

# Policy Options to Improve The U.S. Standard of Living

By C. Alan Garner

Citizens of the United States are accustomed to having the world's highest living standard. However, some observers have become concerned about recent trends in the U.S. standard of living and the prospects for future generations.<sup>1</sup> One reason for concern is that other industrial countries have gradually been gaining on the United States in real output per person, which is often used to compare living standards across countries. Another reason for concern is the large U.S. trade deficit and the growing indebtedness to foreigners. The United States must eventually export a larger share of domestic output in order to close the trade deficit and pay interest on the foreign debt. As a result, a smaller share of domestic output will be available to meet the needs of U.S. citizens.

In response to these concerns, various policy options might be considered to raise the future

standard of living. Some policy options would require greater government involvement in the business sector, either through protectionist trade legislation or industrial policies. Other options would involve changing the tax laws to encourage more private saving and investment. And macroeconomic options, such as cutting the federal budget deficit, might be adopted to ease international trade imbalances and foster private investment. But not all of these policy options would actually raise the future standard of living, and not all of the options with a beneficial effect are equally feasible. Moreover, some policies that would ultimately raise the standard of living may require slower growth of consumer spending in the near term.

This article evaluates the options available to policymakers for improving the U.S. standard of living. The first section defines the standard of living and describes recent trends. The second section shows that both policy and nonpolicy factors have affected the standard of living in recent years. The third section examines four broad policy options that might be adopted to improve the standard of living. Although other policy changes might be effective, it is concluded that

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<sup>1</sup> For example, see Malabre (1988) and Bernstein (1987).

cutting the federal budget deficit is the most dependable way to raise the future standard of living.

## **Trends in the standard of living**

A nation's economic welfare depends on many factors besides the consumption of goods and services—for example, the quality of the environment, the distribution of income, and opportunities for advancement. But economists have never been able to devise a simple set of statistics summarizing the many dimensions of economic welfare. As a result, economists focus on the narrower goal of measuring the quantities of goods and services that determine the material standard of living.

### *Measuring the standard of living*

The standard of living is defined in this article as the average level of goods and services that a nation can provide its citizens. This definition does not take into account the unequal distribution of income, nor does it imply any notion of a minimum level of goods and services necessary for an acceptable or customary lifestyle.<sup>2</sup> Within this definition, alternative measures of the living standard are available.

One common measure of the living standard is real, or inflation-adjusted, consumer spending per person. This measure includes personal expenditures for goods and services in the cur-

rent period only; it does not reflect personal savings that will be used to buy goods and services in the future. Although some consumer spending is for durable goods, such as cars and refrigerators, that will provide services to the consumer long after the initial purchase, real consumer spending per person is primarily a measure of the current living standard.

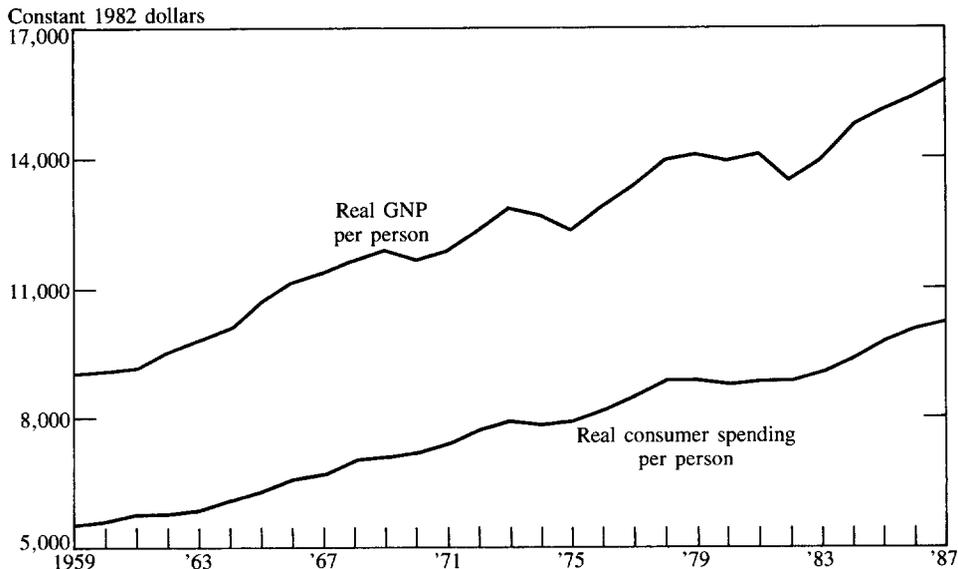
Another common measure of the living standard is real output per person. In some respects, this measure is superior to real consumer spending per person because the level of consumer spending that a country can sustain over time depends on its ability to produce. Real output typically is measured by real Gross National Product (GNP), which includes not only consumer goods and services but also investment goods, government purchases, and international trade. Although investment goods do not add directly to current consumption, investment enhances the nation's future consumption possibilities by increasing productive capacity. Government purchases of goods and services also affect the standard of living. Government spending for health care, for example, adds to the living standard in the same way as private expenditures for health care, which are included in consumer spending. And producing export goods in excess of imports increases the country's international assets that can be used for future consumption. Real output per person, therefore, is a useful alternative measure of the living standard because each component has some effect on current or future consumption.

Both measures of the U.S. living standard have increased over the last 30 years (Chart 1). Real consumer spending per person was about \$5,500 in 1959 but increased to about \$10,300 in 1987. Real GNP per person has similarly increased from about \$9,200 in 1959 to about \$15,800 in 1987. However, this latter measure of the living standard declined briefly in 1974-75 and 1980-82 as the U.S. economy experienced recessions. Real

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<sup>2</sup> The term "standard of living" has been used in different senses by different authors. The definition adopted here is similar to that in Pearce (1986), which defines the standard of living as "the level of material well-being of an individual or household." However, other definitions imply a minimum level of goods and services necessary to achieve a particular culturally determined lifestyle. For example, *Webster's Third New International Dictionary* defines the standard of living as "a minimum of necessities, comforts, or luxuries that is essential to maintaining a person, class, or race, in customary or proper status or circumstances."

**CHART 1**  
**Measures of the U.S. living standard**



Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, various issues.

GNP per person fluctuates more than real consumer spending per person because GNP includes investment spending, the component of U.S. output that varies most over the business cycle.

Both measures of the living standard have grown more slowly in the 1970s and the 1980s. Average growth rates of real consumer spending per person and real GNP per person are shown in Table 1. Real consumer spending per person has grown at a 1.9 percent annual rate in the 1980s, down from a 2.2 percent rate in the 1970s and a 2.7 percent rate in the 1960s. Similarly, the average growth rate of real GNP per person slowed from 2.7 percent in the 1960s to 1.7 percent in the 1970s and 1.3 percent in the 1980s.<sup>3</sup>

<sup>3</sup> Other statistics that are useful in measuring the living standard are real consumer spending per worker and real GNP per worker. The average growth rates of these measures have slowed

On average, growth of real consumer spending per person has slowed less than growth of real GNP per person in the 1970s and the 1980s. This smaller slowdown of consumption growth has been possible because of such factors as a declining personal saving rate and the rapid growth of consumer spending on imports.

#### *International comparisons*

The recent concern about the U.S. living standard results not only from the slower growth rates

even more dramatically in the 1970s and the 1980s. For example, real consumer spending per worker grew at a 1.3 percent annual rate in 1979-87 and a 0.8 percent rate in 1969-79, after growing at a 2.1 percent rate in the 1960s. Real GNP per worker increased at only a 0.7 percent annual rate in 1979-87 and a 0.4 percent rate in 1969-79, down from a 2.7 percent growth rate in the 1960s.

**TABLE 1**  
**Average growth rates of real consumer**  
**spending per person and real GNP per**  
**person in the United States**  
 (percent change at annual rates)

	1959-69	1969-79	1979-87
Real consumer spending per person	2.7	2.2	1.9
Real GNP per person	2.7	1.7	1.3

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, various issues.

of real consumer spending per person and real GNP per person but also from calculations showing a sharp decline of the living standard in the United States relative to such countries as West Germany and Japan. Some of the published international comparisons are flawed, however, and exaggerate the recent decline in the U.S. living standard. The best available statistics suggest that the U.S. standard of living is still the world's highest but has declined moderately relative to other industrial countries since 1970.

The living standards of different countries can be compared by examining each country's real output per person. Because appropriate GNP statistics are not readily available for other countries, real output is typically measured by Gross Domestic Product (GDP). Gross Domestic Product is an output measure similar to GNP that is often used in intercountry comparisons produced by the Organization for Economic Cooperation and Development (OECD), an international organization of 24 industrialized countries.<sup>4</sup> Gross

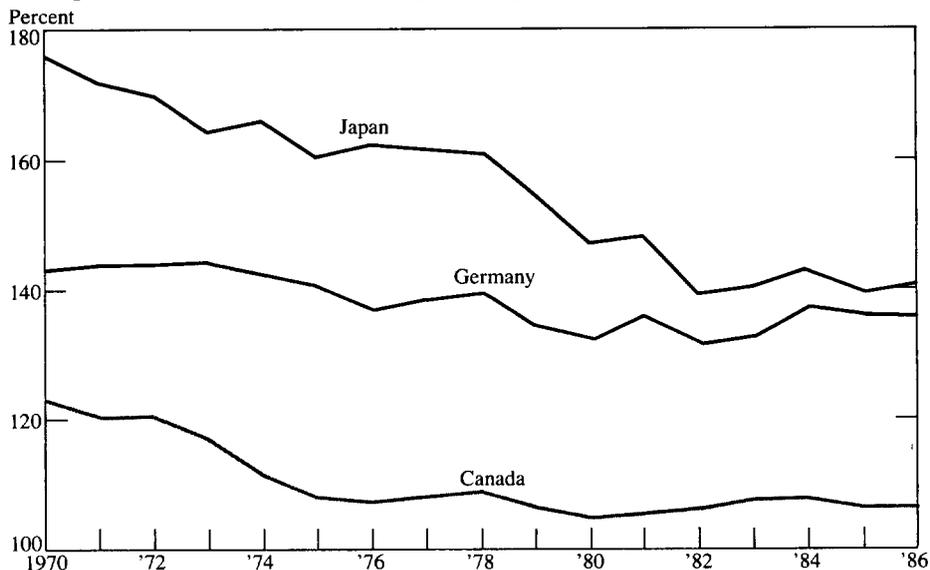
Domestic Product per person is preferable to consumer spending per person in international comparisons because countries differ in the extent to which particular services, such as health care or education, are provided by the government rather than the private sector.

The OECD statistics on GDP per person show that the U.S. living standard has decreased moderately relative to other OECD countries since 1970 (Chart 2).<sup>5</sup> Gross Domestic Product per person in the United States was 76 percent greater than Japanese GDP per person in 1970 but only 41 percent greater in 1986. The decline in the U.S. living standard relative to Germany has been less dramatic. Gross Domestic Product per person in the United States was 44 percent greater than German GDP per person in 1970 but 37 percent greater in 1986. And the Canadian living standard comes closest to that of the United States. Measured by GDP per person, the U.S. living standard was 24 percent above the Canadian living standard in 1970 but only 7 percent higher in 1986. Despite the relative decline, the

<sup>4</sup> Gross Domestic Product differs from GNP in that net factor income from abroad is excluded. The GDP measure for the United States includes output by factors of production located within the United States, whether or not these factors are owned by U.S. residents. In contrast, GNP is output by factors of production owned by U.S. residents, whether or not the production actually occurs within U.S. boundaries. Thus, GDP can be obtained from GNP by adding factor income (such as wages or profits) earned in the United States by foreigners and subtracting factor income received from abroad by U.S. residents.

<sup>5</sup> The OECD statistics provide the best available measure for comparing living standards across countries. The OECD statistics adjust individual countries' GDPs for international price differences with special conversion factors called purchasing power parities. Purchasing power parities essentially value each country's goods at average international prices. As a result, comparisons of GDPs between any two countries reflect only differences in the volume of goods and services produced, not differences in price levels between countries. The OECD statistics on GDP per person are from Organization for Economic Cooperation and Development (1988). Further explanation of purchasing power parities can be found in Blades and Roberts (1987).

**CHART 2**  
**The U.S. living standard relative to foreign living standards**



Note: The relative U.S. living standard is the ratio of the OECD index of U.S. GDP per person to the index of foreign GDP per person.

Source: Organization for Economic Cooperation and Development, *National Accounts: Main Aggregates 1960-1986, Vol. I.*

United States still had the highest living standard of any industrial country in 1986. Expressed in U.S. dollars, GDP per person in 1986 was \$17,324 in the United States, \$16,105 in Canada, \$12,741 in West Germany, and \$12,339 in Japan. But GDP per person in the United States clearly has had a small downward trend relative to other industrial countries.

### Factors affecting the standard of living

The slower growth of the U.S. living standard since 1970 and the moderate U.S. decline relative to other industrial countries over this period raise questions about the future and whether U.S. economic policies should be changed. But the factors affecting the U.S. living standard should be considered first since the appropriateness of different policy options may depend on which of

these underlying factors are responsible for the declining performance of U.S. living standards. As discussed below, the U.S. standard of living was affected by a complex set of policy and non-policy factors in the years since 1970.

### *The slowdown in productivity growth*

An important reason for the poor performance of the U.S. living standard since 1970 has been slow productivity growth. Productivity is often measured by average real output per hour of work. Productivity growth enhances the standard of living because national product increases and firms can pay workers higher real wages. However, productivity has grown more slowly in the United States than in most other industrial countries since 1960. Output per hour in the U.S. manufacturing sector grew at a 3.2 percent annual

rate in the 1960-73 period, well below the average productivity growth in Canada, Japan, and West Germany. In the early 1970s, productivity growth slowed in all the major industrial countries. But the growth of U.S. manufacturing productivity was particularly sluggish in the 1970s. Although it has improved somewhat in the 1980s, output per hour in U.S. manufacturing increased at only a 2.5 percent annual rate since 1973, slightly better than in Canada but worse than in Japan and West Germany.<sup>6</sup> Moreover, productivity growth in the service sector of the U.S. economy has been even lower than in the manufacturing sector.

Both policy and nonpolicy factors have contributed to the poor U.S. record of productivity growth. An important policy factor may have been the effect of the U.S. tax system on private saving and investment in the 1970s. The U.S. rate of net investment, investment over and above what is needed to replace depreciating capital, has been relatively low in the 1970s and the 1980s. Some economists have argued that low U.S. net investment reflected relatively high taxation of capital invested in the manufacturing sector.<sup>7</sup> High tax rates on investment income reduce the incentives for taxpayers to save and invest because the after-tax rate of return is lower. To the extent that U.S. tax laws reduced the incentives to save

and invest, slower growth of the capital stock would reduce productivity growth and the growth rate of the living standard.

An important disincentive to investment spending in the 1970s was a higher effective tax rate on investment income arising from the interaction of high inflation rates with the U.S. tax system. A fully indexed income tax would adjust all standard deductions, depreciation allowances, and tax rates to offset the effects of inflation on real tax burdens. But U.S. income taxes are not fully indexed even today, despite the Tax Reform Act of 1986, and had no automatic inflation indexing in the 1970s. As a result, inflation increased the real tax burden of many U.S. corporations in the 1970s and reduced the real after-tax return from new investment.<sup>8</sup> However, declining inflation rates in the 1980s have made this disincentive to business investment less of a problem.

Factors unrelated to U.S. economic policy have also contributed to the poor U.S. productivity performance in recent years. One nonpolicy factor affecting international comparisons of productivity growth has been a natural catch-up in Japanese and European productivity since World War II. The war destroyed an enormous amount of physical capital and human resources, leaving the United States the undisputed technological leader. As a result, the manufacturing sectors of the war-ravaged countries were much less productive than the U.S. manufacturing sector. Japan and Europe have devoted much of the period since

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<sup>6</sup> The choice of time period has some effect on these international comparisons of productivity growth. Over the 1979-87 period, output per hour in U.S. manufacturing grew faster than in either Canada or West Germany. However, Japan, Italy, and the United Kingdom all outperformed the United States by large margins. See Neef and Thomas (1987), Bureau of Labor Statistics (1988), and Organization for Economic Cooperation and Development (1987).

<sup>7</sup> Few studies have compared the effective tax rates on capital income across countries. One important study compared marginal effective tax rates in 1980 for the United States, the United Kingdom, Sweden, and West Germany. This study found that the overall U.S. tax rate on capital income was not unusually high, but the United States did have a high effective tax on income from the manufacturing sector. However, substantial changes have occurred in the tax laws of the United States and other industrial countries since 1980. See King and Fullerton (1984).

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<sup>8</sup> One important way that inflation reduced the after-tax return to capital investment was through depreciation allowances based on historical cost. A company can deduct depreciation allowances from its income, reducing the taxes paid. However, inflation erodes the purchasing power of a given dollar-denominated depreciation allowance. Firms thus cannot deduct the full real value of their depreciation, their taxes are higher on a real basis, and the after-tax return is correspondingly lower. The taxation of nominal capital gains on business inventories also raised the real tax burden of U.S. corporations. See Feldstein (1982) and Feldstein and Summers (1979).

World War II to rebuilding their capital stocks and adopting superior U.S. technologies. But, to the extent that the catch-up effect is the correct explanation for the poor U.S. performance in international comparisons, productivity growth rates eventually should converge as foreign capital stocks are replenished and the most efficient technologies are widely adopted.<sup>9</sup> That this convergence has not yet fully occurred suggests that other factors are important.

Another nonpolicy factor causing slow U.S. productivity growth in the 1970s was the large number of new entrants into the U.S. labor force. The labor force grew rapidly in this period because the postwar baby-boom generation was entering the labor force for the first time and because the proportion of women in the labor force was increasing. The entrance of these new workers into the labor force probably lowered productivity growth because new workers are inexperienced and thus have lower productivity levels than veteran workers. In contrast, the labor force did not grow rapidly in Germany or Japan during the 1970s. As a result, the typical German or Japanese worker was older and more experienced. Thus, faster growth of the U.S. labor force in the 1970s helps explain the poor U.S. performance in international productivity growth comparisons because foreign productivity growth rates were not depressed by a large number of new workers.

The maturing of the baby-boom generation also may have reduced U.S. productivity growth by lowering the personal saving rate. Because of the baby boom, the average age of the population was lower in the United States than in Europe or Japan in the 1970s. Younger people typically save a

smaller fraction of their income, or even go into debt, because they are setting up households and acquiring durable goods. As a result, a smaller quantity of savings was available to finance capital formation by the U.S. business sector. At the same time, the higher average age in other industrial countries encouraged saving because older workers typically save a higher fraction of their income to prepare for retirement. Higher saving rates helped build foreign capital stocks and raise foreign labor productivity relative to that in the United States.

Other nonpolicy factors also may have contributed to the slow U.S. productivity growth in the 1970s. Some economists argue that an important factor was a reduced rate of technological innovation. Evidence of reduced U.S. technological progress includes a decline in the number of patents issued and a lower level of research and development spending relative to GNP. Other economists believe that higher energy prices and the low capacity utilization rates caused by the recession in the mid-1970s reduced the profitability of new business investment. Such factors as poor corporate management, a decline of the work ethic, the diversion of corporate funds to pollution abatement expenditures, and an inadequate educational system have also been mentioned by some observers. Many economists would agree that both the worldwide slowdown in productivity growth in the 1970s and the poor U.S. performance relative to other industrial countries are not yet fully understood.<sup>10</sup>

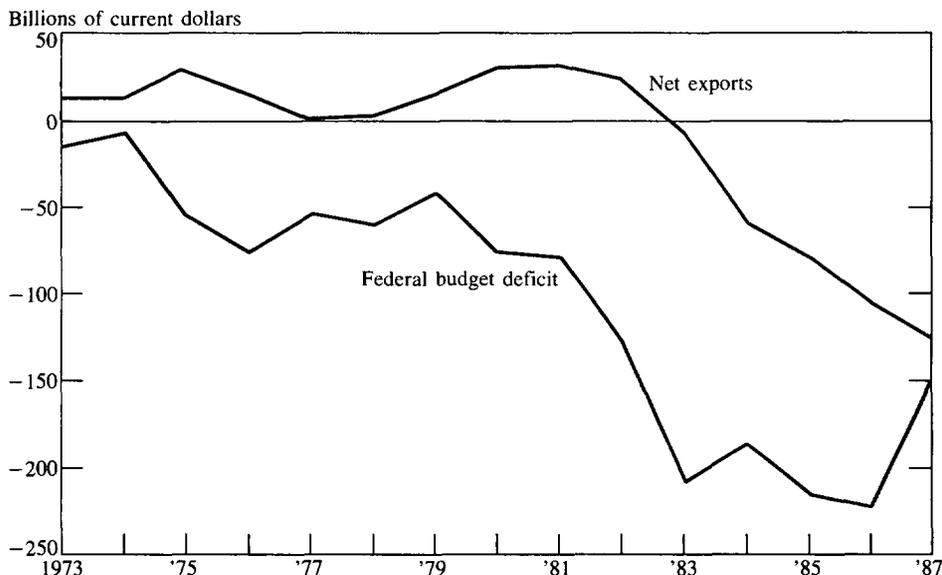
### *The twin deficits*

Although productivity growth has been

<sup>9</sup> Some empirical evidence suggests that the productivity growth rates of the major industrial countries have been converging. See, for example, Helliwell, Sturm, and Salou (1985). A convergence of international productivity growth rates, however, does not imply that all countries will eventually have the same standard of living.

<sup>10</sup> Further discussion of the factors affecting productivity growth can be found in Denison (1985) and Englander and Mittelstadt (1988). Economic studies have reached differing conclusions about the effects of higher oil prices on real output and productivity growth. For additional discussion and references on this topic, see Darby (1982).

**CHART 3**  
**Net exports and the federal budget deficit**



Sources: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, various issues; Office of Management and Budget, Historical Tables, Budget of the U.S. Government, 1989.

somewhat better in the 1980s, other factors have threatened the outlook for the U.S. standard of living. Chief among these factors, some economists argue, have been the twin deficits—the large U.S. budget and international trade deficits.<sup>11</sup> The ultimate effect of the twin deficits is to lower future U.S. living standards relative to other industrial countries.

Unprecedented peacetime government deficits in the 1980s discouraged private capital formation by raising the cost of borrowed funds. As

<sup>11</sup> See Feldstein (1982) and Makin (1985). Some economists have argued, however, that budget deficits and interest rates are not closely related. This viewpoint is presented in Evans (1985).

The discussion in this article assumes that the theory of Ricardian equivalence does not hold for the U.S. economy. This theory implies that a government budget deficit might not increase aggregate demand or interest rates because taxpayers would raise their saving rate in anticipation of higher future taxes. This theory is discussed further in Buiter and Tobin (1979).

Chart 3 shows, the budget deficit increased from \$40 billion in 1979 to \$221 billion in 1986 before declining to \$150 billion in 1987. Although lower tax rates encouraged saving and investment by increasing after-tax returns, this positive effect on capital formation was more than offset by the effects of large federal borrowings in the credit markets. Heavy government borrowing to finance the budget deficit bid up market rates of interest and diverted funds from private investment projects.

Both nominal and real interest rates increased as a result of the higher government deficit. Nominal interest rates are simply observed market rates, unadjusted for expected inflation. Real interest rates, however, are expected rates of return after adjusting for inflation. According to economic theory, saving and investment decisions depend on real rates of interest. On average, real

interest rates have been extremely high in the 1980s compared with previous U.S. experience.<sup>12</sup>

The budget deficit and the accompanying high real interest rates were, in turn, a major cause of the record U.S. trade deficits in recent years. High real interest rates attracted massive inflows of foreign capital. Converting these foreign funds into U.S. investments created a strong demand for dollars in the foreign exchange market and made the dollar appreciate sharply relative to the Japanese yen and various European currencies. This increase in the foreign exchange value of the dollar made U.S. goods more expensive abroad and made imports cheaper in the United States. As a result, the current-dollar deficit in net exports of goods and services expanded from \$19 billion in 1979 to \$123 billion in 1987 (Chart 3). Also contributing to the trade deficit was an international imbalance in economic growth rates in which strong domestic spending increased the U.S. demand for imports while weaker growth in the other industrial countries limited their demand for U.S. exports.<sup>13</sup>

The twin deficits have had conflicting effects in recent years on the two measures of the living standard. The federal tax cuts that contributed to the budget deficit raised the after-tax incomes of consumers. Combined with the downward trend in the personal saving rate since 1970, this increase in after-tax income produced rapid growth of real consumer spending per person. The strong growth of consumer spending also promoted a rapid recovery of real GNP per person after the last recession. However, much of the increased consumer spending in the 1980s went for imported goods. The growing trade deficit eventually weakened domestic industrial production and, therefore, the growth rate of real output per person. Thus, the twin deficits con-

tributed to a temporary situation in which real consumer spending per person grew faster than real output per person.

The ultimate effects of the twin deficits, however, will be to reduce future U.S. living standards, whether measured by real consumer spending per person or real output per person. One way that the twin deficits harm the living standard is by reducing the investment spending of U.S. businesses. High real interest rates caused by the budget deficit depress domestic investment, reducing labor productivity and the growth of real wages. Weak growth of industrial production when the trade balance was worsening also reduced U.S. investment spending because firms were reluctant to invest when excess capacity already existed. Reduced productivity growth and lower international competitiveness restrain the growth of real output per person. But future growth of real consumer spending will also be reduced because the real income that is available for consumer spending depends directly on the level of U.S. production.

Another way the twin deficits harm future living standards is through the growing U.S. international debt. Although domestic spending can temporarily exceed domestic production because of imports, this situation cannot continue indefinitely because it implies a growing foreign debt and growing net interest payments to foreigners. Foreigners will not be willing to acquire an unlimited amount of dollar-denominated assets. To meet its interest obligations, the United States will eventually have to export more than it imports, that is, it will have to run a trade surplus. Creating this trade surplus will require the United States to hold down domestic spending relative to domestic production, leaving the extra output to be exported. Thus, a higher U.S. foreign debt implies a lower future level of real consumer spending for any given level of domestic production.

Although some of the factors that hindered

<sup>12</sup> See Cecchetti (1986).

<sup>13</sup> See Hakkio and Higgins (1985).

improvement of the living standard in the 1970s and early 1980s are now reversing directions, U.S. citizens still have reasons for concern. For example, even though U.S. productivity growth has improved in the 1980s, productivity growth in the United States remains mediocre compared with other industrial countries.<sup>14</sup> Moreover, despite clear signs of improvement in recent quarters, the trade deficit remains large. A substantial international debt will likely accumulate before the United States solves its international trade problems, and interest payments to foreigners are growing rapidly as the United States becomes a debtor nation. These developments suggest that concern about the living standard will not disappear in the near future.

## **Policy options**

The concern about the living standard shows that many U.S. citizens feel recent levels of real output per person and real consumer spending per person are unsatisfactory. People who share this view are likely to favor policy changes designed to increase the living standard over time. Policy changes may be especially desirable to the extent that existing policies contributed to the problem. A number of policy options might be considered.

### *Trade policy*

A policy option that some observers believe would improve the standard of living is to provide greater protection for U.S. industry from import competition.<sup>15</sup> Such protection could be provided by tariffs, import quotas, or other regulations designed to limit the influx of foreign products. Protectionists justify these policies by

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<sup>14</sup> See Koretz (1988).

<sup>15</sup> See Culbertson (1986).

pointing to the lost manufacturing jobs and numerous plant closings in the mid-1980s when the trade deficit was worsening. Although an improving trade deficit is now restoring some of these jobs, protectionists argue that the international competitiveness of U.S. goods could again deteriorate sharply. Protectionism, they argue, would permit U.S. industry to restructure and would boost capital spending by guaranteeing the profitability of the industrial sector.

Most economists believe, however, that protectionist trade policies would ultimately harm the U.S. standard of living. Free international trade can provide gains for all countries by allowing each country to specialize in the goods and services that it produces most efficiently and to trade these products for what other countries can produce most efficiently. Although protectionist policies might increase domestic production temporarily, protectionism would also bring higher prices for consumer goods and the threat of foreign retaliation against U.S. exports. Eventually, the loss of competitive pressure on manufacturers and higher prices for imported raw materials would make U.S. products less competitive in world markets by raising production costs. And the reduced efficiency of domestic producers could slow the rate of improvement in future U.S. living standards. Economic research suggests, therefore, that the costs of protectionist trade policies would likely outweigh the benefits.<sup>16</sup>

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<sup>16</sup> The dangers of protectionism are discussed further in Maskus (1984). Recent theoretical research has shown that protectionist trade policies might produce some economic gains when markets are characterized by imperfect competition and increasing returns. This literature is reviewed in Krugman (1987). But Krugman argued that several factors limit the economic gains from such protectionist policies. And these limited gains are probably outweighed by political factors such as the possibility of trade wars. As a result, Krugman concluded that it would be unwise to abandon the principle of free international trade.

## *Industrial policy*

Another option that might be proposed to improve the U.S. standard of living is industrial policy. This option actually encompasses a wide range of government actions that proponents believe would increase the productivity and competitiveness of U.S. industry. Such policies often appeal to those who believe that slower growth of the living standard has been due to the competitive failures of U.S. companies. Moreover, proponents of industrial policy often argue that the foreign competitors of U.S. companies have received valuable assistance from their governments. Specific examples of industrial policies include government spending to support the commercial development of new technologies, labor training programs, and policies that make it easier to close inefficient older plants and open efficient new ones. Successful application of industrial policy often would require policymakers to identify which mature industries are losing their competitiveness and which emerging industries provide the best opportunities for future growth. Government policies would then encourage the movement of productive resources into these emerging industries through such policies as tax incentives, subsidies, and worker training programs.<sup>17</sup>

A general evaluation of industrial policy is difficult because of the diversity of the proposals. In general, industrial policy should be approached with caution because some of the proposed government policies have the potential to do great harm if the policies are not implemented correctly. There is little economic research to substantiate the view that U.S. productivity and trade problems are caused primarily by management failures or the industrial policies of foreign

<sup>17</sup> The case for industrial policy is developed in Magaziner and Reich (1982).

governments. Indeed, the trade deficit clearly has a large macroeconomic component resulting from the federal budget deficit and differing economic growth rates among the major industrial countries.

The successes of foreign industrial policies also may be greatly exaggerated. As an example of successful foreign industrial policy, analysts often cite the efforts by the Japanese Ministry of International Trade and Industry to develop a domestic steel industry. Yet careful analysis shows that policies promoting the steel industry probably did not benefit the Japanese economy.<sup>18</sup> In addition, the European economies have generally experienced higher unemployment than the United States in the 1980s despite the fact that European governments have been more actively involved in targeted industrial policies.

The greatest potential for industrial policy to be harmful arises in government decisions about which industries and technologies should be encouraged to grow and which should be discouraged. Economic theory does not provide operational criteria for deciding which industries should grow and which should contract.<sup>19</sup> If government policymakers did a worse job than private investors in identifying the prospects for various industries, inappropriate government policies could result in the misallocation of capital and regulations that stifle growth and innovation in existing industries. There is little reason to believe that government policymakers could consistently make better decisions than private investors. Investors in the United States have access to well developed capital markets and a broad range of information to guide their invest-

<sup>18</sup> See Krugman (1983), pp. 141-47. Krugman's conclusion about Japanese steel policies is that "the most famous of industrial policy successes was no success at all."

<sup>19</sup> The difficulty of establishing economically valid criteria for industrial policy is discussed in Krugman (1983), pp. 124-39.

ment decisions. Despite recent concerns, private investment has served the United States well, producing an enviable standard of living. Government should thus be cautious about interfering with the market allocation of capital because inappropriate policies could ultimately harm economic efficiency and future living standards.

### *Capital formation policy*

Another broad policy option to improve labor productivity and raise the living standard is to increase saving and investment incentives by changing the federal tax structure. Although tax rates on personal and corporate income have been reduced in the 1980s, a variety of further tax changes are possible. These potential tax reforms include decreasing or eliminating the capital gains tax, easing restrictions on contributions to Individual Retirement Accounts, eliminating the double taxation of corporate earnings paid as dividends to investors, restoring the investment tax credit, and introducing a consumption tax. Because the interaction of high inflation rates and the nonindexed tax system probably depressed business investment in the 1970s, another possible reform might be greater indexing of the U.S. tax code.<sup>20</sup>

Economic research suggests that tax changes to increase the after-tax returns to saving and investment typically would increase private capital formation. But the effectiveness and feasibility of these policy options are open to dispute. Although economists disagree about how sensitive private saving is to a change in the after-tax

return, many studies find the response in saving behavior to be relatively small.<sup>21</sup> Researchers also disagree about the sensitivity of business investment spending to after-tax returns. Nevertheless, a substantial body of economic theory and empirical research supports the view that expected after-tax returns influence investment decisions. Economic research thus implies that tax changes to increase the after-tax rewards to saving and investing would raise the private capital stock to some extent, raising the future standard of living.

Various practical considerations, however, may make substantial changes in the tax laws infeasible at this time. A major practical problem is that tax reductions to encourage saving and investment would worsen the federal budget deficit unless offsetting changes are made in other taxes or in federal spending. The Congress and the new administration may be reluctant to make tax changes that worsen the budget deficit because the adverse effects of a growing deficit could possibly outweigh any gains in saving and investment resulting from further tax reforms. Moreover, the tax laws have been changed substantially at several times during the 1980s. Because these tax changes create uncertainty and impose costs on both businesses and households, further large changes in the tax system may be considered undesirable at this time.

### *Macroeconomic policy*

Macroeconomic policy options deserve special consideration because the federal budget deficit was a major contributor to high real interest rates and the worsening trade deficit in the mid-1980s. Reducing the budget deficit is probably the most dependable way, at present, to raise the future

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<sup>20</sup> Although the Tax Reform Act of 1986 introduced indexing of personal tax brackets, personal exemptions, and standard deductions, such important features of the tax code as depreciation allowances and capital gains computations remain unindexed. As a result, higher inflation could still increase the real tax burden of savers and investors. For a more detailed analysis of various possible tax changes, see Miller (1984) and Pechman (1983).

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<sup>21</sup> The response of saving to higher after-tax returns is discussed further in Garner (1987).

standard of living. Reducing, and ultimately eliminating, the budget deficit would make a larger share of domestic savings available for private investment because the federal government would raise no new funds in the credit markets. Reducing the budget deficit also would lessen the need for foreign capital inflows and, therefore, help protect the dollar against upward pressures that could endanger the current recovery in the traded goods sector. Indeed, some observers advocate running a surplus in the federal budget so that the reduction in outstanding federal debt frees up funds for private investment.<sup>22</sup>

Although reducing the federal budget deficit or creating a surplus would ultimately raise the U.S. standard of living, such policies might lower real consumer spending per person temporarily until the economy had adjusted to the improved fiscal situation. Solving the budget problem would require either tax increases or slower growth of government spending. Tax increases would immediately lower consumer spending by reducing after-tax spendable income. Slower growth of government spending could also lower consumer spending by restraining general business activity and, therefore, household spendable income.

Reducing the federal deficit, however, would eventually raise consumer spending by increasing the nation's ability to produce. The positive effects of deficit reduction on the standard of living would be expected to occur gradually as lower interest rates and improved international competitiveness raised the capital stock and the productivity of labor. Higher productivity would increase real wage rates and aggregate produc-

tion, permitting consumption ultimately to be higher than would be possible if the budget deficit were not corrected.

Reducing the federal budget deficit would also raise future living standards by helping to close the nation's trade deficit and stem the buildup of foreign debt. As a result, future interest payments and debt repayments to foreigners would be less, and a smaller share of future output would be exported to meet these obligations to foreign lenders. The future U.S. living standard would benefit because a larger share of domestic production would be available for U.S. consumers.

While reducing the federal deficit is the most dependable way to raise the future standard of living, monetary policy can also play an important role. The primary way that monetary policy can contribute to a higher living standard is by continuing to pursue policies that maintain economic growth with a relatively stable inflation rate. Inflation rate stability—and over a longer horizon, inflation rate reduction—is particularly important in the absence of a fully indexed tax system because higher inflation could again reduce business incentives to invest. Even if the tax system were fully indexed, however, stable inflation would remain an important policy goal because a high inflation rate reduces economic efficiency by increasing uncertainty and arbitrarily redistributing income and wealth.

## Conclusion

A broad range of policy options have been proposed to address the slower rate of advance in the U.S. living standard. Not all of these policy options would actually raise the future standard of living, however, and some of the options with positive effects may not be feasible at this time. Protectionist trade policy, for example, would likely reduce the future standard of living by decreasing the efficiency of domestic industry and causing other countries to erect greater barriers

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<sup>22</sup> For example, Federal Reserve Chairman Alan Greenspan has said that "the inadequacy of our domestic saving rate, certainly relative to our major trading partners, suggests that the United States ought to be running a federal budget surplus to augment the supply of domestic savings." See Greenspan (1988).

to U.S. exports. Although the verdict is less clear on industrial policies, such policies have the potential to lower the living standard by misallocating capital. Policies to increase the after-tax returns to saving and investment would probably have positive effects on the future living standard as long as these policies did not worsen the federal deficit. However, many of the proposed tax changes would have relatively small positive effects that could be outweighed if they slowed progress in reducing budget deficits.

The most dependable policy for future gains in the living standard would thus be to reduce the federal budget deficit. While the tax increases or spending restraint needed to eliminate the deficit could temporarily weaken the growth of the living standard, the ultimate effect would be to raise real output per person and real consumer spending per person in the years ahead. Reducing the federal deficit, though not an easy road to national wealth, would be a dependable policy to enhance the future standard of living.