy path that our economy is now on 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—that is, 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 can be influenced by government policies—by taxes, regulation, government programs, and fiscal deficits.

But 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 “competitiveness”—our national ability to export and to compete with imports from China and other countries. That wasn't an oversight. Our nation's ability to export and to replace imports with American-made goods and services does not 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 rather than of greater American productivity. 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. It would help American firms and workers that want to sell to China and that compete with Chinese products here in the United States. But the rise in the renminbi would increase the real cost of everything we buy from China. For Americans as a whole the increased competitiveness brought about by 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 the tradition of independent private universities and the national market in higher education in which those institutions compete for students and faculty.

We could of course do better and I worry that our system of financing students in public postsecondary institutions is making it hard for the private institutions to survive and flourish. Fewer than 30 percent of students are enrolled in private institutions. Wouldn't it be better if, instead of subsidizing their state public-sector universities and colleges directly, the state governments gave scholarship grants directly to students?

We are also failing to keep many of the talented foreign-born science and engineering graduates of our universities here in America because of our immigration policies. Nearly half of our nation's output of PhDs in science and engineering goes to foreign nationals, many of whom would like to stay in this country but are forced to leave. What's wrong with the idea of giving a green card to anyone who gets an American PhD in science or engineering?

But the real problem with our education system is in the primary and secondary schools. While there are some excellent schools, far too many of our schools are failing to educate the students that sit in their classrooms. 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. The most recent OECD-sponsored test of science and math skills found American students below the average for all the OECD countries. Chinese students in Shanghai finished first. The scores of American students were well below those in such diverse countries as Korea, Canada, and Finland.

We know the primary reasons for this failure—the lack of choice that students and their parents have and the power of monopoly teachers unions. The result is that teaching does not attract talented college graduates and that schools do not weed out poor teachers. I can only hope that the accumulating evidence on the positive effects of school choice and the changes that computer technology will make possible in education will improve this situation in the future. The recent willingness of state governors to stand up to public unions over budget issues gives me some optimism that someday they will focus on the seniority rules and other features that handicap our educational system.

Our productivity growth also reflects the way that government policies, especially tax policies, influence what students do when they leave school and join the workforce. High tax rates affect the occupations they choose, the effort that they make on the job, their desire for promotion, their decisions to change jobs and to move in pursuit of better employment, 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.

Let me spend a moment on the effect of tax policies on economic incentives, a subject that has been a focus of much of my research over the years.

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

The reason that 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 revenue. Those features are really forms of government spending that have been built into 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 on the same excessive first-dollar health insurance. And the deductions for interest on home mortgages provide a government subsidy for excessive investment in homes and excessive mortgage leverage. Those overleveraged home mortgages were important contributors to the housing bubble and subsequent collapse.

These special features—known as tax expenditures—add more to the deficit each year than all the nondefense discretionary spending in the budget. Once enacted, the tax rules that create tax expenditures do not face any annual review as part of the appropriation process, a review that is in principle given to ordinary defense and nondefense outlays. Restricting the size of these tax expenditures would generate revenue that would permit reducing marginal tax rates while at the same time cutting the budget deficit.

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

It is possible to limit spending through the tax system without eliminating or reducing any specific tax expenditures. A better way is to allow individuals to have all of the current tax expenditures but just to limit the total tax saving of each individual to a maximum percentage of that individual's adjusted gross income. In other words, individuals can continue to have all of the current tax expenditures but cannot be too greedy about the total amount of tax they save in this way.

A 45 percent combined marginal tax rate may not discourage everyone but it is undoubtedly a drag on effort and entrepreneurship for the economy as a whole. The marginal tax rate on middle-income families has increased because of the rise in the payroll tax rate—from 6 percent in 1960 to more than 15 percent now. And the top federal income tax rate has risen from 28 percent after the Reagan tax cuts to more than 40 percent now.

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. We should insist that reducing poverty and maintaining income mobility, not limiting inequality, are the appropriate goals of government policy.

The productivity of the workforce depends also on the size of our capital stock—the equipment, software, and buildings. The size of the productive capital stock depends on how much we save as a nation and how we divide that saving between housing and productive business investment. We don't score well on either of these.

Many government policies depress our national saving rate, starting with our enormous fiscal deficit that offsets the positive saving of households and businesses. Our household saving rate of about 4 percent of GDP is low by both historic and international standards. A major reason why lower- and middle-income households save very little is that Social Security benefits replace about half of the preretirement income of an average earner, leaving much less incentive to save.

The household saving of higher-income individuals is depressed by high marginal taxes on interest, dividends, and capital gains. 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 a very unfair tax: a double tax on incomes that have already been taxed at the corporate level, a tax on nominal gains that reflect inflation, and a tax on gains without allowing a full deduction for losses.

The estate tax also discourages saving and unfairly taxes funds that have previously been subject to the income tax. And by causing a large fraction of potential estates to go to charitable institutions, the estate tax destroys the future income tax revenue that would otherwise have been paid if those funds had remained in private hands. This loss of income tax revenue may actually exceed the revenue collected by the estate tax—making it a net revenue loser as well as an economically harmful and unfair tax.

The corporate tax—and America has the highest corporate tax rate in the world—reduces corporate saving, lowers the net return to individual savers, and drives capital into housing rather than more productive uses. And our corporate tax rules for foreign-source income induce American firms to leave profits abroad rather than bringing them back to invest in the United States.

It is clear that we need tax reform to lower marginal tax rates and improve incentives for saving and investment. Reforming all aspects of our tax system should be combined with bringing our budget deficits under control. The unprecedented deficits that are now projected for the current decade and beyond will absorb most of private saving, crowding out productive investment and keeping the United States 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 of 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 that is 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 brought our national debt down from 109 percent of GDP to 46 percent of GDP in 1960. We did it by avoiding any growth of the government's debt during those years—that is, by balancing deficit years with surplus years.

And with the debt no longer growing, the combination of a 2.6 percent real growth rate and a 3.3 percent inflation rate was enough to bring the ratio of debt to GDP down to 46 percent over 15 years. We did that then and we can do it again.

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—we will unleash the rising incomes that American creativity and a free enterprise system can produce.

We will have only ourselves to blame if the decades ahead do not experience the same rising standard of living that Americans have enjoyed during our lifetimes.

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 that same 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 income of about \$45,000 today would be \$90,000 in today's prices after 30 years and \$225,000 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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