SENATE FINANCE COMMITTEE HEARING
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PREPARED REMARKS

Mr. Chairman, Members of the Committee, I appreciate very much this opportunity to testify before the Senate Finance Committee at what I believe is a critical juncture for U.S. economic policy. The set of changes that collectively have come to be labeled as globalization are creating an economic environment that is in important respects unprecedented. The mutually reinforcing combination of rapid technological change that promotes economic integration and dramatic economic progress in key parts of the developing world puts us in uncharted territory in formulating economic policy.

Start with technology. As Alan Greenspan noted several years ago while the value of our GDP rises each year its mass is constant or actually declining as value comes increasingly to reside in information rather than physical substance.[1] This, along with dramatic improvements in communication and transportation technology increases the extent of international integration and the range of areas in which international competition is possible. Alan Blinder, while noting that offshoring has not had yet a major impact on the US labor market, predicts that within one or two decades as many as twenty-two to twenty-nine percent of jobs could be subject to competition from offshoring.[2]

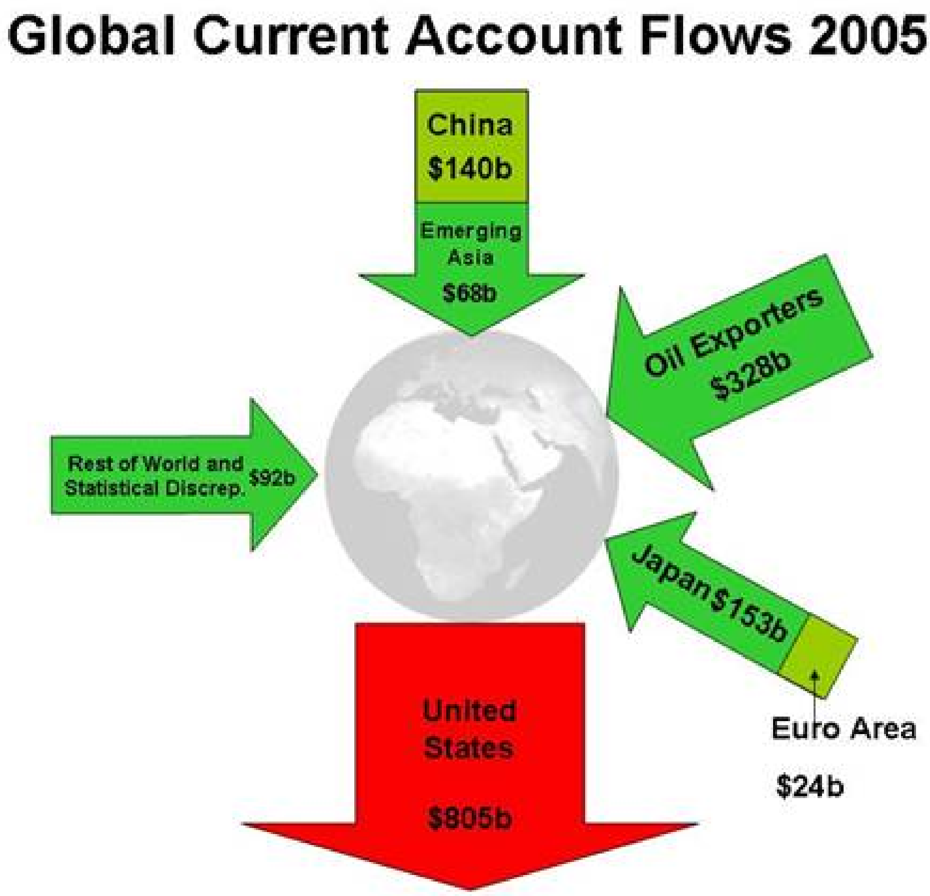
Equally remarkable is what is happening in the developing world, especially in Asia. The period between the late 18th and early 19th centuries in Britain and continental Europe was called the Industrial Revolution for a reason. For the first time in human history, the standard of living of one generation was demonstrably better than the one before: in a single lifespan, real per capita incomes doubled and then doubled again. If one looks at the growth rate of China during the past 30 years, living standards are increasing at a rate that will lead to a hundred-fold improvement over a single human lifespan.

These developments have in their totality had profoundly positive consequences. After 20 years of slow productivity growth following the 1973 oil shock, technological changes have spurred rapid productivity growth making it possible for the American economy to grow faster on a sustained basis than its industrial country competitors for the first time since World War II. Technology and global integration have supported a great moderation in the cyclicality of the American economy which has experienced only two relatively mild recessions in the last generation. The spur of foreign competition has played an important role in permitting the American economy to sustain sub 5 percent unemployment and inflation in the 2 percent range--a combination that would have been thought impossible not so long ago. And an open global capital market has enabled American mortgage rates to remain below 6 percent far into an economic expansion – permitting the achievement of record levels of home-ownership.

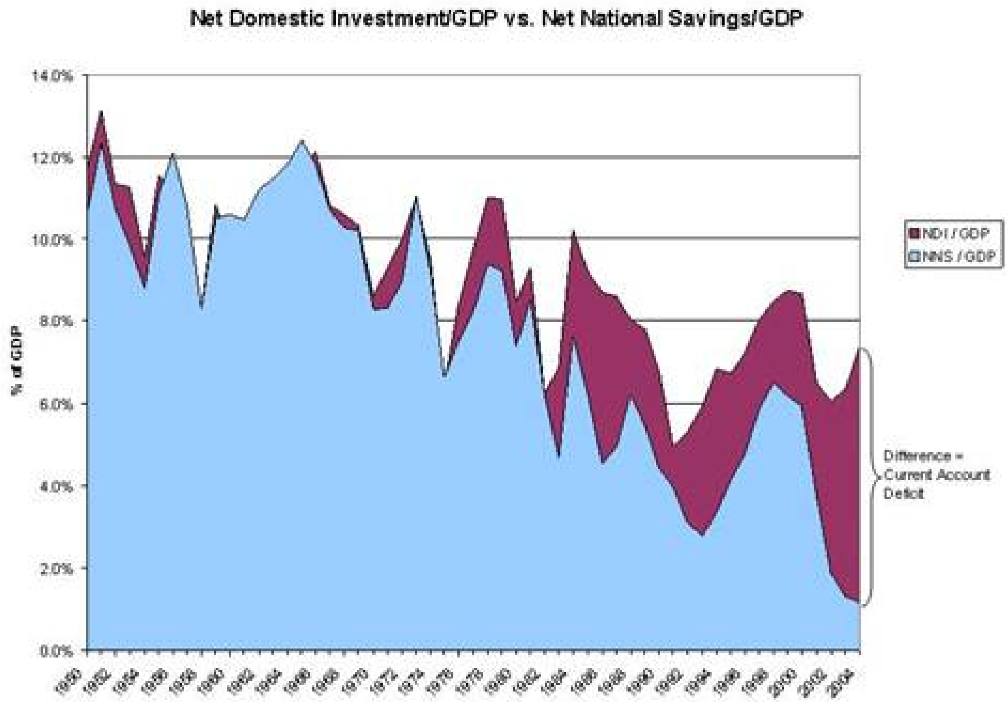
Without the combination of technological change, deeper global integration and rapid progress in the developing world the American economy would have performed less well over the last decade.

Nonetheless, globalization presents us with profound policy challenges. Four stand out.

First, the United States is now borrowing from abroad in a historically unprecedented way largely to finance consumption. It is an irony of the current moment that the United States is both the world's greatest power and its greatest debtor. Because of our low level of national saving, which is now at a record low level of under 2 percent, we find ourselves dependent on foreign capital to a historically unprecedented degree. As the figure below illustrates, the United States is an overwhelming absorber of global savings while the rest of the world is a supplier of global savings. While the combined current account surpluses of Japan and the non-European industrialized countries represents about 35 percent of U.S. net international borrowing, the remainder is financed overwhelmingly by emerging markets and oil exporting countries. This broad pattern, which has been going on for several years now and on current projections will continue for quite some time, runs very much counter to the traditional idea that core countries export capital to an opportunity rich periphery.



Furthermore, it is clear that this flow of capital from the developing world to the United States is financing consumption rather than investment, as the figure below illustrates.



There is no one who believes that the US can continue to borrow indefinitely at its current rate. It follows that either our level of saving has to rise or our level of investment has to fall. This is the critical reason why action to improve the government’s fiscal position is essential over the next few years. Failure to act risks a dangerous collapse of investment if the flow foreign capital dries up.

While the focus of this hearing is on globalization, I cannot overemphasize the linkage between it and this committee’s responsibilities in the areas of tax and expenditure policies. The US trade position cannot improve without an improvement in its saving investment balance -- an outcome best achieved through increased savings –- especially public saving. Moreover, if history is any guide, the greatest risks from protectionism come at time like the present when macroeconomic developments drive large trade deficits, reinforcing the case for fiscal discipline.

Second, we need a national investment strategy to assure that our firms are as competitive as possible. From the end of the Second World War until the mid nineteen-seventies, Americans benefited from rapid productivity growth. Subsequently, a sharp slowdown in productivity growth manifested itself and lasted until the mid nineteen-nineties. Since then, productivity growth has been quite rapid, though there are signs that it may be slowing once again. Economists do not fully understand all the determinants of these trends.

There can be no certainty as to how best to increase productivity growth going forward in the United States but there is no question that public investments are essential. I would highlight three areas of public investment where I believe our national effort has been insufficient in recent years.

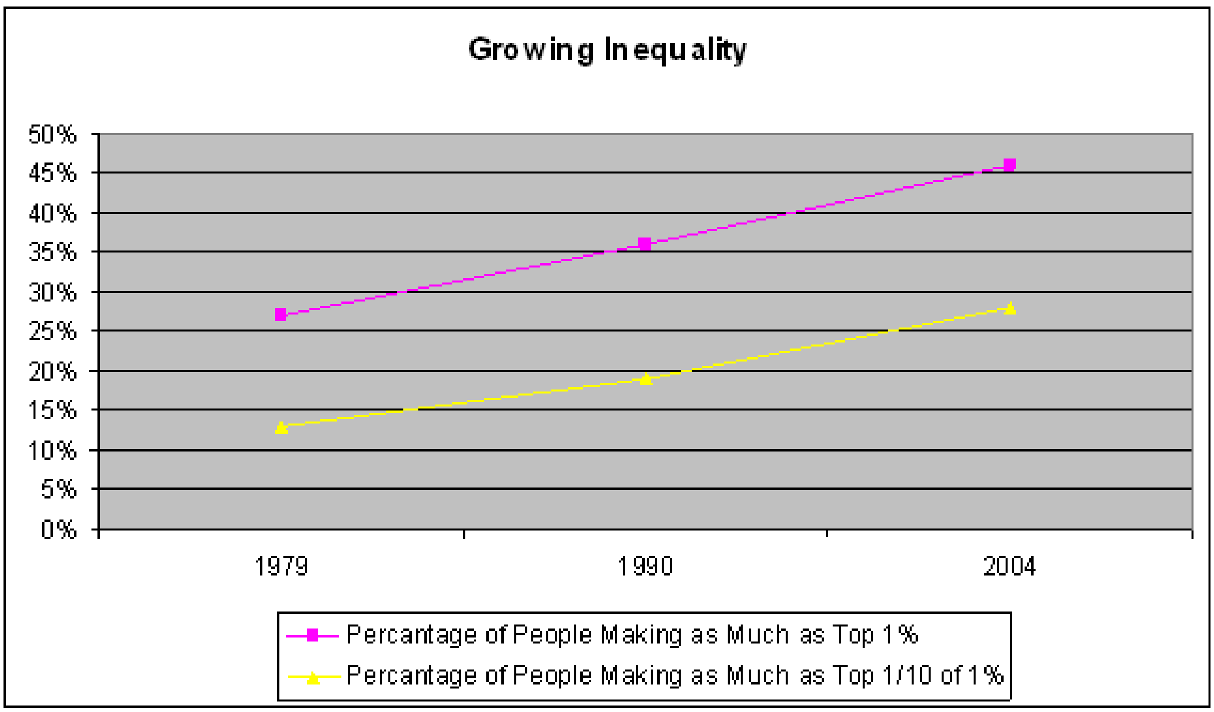
First, our investments in research and development, after increasing rapidly since the nineteen-nineties, have lagged. In a time when the world stands on the brink of revolutionary progress in the life sciences, it cannot be rational for the NIH budget to decline as it did this past year for the first time in nearly forty years. If one looks at funding levels adjusted for inflation, the decline in our national commitment to basic research is even more remarkable.

The second key element of public investment in productivity growth is education funding. Ultimately, nothing is more important to our prosperity than the quality of the American labor force. It is particularly important that investments be made to ensure all of our citizens have a chance to fully participate and share in our prosperity. A growing body of evidence suggests that pre-school education has an enormous rate of return, particularly for children from disadvantaged background, and funding these kinds of programs should be a high priority.

There is also a major need for national investment to ensure the affordability of higher education for all of our citizens. One of the most disturbing statistics I encountered in recent years is the observation that just ten percent of students attending our leading universities come from the lower half of the American income distribution.

The third crucial area of investment is in infrastructure. Here, there are clearly areas in which there has been excess national investment in response to political pressures. But there are also key areas such as transportation and other infrastructure facilities where investment has been grossly inadequate.

Third, and perhaps most urgently, we need to find creative policy responses to rising inequality so as to assure that most Americans share in the growing prosperity that globalization can bring. The figure below points to a disturbing trend. In 1979, the top 1 percent of the population earned as much as the lower 27 percent combined; by 1990 the figure had risen to 36 percent; by 2004 it was 46 percent. Given the strong trend growth in inequality we may be on the brink of the moment when the top 1 percent of the population earns as much as the lower half of the population combined and the top 1/10 of 1 percent earns as much as the lower third combined.



These trends are complemented by parallel developments. As inequality has increased so has its transmission from generation to generation. The difference between the life chances of the children of the affluent and the poor has never been greater.

The precise cause of these developments is not clear. Surely technology has reinforced those with high levels of skill. And trade and globalization have surely benefited those fortunate few in a position to take great advantage of new opportunities while at the same time raising competitive pressures on ordinary workers. Perhaps also greater competition in general has led to more ruthlessness in pay decisions.

Whatever their precise causes, increases in inequality and volatility of the magnitude we have observed, even when coupled with rapid GDP growth, represent a serious economic challenge. They may overtime undermine our commitment to the market system and an open global economy. They stratify society and undermine the middle class. And they mean that too many Americans experience themselves as falling behind or in great danger of falling behind.

It is important to recognize the magnitude of the changes we have observed. Since 1979, the share of income going to the top 1 percent has risen by 7 percent of total income and the share going to the bottom 80 percent has declined by an approximately equal amount as the table below demonstrates.

	Decline in Before-Tax Share for Bottom/Middle	Increase in Before-Tax Share for the Top	$ “Loss” For Bottom/Middle in 2004 ($billions)
1979 – 2004, Bottom 80% vs. Top 1%	-7.4%	+7.0%	-$664
1990 – 2004, Bottom 80% vs. Top 1%	-4.0%	+4.2%	-$359

To offset these changes would require a transfer of nearly 664 billion dollars from the top 1 percent to the lower 80 percent. Similar calculations looking only at the changes inequality since 1990 would suggest transfers of about 359 billion dollars.

While globalization is only one of the causes of inequality, these calculations suggest that its consequences dwarf the kind of compensatory adjustment programs that are usually contemplated alongside trade agreements.

What is the right policy response? It is important to recognize that most of globalization’s impact on the US economy reflects technology and changing economic conditions in our trading partners, not trade agreements. Trade agreements have historically had a much greater impact in creating and increasing markets for US exports than in reducing inhibitions to US imports. For some years now, our market has been largely open in almost every sector, so the scope for new agreements to materially affect the distribution of income for good or ill is not large. A fortiori, changes in the details of trade agreements are not likely to have significant impact on US inequality.

Rather, I believe the main policy levers for addressing inequality and insecurity lie outside the trade domain. They include improving the effectiveness of the tax system while at the same time increasing its progressivity and fairness. The biggest gains here potentially come from making a serious assault on the tax gap resulting from non-compliance with the Internal Revenue Code – a subject, Mr. Chairman, on which I know you have been a leader on in the Congress. Using the most recently available IRS data and extrapolating from that into the future, it is conceivable that by 2015 the gross tax gap will be as much as $751 billion per year. Over the next 10 years, as much as 5.8 [3] trillion dollars in tax revenue will be lost to non-compliance with the Code. I would note the tax gap is greatest for those categories of income that go disproportionately to the upper ends of the income distribution. There are also important issues and abuses associated with transfer pricing and the sheltering of both individual and corporate income that require Congressional attention. I am convinced that substantial revenues can be obtained from these sources – revenue that could potentially be devoted to ameliorating the dislocating effects of technological change and globalization.

We also need to recognize that in a world where jobs are going to be increasingly impermanent, economic security cannot come only from the employment relationship. This will require new approaches in the areas of health insurance and other benefits. I believe it is also appropriate that consideration be given to thinking about methods of wage insurance that would enable increasingly inevitable economic mobility to take place without significant and painful dislocation.

A third type of response involves taking comprehensive and systematic policy approaches to the future of key industries and regions. Indeed, reliance on clusters is, it seems to me, profoundly important for our economic future. Any individual faces the possibility of competition from a lower earning and equally skilled individual, but it is much more difficult to compete with or replicate entire clusters of economic activity. Indeed, the supremacy of New York City as the world's financial capital illustrates this point.

While the impact of trade agreements on inequality may not be great, the impact on inequality on Americans willingness to support international integration is great. It cannot be an accident that the Marshall Plan came at roughly the same time as major new commitments to the GI bill and to making credit available for ordinary families to buy houses through the FHA. This underscores the importance of addressing the anxieties facing middle class families.

The fourth critical priority is assuring that the United States leads in the creation of an international economic system that promotes collective prosperity and reduces the risks of conflict. Respect for the United States around the world is at low point despite our formidable strength. In part this is a consequence of all that has happened in the Middle East over the last few years. In part it is a consequence of American resistance to multilateral efforts in spheres ranging from global warming to human rights to trade. The United States would in my judgment be taking grave risks if it allowed itself to appear as resistant to international economic integration that provided growth opportunity for emerging markets. To withdraw from, or even to fail to promote, efforts to increase international exchange would send a very damaging signal. At the same time, it would create a void that would quickly be filled by our major economic competitors. It would also risk engendering tremendous resentment from those who feared that the United States was seeking to deny them the opportunity to become prosperous because of fears about our ability to compete.

All of this is to say that we as a country have a great stake in continued progress towards a more open trading system and in being perceived as a leader in promoting more open trade. To be sure, it is important that trade agreements be based on bipartisan consensus, and developed with the close involvement of both the executive and legislative branches. It is also important to recognize that the promotion of trade must be approached within the overall context of our efforts to promote global economic and social progress. And it is important to be clear with other nations that trade agreements are a two way street and that the United States will not accept agreements that disproportionately benefit its trading partners.

All of this said, it is critical in my judgment that the United States be prepared to move forward with an active trade policy agenda. Most important, we should be and be seen as leaders in trying to bring the Doha Round to a successful conclusion. It would provide an important spur to global growth and would in particular be of benefit to developing countries. The failure of the Doha Round would set loose protectionist forces around the world in ways that could be quite dangerous and for which we surely do not wish to take responsibility.

While the economic merits of specific bilateral trade agreements are more debatable than in the case of multilateral agreements, there is, it seems to me, a strong case for maintaining the flexibility to enter into bilateral agreements. Such agreements can play an important geo-strategic role in reinforcing our allies in their efforts in economic reform. They can also play an important role in assuring that the United States does not fall behind as other countries rush to enter bilateral agreements. And in some cases bilateral agreements can provide important economic benefits.

Mr. Chairman, I am very much aware of the intense feelings aroused by trade and globalization. To sum up my views, it is essential not to confuse ongoing globalization, which is driven by technology, and the success of developing countries with the effects of particular trade agreements. It is maybe possible to prevent new trade agreements or to repeal old ones, but globalization and technological change cannot be stopped. The real policy challenge is to respond to their adverse consequences by embracing the full set of measures that ensure inclusive growth for middle class families.

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[1] Remarks by Chairman Alan Greenspan. "Trade and technology," Before the Alliance for the Commonwealth, Conference on International Business, Boston, Massachusetts, June 2, 1999.

[2] Alan S. Blinder. "How Many U.S. Jobs Might be Offshored?" Princeton University Working Paper, February 2007.

[3] Summers, Lawrence. "On Globalization and the Possibility of Progressive Taxation." Forthcoming, Proceedings of the National Tax Association Annual Meeting 2006.