# Blueprint for America

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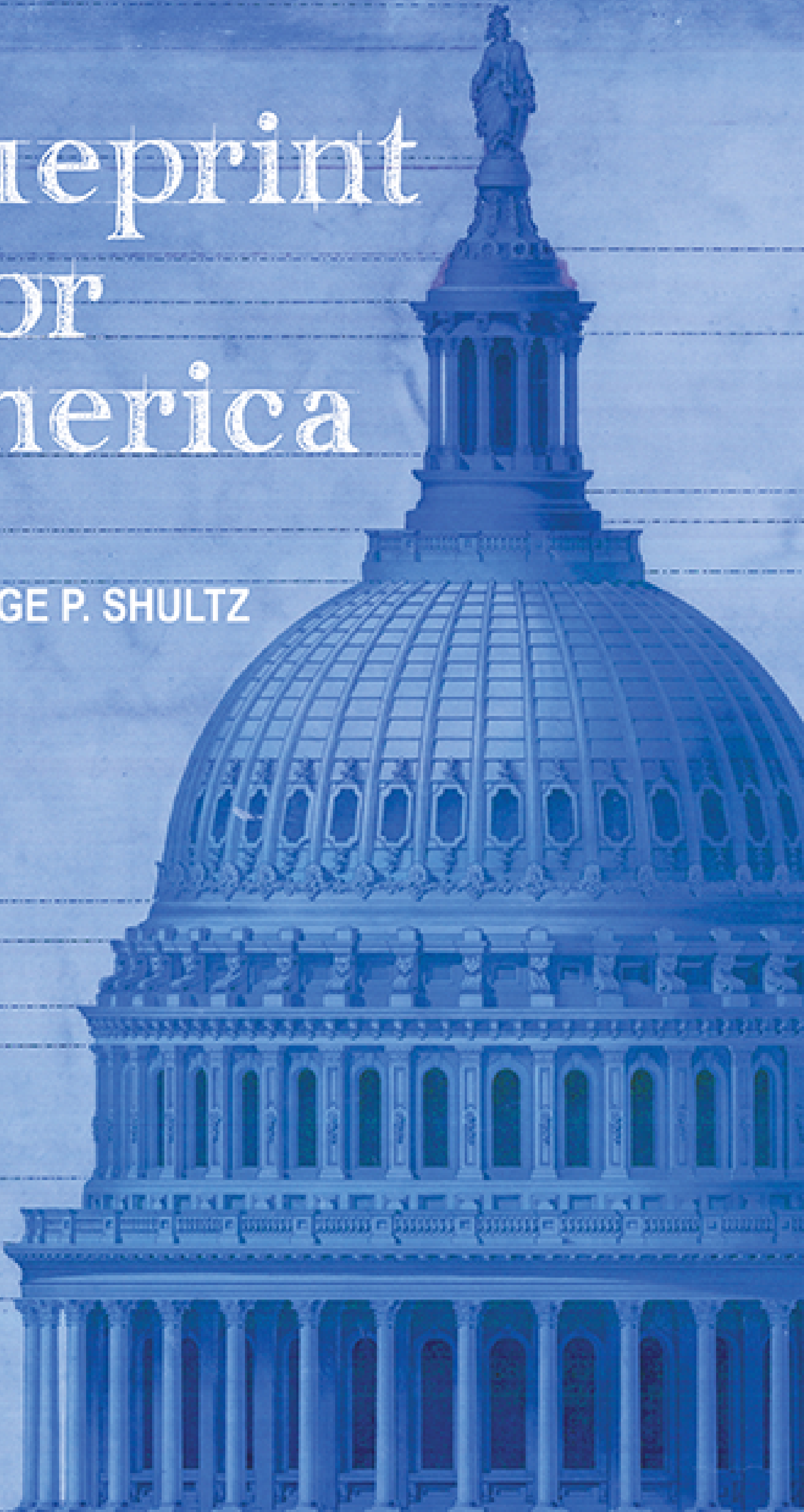

CHAPTER 1

# THE DOMESTIC LANDSCAPE

*Michael J. Boskin*

America is at a historic crossroads. Two in three citizens believe the country is on the wrong track, a majority that the next generation will be worse off than this one.

The next president and Congress face domestic crises that must be addressed robustly if our country is to enjoy widely distributed prosperity. Those taking office need strategies and ideas to deal with the issues and they must recruit the best talent to use their offices effectively. We set out here a *Blueprint for America* in an effort to define these issues. The first part of this book deals with the domestic economic spheres.

Too much contemporary policy discussion has focused on short-run issues while neglecting the long. The 2008–09 recession led to an obsessive debate on how to deal with the present downturn. As difficult as this economic condition has been, it is modest relative to the issues of long-run growth; and it is that growth which will determine the well-being of Americans and their position in the world.

## THE ECONOMY

A strong economy means long-term prosperity for Americans. So economic policies are the critical foundation for raising living standards, growing government revenue for necessary national purposes, and reducing social conflict over the division of the pie.

Through all the vicissitudes from World War II to the Great Recession, the American economy averaged more than 3 percent annual growth. Yet it has not had as few as three consecutive quarters of 3-percent growth in a decade. Recoveries from other deep post-war recessions averaged growth of 4 percent or more for several years. Yet the recovery from the 2008–09 recession has averaged just over 2 percent. So among our economic and social priorities, the strongest possible economic growth comes first.

The case for growth is not hard to make, but that doesn't mean we shouldn't make it. Economic growth is determined by gains in productivity and the growth in the number of workers. Government economic policies—fiscal, monetary, regulatory, and trade—must be designed to support the strongest possible non-inflationary growth. Productivity gains, which determine wage increases, are driven by improved technology and investment in capital and worker skills.

To encourage growth and associated improvements in living standards, the private sector must have incentives for innovation, entrepreneurship, and investment in physical and human capital. We must cut red tape, rein in deficits and debt, enact tax policies conducive to capital formation and work, reform the education system, and invest in precompetitive generic research and development. These specific policies must be embedded in sound macroeconomic monetary and fiscal policy that lays a foundation for economic growth.

### THE SIZE AND SCOPE OF GOVERNMENT

A successful society needs an effective government. There are important functions for which the federal, state, or local government has a natural comparative advantage and which should not be left to private markets. It is essential that government perform these functions effectively and that its revenues are adequate to fund its necessary functions.

Examples of successful government programs include the military that has kept us free for almost 240 years; the GI Bill that was an investment in human capital; and a Social Security system that has reduced poverty among the elderly. Even successful programs, however, can be implemented at lower cost, and more effectively. Social Security was designed, in the words of President Franklin Roosevelt, "to secure a measure of protection against poverty-ridden old age." Yet someone earning the Social Security maximum taxable earnings will retire with Social Security benefits of more than twice the poverty level, not counting any other sources of income. Does that make sense?

Just as markets sometimes fail, there are government failures. These include crony capitalism, rent-seeking (i.e., using the political system to obtain special economic gains), regulatory capture, excessive social engineering, incompetence, waste, and corruption. Recent examples include three million phony tax refunds paid by the IRS, a 21 percent fraud rate in the earned income tax credit, massive fraud in Medicare and Medicaid, billions in unpaid income tax, and the "capture" of bank regulators that contributed to the financial crisis.

To be sure, even the most successful private enterprises sometimes fail. Apple flopped with the Lisa and the Newton. But that didn't hinder great success, given the willingness to recognize those failures and try a different approach. While market forces weed out the failures, there is no mechanism to eliminate failed government programs. When government becomes so large that it performs unnecessary functions—and necessary ones abjectly—reform is essential. A major reexamination is overdue, one designed to make the government more effective at serving citizens at lower cost to taxpayers.

The General Accountability Office identified 162 areas where federal programs overlap or fragment. For example, the federal government has ninety-two programs designed to help low-income Americans, costing over $800 billion per year. Do we really need forty-six job-training programs, sprawling over nine agencies, costing $20 billion a year, many with no metrics . . . seventeen federal food-aid programs across three agencies costing $100 billion per year . . . and twenty federal housing programs across three departments costing $50 billion a year?

The cumulative effect of this proliferation of programs can be pernicious. The Congressional Budget Office (CBO) reports that the interaction of several anti-poverty programs leaves some low-income Americans with marginal tax rates approaching 100 percent. How? The benefits phase out as income rises (to avoid supporting people further up the income distribution). But when several programs start to phase out simultaneously, a low-income worker may face the prospect of working more, but with any additional income offset by an equal reduction in benefits phased out. In short, a massive work disincentive traps them in continuous dependency. The time is due for an aggressive modernization and consolidation of programs and the elimination of those that burn the taxpayers' investment.

### SPENDING

Government spending has gotten out of control, and with it our national debt. Low interest rates have helped to drop the issue off of the political radar, but they will not last. Studies suggest that slowing spending growth enough to prevent projected large increases in the national debt, as a share of gross domestic product, would increase GDP by 15 percent or more in a generation. Doing this, while preserving the already declining proportions of our budget reserved for basic government functions such as defense and infrastructure, will absolutely require entitlement reform. For Social Security, that means, at the basic level, a change from wage- to price-indexing in calculating initial benefits. It is a good job for Washington politicians to figure out the tactical maneuvers required to do so.

Federal research and development (R&D) spending is short-term and sometimes degenerates into an industrial policy of picking commercial winners and losers. Policies to encourage innovation in the private sector as well as more, and more effective, R&D funding from the federal government are essential to strong economic growth.

IN HEALTH CARE, improvements are more complex. Demographics are changing as the population ages. The incidence of the most disabling diseases, including some that require expensive technology and drugs for diagnosis and treatment, will rise. Obesity, a most serious public health problem, assures unprecedented costs and harm. The nation's fiscal challenges will likely worsen in the absence of change. Medicaid and Medicare have expanded to consume over a trillion dollars per year, while physician acceptance of patients under those programs has continued to diminish. National health expenditures are again projected significantly to outpace GDP.

Yet the twenty-first century holds vivid promise for medical care. We are entering a new era in which genetics, medical technology, and new drugs will change medicine to a more personalized system of earlier diagnoses, targeted treatments, and prevention. To fix the inadequacies and reduce the cost of American health care without jeopardizing its excellence, significant reforms are essential.

The best way to control prices is through competition for empowered, value-seeking consumers. The key is to replace centralized models based on misguided incentives to one of individual empowerment with personal responsibility. Refocus the system toward one of bottom-up control, with incentives for high-deductible catastrophic insurance coverage and health savings accounts (HSAs) for better value and more consumer choices across services of known prices.

### TAX REFORM

The primary purpose of taxation should be to raise the revenue necessary to finance government spending. While governments may also borrow, debt must be repaid or refinanced, and in either case will require higher future taxes. Federal spending is projected to grow rapidly, the primary drivers being the costs of entitlements and higher interest costs on the growing debt. In order to cover the cost of projected spending in, say, 2040, income and/or payroll tax rates would have to rise so much that middle-income families could face marginal tax rates over 60 percent. That is a recipe for permanent stagnation.

Taxes distort economic decisions. By reducing after-tax wages and returns to saving, income tax reduces work and saving. The corporate income tax discourages capital formation, encourages excessive leverage, and reallocates capital by industry and sector with its numerous special provisions. These biases ensure that overall capital formation runs steeply uphill, with deleterious consequences.

The harm from these distortions rises with the square of the tax rate, so doubling the rate quadruples the harm. This is the primary reason to keep marginal tax rates as low as possible while raising sufficient revenue to fund the necessary functions of government. Tax systems with low rates and broad bases are the most effective foundation for an efficient, growing economy. Replacing the current personal and corporate income taxes with a broad-based, low-rates tax on consumed income could increase GDP by 6–15 percent. Studies of the tax base conclude that the corporate tax is the most harmful to growth, followed by income taxes, with taxes on consumption the least harmful.

The United States has the highest corporate tax rate among the leading economies, thereby encouraging companies to operate elsewhere. Our statutory rate is 35 percent, compared with Canada at 15 percent, Germany at 15.8 percent, Japan at 24 percent, or the United Kingdom at 20 percent. We also tax again on any corporate earnings that are repatriated, even though they were already taxed in the country where they were earned. The result: an estimated $2 trillion that we need for investment and hiring remains abroad.

To avoid holding the economy back, we must get the corporate rate at least in line with the 25 percent average rate in other OECD (Organisation for Economic Co-operation and Development) countries and end the double taxation of earnings so that money can be repatriated and invested and spent here.

### REGULATION

Government regulation is pervasive. While designed to achieve social benefits like reduced pollution, it also imposes a substantial cost—a de facto tax—on businesses and households. While most of our laws and Supreme Court rulings wisely demand a balancing of benefits and costs, studies estimate the annual cost of regulation at well over a trillion dollars.

Even scaling down the estimates of costs and taking a generous view of benefits leaves an opportunity for huge economic gains from improvement in the regulatory apparatus. Far more rigorous implementation of unbiased cost-benefit analyses is needed. An overall regulatory budget cap and the requirement that an old regulation of comparable cost be removed for every new regulation imposed—as in Canada—are also options.

To be sure, there may be health, safety, environmental, or other benefits to justify many regulations, and some sectors need regulation. For most of the previous century, economic regulation of "natural" monopolies, e.g., utilities in telecommunications, electricity, and transportation, dominated the regulatory terrain. With large fixed costs, demand was insufficient to support more than one or a very few firms. To gain some of the benefits of competition and decrease monopoly or oligopoly pricing, regulatory commissions set prices sufficient to earn a reasonable return for the firm. Insufficient incentive was left to innovate, as firms had little upside.

But in some cases, regulators are captured by the very industry they regulate. The banking regulators were asleep at the wheel in the path to the financial crisis of 2008–09. As technology has become vitally important in the economy, the notion of Schumpeterian creative destruction has reemerged. In short, monopoly and monopoly profits eventually beget new technology, competitors, and platforms that undermine the entrenched monopoly and give way to a new one. Thus serial monopoly may be good for innovation and less harmful to consumers than traditionally argued, at least if the new firms come along at a rapid enough pace.

Of course, much regulation was not of "natural" monopolies, but of unnatural ones created by government through regulation and licensing that foreclosed entry of new firms. An important current upheaval is the competition Uber is providing to regulated taxis. There are many such real-world examples where lifting regulatory restrictions substantially lowered prices and spurred innovation in telecommunications, trucking, airlines, and package delivery. Such successes should make us think twice about a new wave of regulation.

Our regulatory system presents companies with a maze of abstruse requirements. The result is onerous compliance costs for large companies and discouragement to smaller companies that cannot afford compliance expenses.

### FINANCIAL REGULATION

The basic structure of financial regulation has failed. In that structure, the government guarantees debts through deposit insurance and bailouts, in order to stop runs. To offset the consequent incentives to take on too much risk with government-guaranteed funding, the government tries to regulate banks' and financial institutions' investment decisions. But over and over, the regulators fail to stop excessive leverage, a panic ensues, and the government bails out a wider set of investors. We must escape this treadmill.

The answer is capital. Banks and other financial institutions that hold risky assets must get their money primarily by issuing stock or long-term debt or by retaining earnings. An equity-financed bank literally cannot fail. It has made no promises that can land it in bankruptcy court. It cannot suffer a run. This extreme is not necessary for our financial system, but it makes clear just how effective an equity-financed financial system could be to eliminate bankruptcies with no bailouts and no regulation.

The government should first remove distortions, subsidies, and regulatory incentives that currently favor too much debt. Debt, and especially short-term debt, is the poison in the well that causes financial crises.

For example, interest payments are tax-deductible; dividend payments are not. They should at least be treated equally. Debt is favored as an asset by capital and liquidity regulation, which gives an incentive to produce too much of it. Asset and liquidity regulation should focus on getting through a crisis without selling and running, not encouraging individual firms to hold liquid short-term debt on which they can quickly run. Capital-gains taxation makes it hard to use floating-value assets for transactions, though they may be perfectly liquid. And the multiple subsidies for consumer, housing, student loan, and corporate debt should be gradually phased out.

Second, there should be a regulatory safe harbor for equity-financed firms. If a firm is funded more than half by equity and less than 10 percent by short-term debt, for example, then the vast apparatus of asset regulation no longer applies. Banks that complain of current regulation will then voluntarily capitalize. Unlike current regulation, there must be a definition of how a company can organize itself so as not to cause a systemic threat and a safe harbor from regulation for companies that comply.

FINALLY, when regulations are needed, the best ones are visible and easy to enforce. The maze of the Dodd-Frank Act could be replaced by two simple measures: capital requirements that rise in percentage terms with the size of the financial institution involved and reasonable restrictions on the use of leverage. We also need to position the Treasury Department and the Federal Reserve Board to make it clear that they will protect the financial system—not individual financial institutions. If an organization is mismanaged, let it fail.

### MONETARY POLICY

Monetary policy is key to a healthy, noninflationary economy, but there is often uncertainty about what the Fed will do. Federal Reserve governors have different opinions, and they sound off. The great Red Sox slugger, Ted Williams, handled complaints that he didn't talk enough by saying, "I let my bat do the talking." The Fed carries a big bat, which it does not always use wisely.

The long period of very low interest rates has obscured the burden of the large debt that has piled up. It has also produced unprecedented assets now in the hands of the Fed, which must be returned to the market. A credible renormalization of interest rates and a gradual reduction in the size of the Fed's balance sheet are essential to removing distortions and creating the conditions for strong economic growth

A great deal of uncertainty in the international monetary system is due to these unconventional monetary policies, including large-scale asset purchases, which buffet around and distort exchange rates. A more strategic rules-based monetary policy will remove these distortions.

### INTERNATIONAL TRADE

Open, rules-based international trade has been a bipartisan foundation of American economic policy since World War II. Protectionist policies contributed to the Great Depression; successive rounds of negotiations to reduce barriers to trade helped propel the mostly good times in the post–World War II decades. Contrary to what some are saying, NAFTA (the North American Free Trade Agreement) has been of great benefit to the United States, Canada, and Mexico; has built cohesion in the continent; and, evidence shows, boosted real wages and societal welfare in each country.

With trade promotion authority, the president has the essential authority to negotiate trade agreements, with Congress having an up-or-down vote without amendments to the agreement. In addition to the Trans Pacific Partnership awaiting action, additional agreement should be explored as opportunities allow.

Recently, there has been an uptick in objections to free trade agreements based on trade deficits or "unfair" exchange rates, but these are largely unfounded: trade deficits occur when saving is too low relative to investment; exchange rate swings are often due to discretionary monetary-policy reactions in different countries. On both counts, the best medicine is in improving incentives to save and a steadier rules-based monetary policy—not protectionism. Trade adjustment assistance must also be improved.

### HUMAN RESOURCES

Rounding out our domestic economic policy priorities is the recognition that growth derives from our national human resources: an expansion in, and an increase in the productivity of, the labor force. But today's population is aging rapidly, and labor force participation rates are also dropping; the prime labor force is not increasing. Education and immigration both have a role to play here.

The United States has a skills renewal problem that has direct implications for economic growth, individual well-being, and income distribution. Employers list millions of unfilled jobs, saying they cannot find workers with even basic skills, and US students lag behind achievement levels of many countries. If skills could be lifted through better schooling, and reinforced by more successful job training, GDP would increase by an estimated 6 percent or more. Improving schools requires commitment, and the key is to raise teacher quality: evidence shows that strong accountability, direct financial rewards for superior teachers, dismissal of ineffective teachers, and greater parental choice of schools all contribute to better performance.

Meanwhile, as the population ages and the ratio of workers–to–retirees falls, it will be increasingly important to keep able people in the labor force longer. Policy changes can help—changes to the payroll tax for older workers, for example, that would incentivize both employer and employee to keep working. At the same time, both demographics and education underscore the importance of changing our immigration system so that greater emphasis is put on the potential productivity of those who come to America, as in virtually every other developed country—with a particular emphasis on bringing in, or simply retaining, educated people of working age.

It is important to fight the right battles. Mexico, with fertility rates that are falling to below the replacement level and an improving economy, is no longer the leading source of immigrants to the United States, legal or otherwise. Immigration reform needs to move beyond just "securing our borders" and recognize that the bigger goal is to work with Mexico to prevent it becoming a migrant transit country as we are challenged to renew our nation's own highly skilled and productive work force.

The nation must also find a way to deal with undocumented workers and families already here. It is contrary to our heritage to consign those who have lived and worked here to a different class. As we reform immigration policies, we should develop paths to eventual citizenship for those already here who meet sensible criteria.

In sum, the needs are obvious, and we can meet them if we strengthen growth, which will pull people back into the labor force; offer choice, competition, and accountability in K-12 education to increase achievement; enact reforms that help people remain productive in their senior years; and reform immigration to encourage the flow of the brightest to our shores.

ECONOMIC POLICY MUST BE DEBATED in every generation, because the principles become hostage to the short-term political purposes of various interests. Good economic policy rests on timeless principles. We've got cleaning up to do. No set of policies can eliminate all risks or banish all economic problems. But we are confident that the policies described here are intellectually sound and historically successful and will provide the foundation for economic progress and rising standards of living for all Americans.