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PREPARED REMARKS

Mr. Chairman, Members of the Committee, I appreciate very much this opportunity to testify before the Joint Economic Committee at what I believe is a critical juncture for U.S. economic policy. There are a variety of features of the current economic environment that are without precedent. These include:

- the magnitude of our current account deficit and looming fiscal problems;
- the degree of integration in the global economy;
- the spectacular rise of China, India and other emerging markets;
- the pervasive impact of technology; and
- the substantial increases in inequality and economic insecurity that have been observed in recent years.

We are, to an important extent, in un-chartered territory in setting economic policy and so this Committee is to be commended for taking up these policy challenges at this crucial juncture.

In this new economic environment, the United States faces three main policy challenges:

- returning its finances to a sustainable basis;

- making necessary investments for the continuation of rapid economic growth;
- and assuring the benefits of growth are widely shared, and in particular, that we continue to have the strong middle class that has long been the underpinning of our democracy.

Let me say a few words about each of these challenges.

First, the nation’s finances are not now on a sustainable basis. While projections vary, few observers believe that without significant policy changes the debt-to-GDP ratio of the United States will increase quite rapidly in the next decade and beyond. In part, this is a reflection of an aging society. In part, it is a reflection of the fiscal policies of the last five years in which very large tax cuts have coincided with substantial increases in both defense and domestic spending.

This move towards fiscal un-sustainability has been one of the drivers of the deterioration in international economic position of the United States, as our current account deficit has now reached record levels and is approaching one trillion dollars. The current account deficit reflects both the very substantial international borrowing by the United States government due to significant fiscal deficits as well as a continuing decline in the private savings rate. Indeed, in recent years, the United States has had a net national savings rate that is close to zero.

The consequences of these adverse and unsustainable developments have been masked in recent years by the very substantial investments in U.S. short-term financial securities made by central banks around the world, and in particular by the central banks of emerging Asian countries and the oil-exporting countries. This has created a situation where the world's greatest power is also the world's greatest borrower.

In the short run, the United States benefits from the availability of low-cost capital. However, this low-cost capital has as its counterpart the very substantial volume of exports to the United States in excess of our own imports and the resulting significant trade imbalances. There is also the question of how long foreign investors will be prepared to lend us funds on such generous terms to support deficits of this magnitude.

Clearly, a policy priority in this regard has to be increasing the stability of the nation's financial position. The most important step the Congress can take is to adopt a fiscal policy that puts the government's finances on a sustainable footing. There is no silver bullet here. Undoubtedly, it is important to address the excesses of recent years, to take on entitlement issues, and, perhaps most critically, to return to budget discipline with respect to any new initiatives on either the spending or the tax side.

The second large economic policy challenge is assuring adequate growth in the years ahead. 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 equally, 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.

As President of Harvard, I had the opportunity to observe the remarkable potential of research in the life sciences. I also had the opportunity to observe many extraordinarily talented scholars abandoning the life sciences as the average age of funded investigators rose in the face of budget pressures. Similar trends can be observed in the physical sciences.

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 that 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.

The third, and in some ways most pressing, economic challenge is that of assuring a strong middle class. This has three related but distinguishable elements: assuring equality of opportunity; assuring long-term economic security for those who currently have good jobs; and assuring that prosperity and economic growth are shared widely, rather than benefiting a small part of the population. How best to do this is a question that will require all of our effort in the years ahead, but I think there are three crucial areas that require attention.

First, assuring the fair collection of taxes. There are a number of areas in which we can improve the effectiveness of the tax system while at the same time increasing its fairness. These include making a serious assault on the tax gap resulting from non-compliance with the Internal Revenue Code, which may represent as much as fifty billion dollars per year. 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.

If we are to assure adequate economic security for all of our citizens, we 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 to economic insecurity involves taking comprehensive and systematic policy approaches to the future of key industries and regions. I was struck, Mr. Chairman, by the recent report you and other leaders from your state released on the steps needed to keep New York at the center of the global financial services industry. I could not help but wonder whether similar comprehensive efforts to devise a strategy and assure the leadership of American firms and other regions would not be availing in many different sectors. 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.

Mr. Chairman, these are just a few of the crucial areas of policy that we face. I look forward to answering your questions and engaging in a wide-ranging discussion. Thank you again for inviting me to be here this morning.