Warm Hearts and Cool Heads:
Promoting Growth and Opportunity in a Globalizing Economy

Peter R. Orszag[1]
Joseph A. Pechman Senior Fellow
Director, The Hamilton Project
The Brookings Institution

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Thank you. I am quite honored to be returning to APEC about a decade after I participated in the 1997 meetings in the Philippines. And thank you to the government of South Korea for sponsoring this important symposium.

The great British economist Alfred Marshall once spoke of the need for "cool heads but warm hearts" in making economic policy.[2] The thrust of my speech today is that, in the context of substantial increases in income inequality and given the political economy of globalization, warm hearts are necessary for cool heads – there is no "but" needed.[3]

Long-term prosperity is best achieved neither through an attempt to shut out the forces of global competition, which may seem warm hearted but is ultimately neither achievable nor desirable, nor through the mirage of an excessively individualistic laissez-faire approach, which may initially seem cool headed but ultimately is not.

Instead, policy-makers must embrace the rigors of competition but seek to make economic growth broad-based, to enhance individual economic security, and to design a role for effective government working in conjunction with private markets. These are the themes of the recently launched Hamilton Project at the Brookings Institution, which actively involves former policy-makers such as former Treasury Secretary Robert Rubin and former Deputy Treasury Secretary Roger Altman.[4]

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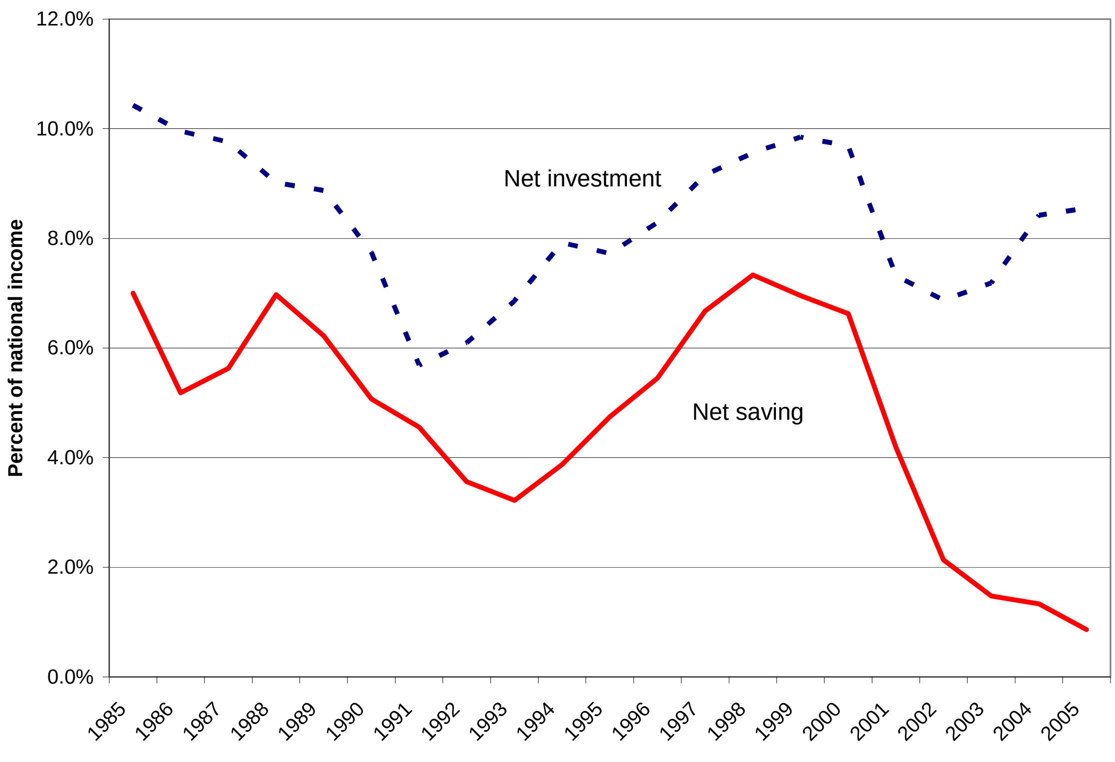
[1] The views expressed here do not necessarily represent those of the staff, officers, or board of the Brookings Institution. I thank Roger Altman, Lily Batchelder, Molly Batchelder, Josh Bendor, Jared Bernstein, Jason Bordoff, Robert Cumby, Michael Deich, William Gale, Robert Greenstein, Rebecca Kahane, Jeffrey Kling, Meeghan Prunty, Robert Rubin, and Gene Sperling for helpful discussions, comments, and assistance.
[2] Princeton economist Alan Blinder updated the term in a 1987 book entitled *Hard Heads, Soft Hearts: Tough Minded Economics for a Just Society*.
[3] Indeed, cool heads are not possible without due attention to warm hearts. On the other hand, cool heads are still necessary for sound policy. Thus we should if anything be seeking "warm hearts but cool heads," not the other way around.
[4] For more on The Hamilton Project, see www.hamiltonproject.org.

I. Background

The background for my remarks is provided through four simple charts about the United States economy. I focus on the U.S. economy both because of its continuing importance to the world economy and because of my greater familiarity with it, but many of the policy conclusions apply to other settings as well.

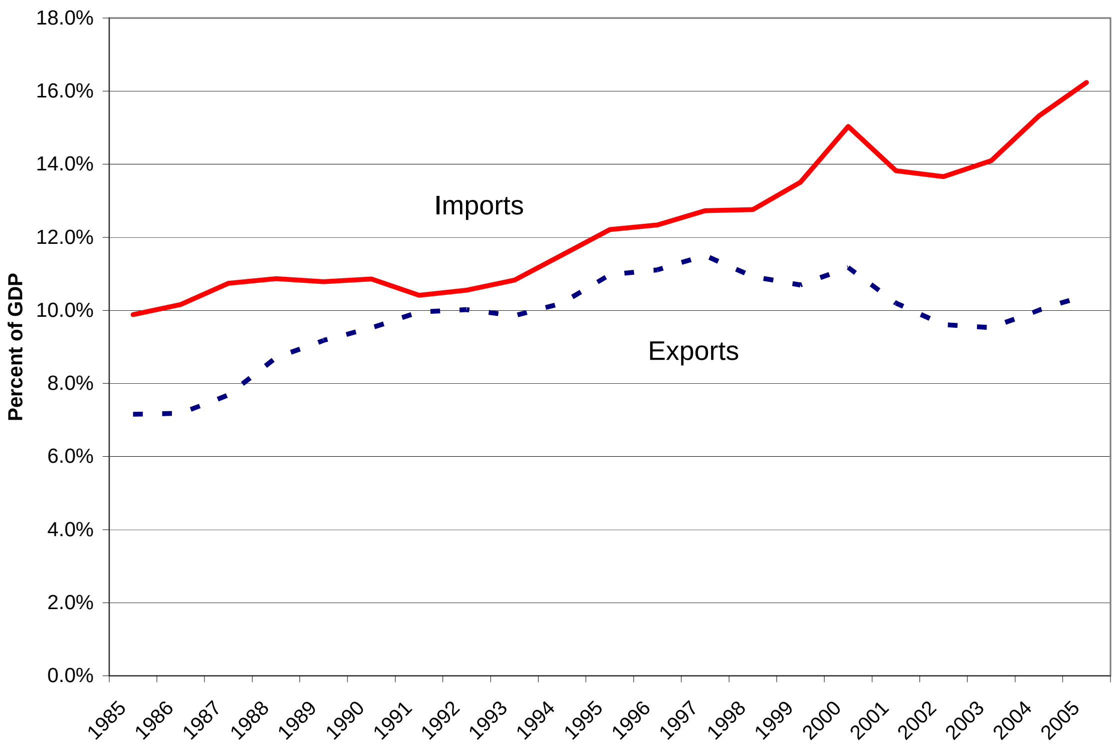
The first figure shows net national saving and net domestic investment – that is, saving and investment minus depreciation – as a share of national income over the past two decades. As the figure indicates, net domestic investment, after climbing steadily during the late 1990s and then declining sharply in 2001 and 2002, has now stabilized at approximately 8 percent of national income, roughly its level in the mid-1990s. This net domestic investment must be financed either by net national saving or borrowing from abroad. Over the past few years, it has increasingly been financed by borrowing from abroad, as net national saving has declined from more than 7 percent of income in 1998 to less than 1 percent in 2005. The increase in borrowing from abroad is reflected in the growing current account deficit, which has increased from under 2.5 percent of national income in 1998 to more than 7 percent in 2005.

Figure 1: Net national saving and investment



The second figure shows exports plus imports as a share of GDP over the past two decades. The sum of the two – which is commonly used as a measure of trade exposure – now amounts to more than 25 percent of GDP and has increased by roughly 10 percentage points of GDP over the past 20 years. In other words, the U.S. economy has become increasingly "open," in the sense that both exports and imports have risen over time relative to GDP.

Figure 2: Exports and imports



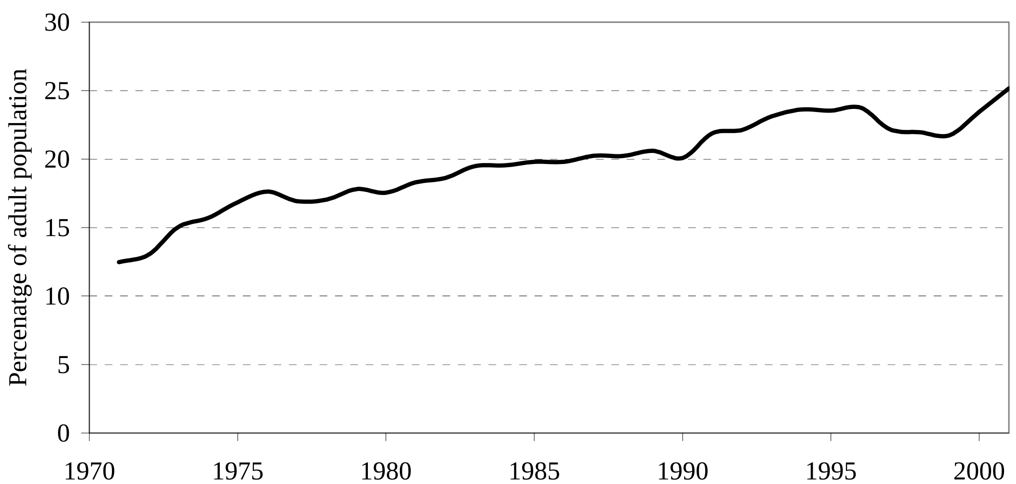
The third figure shows the pattern of growth in productivity and real median family income. Although the two series tracked each other closely between 1947 and 1973, they appear to have gotten a divorce since then. The primary reason is a substantial increase in wage inequality, with stunning increases especially at the very top of the wage distribution. According to data compiled by Emmanuel Saez and Thomas Piketty, the top 1 percent of wage earners accounted for 5.6 percent of total wages in 1975. By 2004, their share had risen to 11.2 percent. The top 0.1 percent – that is, one out of a thousand workers – accounted for 1.3 percent of aggregate wages in 1975 and 4.4 percent in 2004.[5]

The final figure shows that over the past two decades, even as macroeconomic fluctuations in GDP and unemployment have declined relative to previous decades, the volatility of family incomes has grown markedly. As Jacob Hacker of Yale University has shown, the probability that an American family will experience a drop in family income of 20 percent or more in any two-year period has doubled from 12 percent in the early 1970s to 25 percent today (see Figure 4).

[5] Table B2, http://elsa.berkeley.edu/~saez/TabFig2004prel.xls.

Figure 3: Productivity and family income

Figure 4: Predicted Probability of Family Income Decline of 20% or Greater



Source: PSID, CNEF. Probabilities based on time trend, with other variables set at annual means.

These facts are not subject to much debate, but different people will clearly interpret their implications differently. So let me put forward my own interpretation of the implications:

1. Regardless of whether one believes the substantial U.S. current account deficit is sustainable, the nation's net national saving rate is too low and an increase would be desirable.

2. America's increased trade exposure brings substantial benefits, but it also imposes concentrated losses and provides an easy target for those concerned about job loss and economic insecurity.

3. Too many Americans are not sharing in the nation's overall prosperity. Over the medium and long term, for both economic and political economy reasons, growth that disproportionately favors a small segment of the population is likely to implode in one way or another.

4. American families are subject to increased levels of economic risk and income volatility, in part due to changes in the economy but also due to changes in policy. The resultant decline in economic security is not only harmful to families but also potentially harmful to overall economic growth.

These four forces interact with each other. The nation's low net national saving rate is the primary explanation for its current account deficit, which heightens popular concerns about "globalization" and increased trade exposure. International trade has generated substantial benefits for the country; estimates suggest that it creates annual benefits amounting to roughly $1 trillion. But increased trade exposure has also contributed, albeit only modestly according to most estimates, to income inequality. Stagnation of real median family income and increased inequality exacerbates anxieties associated with increased volatility of household income. And concerns about economic security, in turn, are heightened by fears that as other nations increase their productivity in sectors in which the U.S. had previously held a comparative advantage, the gains from trade may be diminished and the U.S. may experience a reduction in living standards compared to historical levels.

II. Principles of The Hamilton Project

The question then becomes what to do about all this. One approach, which is dominant in the United States today, is represented by what Jared Bernstein has called the YOYO approach – you're on your own.[6] YOYO economics emphasizes the paramount importance of individual incentives almost to the detriment of all else, while paying little attention to market failures, the reality of individual decision-making as highlighted by the growing field of behavioral economics, or even the fact that government sets the rules

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[6] Jared Bernstein, *All Together Now: Common Sense for a Fair Economy* (Economic Policy Institute: Washington, 2005).

under which markets operate. Thus under the YOYO view of economics, the most auspicious way to boost private saving is to remove income and contribution limits on tax-preferred saving, the best way of boosting productivity is to cut taxes, and so on. Improving economic performance is simply a matter of "getting government out of the way."

In my view, YOYO economics is not only misleading and historically inaccurate. It is affirmatively damaging in view of the four forces I described earlier. The obsession with tax cuts has led to significant budget deficits that depress national saving and expand the current account deficit. And instead of a deep respect for market forces tempered by knowledge of their limitations, the assumption that unfettered markets always produce the best of all possible outcomes in all possible situations has meant that policy has not leaned against the wind of inequality and insecurity, for to do so under the YOYO view would mean increased distortions and less growth.

Some who oppose YOYO economics go to the other extreme, what I will call the sand-in-the-wheels approach. They favor turning inward and shutting out the forces of international competition, while trying to protect specific jobs. This approach is unfortunately just as unrealistic and unwise as YOYO economics. It is unrealistic given the substantial cross-border connections that already exist: more than 40 percent of U.S. trade occurs between U.S. firms and their foreign affiliates or between foreign firms and their U.S. subsidiaries.[7] Pervasive global supply chains raise significant questions about the practicality of turning inward. As Gene Sperling has emphasized, "however admirable it is to want to take every imaginable step to save existing U.S. jobs, when we impede the economic logic of producers seeking to meet consumer demands by finding the lowest-cost inputs, we are engaging in a losing game."[8] Furthermore, even if it were practical, turning inward would be ill-advised: It would forgo the substantial aggregate economic benefits that can be obtained from trade and risk tit-for-tat retaliatory steps.

Similarly, some believe that as the world economy becomes increasingly integrated and workers face competition from a growing number of workers in other countries, economic security is best promoted by protecting specific jobs in the domestic economy. My view is instead firmly in line with a recent white paper on the topic from the HM Treasury in Great Britain and the Ministry of Finance in Sweden: "The best way to manage the insecurities associated with globalization, and maximize the opportunities, is to provide security by equipping people to manage and take advantage of change, but not to protect specific jobs."[9] In other words, the goal should be to provide workers with the tools to succeed in and navigate the risks associated with a globalized economy, rather than attempt to avoid those risks in an ultimately futile effort to insulate particular jobs from the rigors of competition. Thus economic security must be provided, but it must be provided in the form of skills and market-based social insurance schemes, not by

[7] http://www.census.gov/foreign-trade/Press-Release/2005pr/aip/related_party/rp05.pdf.
[8] Gene Sperling, *The Pro-Growth Progressive*, page 12.
[9] Swedish Ministry of Finance and HM Treasury, "Social bridges: Meeting the challenges of globalization," April 2006.

attempting in vain to hold back the tide of competition through the protection of specific jobs.

The bottom line is that the most auspicious way forward rejects both the YOYO approach and the sand-in-the-wheels one. Instead, it seeks the combination of market competition and measures to bolster personal economic security in a "warm hearts and cool heads" approach. Workers exposed to fierce competition should be provided with the tools they need to navigate such a world, including adequate preparation (in the form of quality education and training programs) and targeted, pro-work assistance if economic difficulties arise. After families suffer a job loss or some other economic shock, the government can use market-friendly policies to help them get back on their feet. This perspective is embodied in the public philosophy being put forward by The Hamilton Project in the United States. Its three key principles are all consistent with the emphasis on warm hearts and cool heads, especially in light of the pressures being exerted by globalization.

Principle 1: Broad-based economic growth is stronger and more sustainable

The first principle is that economic growth will ultimately be stronger and more sustainable if all individuals have the opportunity to contribute to and benefit from it. When public policy excessively favors relatively few, growth suffers because the nation misses out on much of our people's potential for innovation and productivity. For example, without a quality public education, the middle-income child is less likely to become the highly productive worker of the future; without adequate access to capital, the potentially successful moderate-income businesswoman is less likely to get her business off the ground.

In political economy terms, excluding significant parts of the population from the fruits of economic growth also risks a backlash that can threaten prosperity. As former Federal Reserve Chairman Alan Greenspan recently put it, "[A]n increased concentration of income . . . is not the type of thing which a capitalist democratic society can really accept. . . ."[10] Both the economic and political effects underscore the benefits of broad-based growth, a notion supported by a variety of empirical evidence. As the World Bank recently concluded in a major study of the topic,

> "Because talent and ideas are widely distributed in the population, a prosperous modern society requires the mass of people to have incentives—and a state that can and will provide key complementary inputs and public goods. It therefore requires an underlying set of institutions that generate equality of opportunity for individuals and assure the accountability of politicians to all. . . . Growth certainly can occur in societies in which these conditions do not apply. But the preponderance of

[10] Joint Economic Committee, *The Economic Outlook*, 109th Cong., 1st Sess., 2005. Between 1979 and 2002, for example, average after-tax income rose by 111 percent among the top 1 percent of the population but by only 15 percent in the middle fifth of the population. See Congressional Budget Office, *Effective Federal Tax Rates: 1979-2002* (Washington, D.C.: Congressional Budget Office, 2005), table 1C.

> evidence suggests that such growth is unsustainable. This perspective is consistent with historical narratives, basic patterns in cross-country data, and more careful causal empirical work on the sources of prosperity."[11]

Principle 2: Economic security and economic growth can be mutually reinforcing

Economic growth can clearly increase economic security, but economic security can also increase economic growth. Many policymakers and analysts have been trained to believe that providing more security to families must come at the expense of economic performance and that these two goals are thus contradictory objectives.[12]

Especially over the long term, however, the traditional view misses three key points. First, a basic level of security frees people to take the risks—for example, starting a business, investing in their own education, or trying an unconventional career—that lead to economic growth.[13] With inadequate protection against downside risk, people tend to be overcautious, "fearing to venture out into the rapids where real achievement is possible," as Robert Shiller of Yale has argued. "Brilliant careers go untried because of the fear of economic setback."[14] Second, if hardship does occur, some degree of assistance can provide the resources to help a family thrive again. Families with access to some form of financial assistance, educational and training opportunities, and basic health care are less likely to be permanently harmed by the temporary setbacks that are an inevitable part of a dynamic economy. For families experiencing short-term difficulties, a safety net can thus be a springboard to a better future. Finally, a basic level of economic security can lessen political demands for protectionism and other growth-diminishing policies. The benefits of new technology and competition tend to be spread widely across

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[11] World Bank, *World Development Report 2006: Equity and Development* (Washington, DC.: World Bank, 2005), 124-5

[12] As one leading textbook observes, "As the government insures individuals against being poor, it raises the incentive for individuals to be poor." Jonathan Gruber, *Public Finance and Public Policy* (New York: Worth Publishers), 463.

[13] See, for example, Hans-Werner Sinn, "Social Insurance, Incentives, and Risk Taking" (Working Paper 5335, Cambridge, Mass.: National Bureau of Economic Research, 1995). Empirical evidence also suggests that generous personal bankruptcy laws are associated with higher levels of venture capital; that workers who are highly fearful of losing their jobs invest less in their jobs and job skills than those who are more secure; and that investment in education and job skills is higher when workers have key risk protections. See John Armour and Douglas Cumming. "The Legal Road to Replicating Silicon Valley" (Working Paper 281, Cambridge, UK: Centre for Business Research, University of Cambridge, 2004); Lars Osber, "Economics of Insecurity" (Discussion Paper 88, Sydney: Social Policy Research Centre University of New South Wales, 1998); Margarita Esteves-Abe, Torben Iverson, and David Soskice, "Social Protection and the Formation of Skills: A Reinterpretation of the Welfare State" (paper prepared for the 95th American Political Science Association Meeting, Atlanta, September 2-5, 1999); and Sauro Mocetti, "Social Protection and Human Capital: Test of a Hypothesis" (Working Paper 425, Siena, Italy: Department of Economics, University of Siena, 2004)

[14] Robert Shiller, *The New Financial Order: Risk in the 21st Century* (Princeton, NJ.: Princeton University Press, 2003), 8. Senator Barack Obama has made a similar point, arguing that "these safety nets are exactly what encourage each of us to be risk-takers and entrepreneurs who are free to pursue our individual ambitions…We take a chance on start-ups and small businesses because we know that if they fail, there are protections available to cushion our fall. Corporations across America have limited liability for this very reason. Families should too- and that's why we need social insurance" (Barack Obama, "A Hope to Fulfill" [remarks prepared for luncheon at the National Press Club, Washington, D.C., April 26, 2005]).

the economy, but are often highly disruptive to a certain industry or set of jobs. Individuals in the affected sectors may naturally resist the adverse effects on their own jobs associated with such overall progress. In this context, providing a basic level of economic security can ease transitions and help to avoid policy responses that may hamper overall economic growth.

To be sure, providing too much security can harm economic growth by excessively blunting incentives to work, innovate, and invest, and some developed nations have gotten the balance wrong in this way. But any such adverse effects on growth can be as much a matter of how economic security is provided—and in particular whether policy design pays careful attention to incentives—as how much security is provided. Furthermore, insufficient economic security also harms growth, and thus even from the perspective of economic growth alone, providing a core level of security is beneficial. Policymakers must thus seek the right balance, recognizing that both the form and amount of economic security can affect economic growth and individual well-being.

Principle 3: Effective government can enhance economic growth

Markets are the cornerstone of economic growth. Yet market forces, while potent, will not by themselves generate adequate investments in education and training. Neither will markets generate sufficient investments in science and infrastructure—such as the type of government-funded "blue sky" research with no immediately apparent commercial viability that led to the Internet's creation—which are crucial to economic growth. To achieve strong, sustained, and broad-based economic growth, market forces must be supported and supplemented by an effective public role. For example, government must ensure that the rules of the game are fair, transparent, and binding for all parties. The YOYO notion that strong growth over the long term is possible simply by "getting government out of the way" is fundamentally misguided, since sound government policy is essential to maximizing long-term growth.

III. Policy responses

With these principles in mind, what specifically can be done to increase broad-based economic growth? Allow me just to provide a few selective examples in three areas: saving, social insurance, and tax reform. Together they and other similar proposals would be much more effective at promoting long-term growth than continued tax cuts.

Increase national saving

First, higher national saving would reduce the current account deficit, raise future economic growth, and increase future living standards. Since national saving is the sum of public saving and private saving, the key to raising it is to reduce public dis-saving and to increase private saving, and the effect of policies aimed at reducing public dis-saving is admittedly likely to be larger than the effect of policies aimed at raising private saving.

But since reducing budget deficits involves politically painful steps like tax increases and spending cuts, policy-makers often focus instead on ways to increase private saving.

Higher private saving could be accomplished through two policy shifts: making it easier for middle- and lower-income households to save and increasing their incentives to do so.[15] A recent proposal from The Hamilton Project argues that families don't have time to focus on saving decisions, and tax incentives to save for many middle- and low-income households are weak.[16] The proposal would provide new tools to address both issues. To make it easier to save, the proposal would require every firm (with potential exceptions for the smallest businesses) to automatically enroll their new workers in a traditional defined benefit plan, a 401(k), or an IRA. Workers would always have the ability to opt out of these savings vehicles. New Zealand has already adopted this type of approach through its Kiwi Save program, and the UK has embraced the same approach in its most recent government white paper.[17]

Our proposal would also replace the existing "upside down" set of tax incentives for retirement saving, which mostly subsidize asset shifting by higher-income households rather than new saving by middle- and lower-income households, with a simple 30 percent match for everyone.[18] The result would be a stronger incentive to save for 80 percent of households.[19] New randomized evidence also suggests that transforming the incentive from a *credit* (that is, money returned to the tax filer in the form of a reduction in tax liability or a refund) into a *match* (that is, money deposited directly into the retirement account) would be more effective at inducing retirement contributions.

While I'm on the topic of private saving, let me contrast the proposal I just described with the YOYO approach to the problem, since I think the comparison is illuminating. Rather than bolstering saving among middle- and lower-earners, the YOYO approach instead focuses on increasing income and contribution limits to tax-preferred accounts. For example, one common proposal would increase the maximum amount that can be saved on a tax-preferred basis, such as by raising the amount that can be contributed to an IRA or 401(k). Yet less than 10 percent of 401(k) participants make the maximum contribution allowed by law, and only about five percent of those eligible to contribute to IRAs make the maximum contribution. Increasing the maximum contribution amounts would thus be unlikely to have much effect on the vast majority of families and individuals, since they are not currently making the maximum allowable contribution. Instead, raising the contribution limits would largely provide windfall gains to households already making the maximum contributions to tax-preferred accounts *and*

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[15] For more information, see www.retirementsecurityproject.org.

[16] William Gale, Jonathan Gruber, and Peter Orszag, "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households" (White Paper 2006-02), Washington, D.C.: The Hamilton Project, 2006).

[17] See J. Mark Iwry, "Automating Saving: Making Retirement Saving Easier in the United States, the United Kingdom and New Zealand," Retirement Security Project Policy Brief 2006-2, June 2006.

[18] This basic idea has also been championed by Gene Sperling, among others.

[19] William Gale, Jonathan Gruber, and Peter Orszag, "Improving Opportunities and Incentives for Saving by Middle- and Low-Income Households" (White Paper 2006-02), Washington, D.C.: The Hamilton Project, 2006).

saving more on top of those contributions in other accounts. Furthermore, most of the response to increasing the contribution limits is likely to be shifting of assets from other accounts. The expanded tax preference thus would mostly translate into subsidizing saving that would have occurred anyway, rather than encouraging new saving. Furthermore, if the expanded tax preferences are deficit-financed, the net result may well be a reduction in national saving rather than an increase. The result improves neither economic performance nor equity.

Economic security and social insurance

Another critical topic involves social insurance programs. Proponents of YOYO economics would significantly weaken these programs, shifting yet more risk onto families despite the significant increase in income volatility shown in Figure 4. Instead, the warm heart and cool head approach is to update social insurance programs to provide better protection against the most important risks while also paying careful attention to individual incentives.

As just one example, the risks associated with job dislocation are increasingly salient as the world economy becomes more integrated. Jeffrey Kling of Brookings has developed a revenue-neutral proposal to fundamentally restructure the system of social insurance after job loss to improve the protection against long-term effects of involuntary unemployment, to provide a more progressive allocation of benefits, and to encourage work. As part of this reform, the government would create a program of wage-loss insurance for reemployed workers, which would augment the hourly wages of individuals who take jobs that pay a lower wage than their previous jobs. In order to encourage return to work and to shift assistance towards those taking new jobs at lower wages, traditional unemployment insurance payments would be replaced by a saving and borrowing facility for those experiencing unemployment spells. An alternative unemployment insurance proposal is being developed by Lori Kletzer of the University of California at Santa Cruz and Howard Rosen of the Institute for International Economics.

Tax reform

Progressive taxation can play an important role in attenuating after-tax income inequality and thereby promoting broad-based growth. Robert Shiller of Yale University and Len Burman of the Urban Institute are developing a proposal to index the tax system for inequality—meaning that tax rates would be calculated, at least in part, in order to achieve a pre-determined after-tax distribution of income. Adjusting the tax code in this way, the authors argue, would mean that low- and middle-income Americans would share in the benefits of growth-enhancing policies.

Another proposal was developed by Lily Batchelder of NYU, Fred Goldberg of Skadden Arps, and myself.[20] It argues that the roughly $500 billion a year in tax

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[20] Lily L. Batchelder, Fred T. Goldberg, Jr., and Peter R. Orszag, "Efficiency and Tax Incentives: The Case for Refundable Tax Credits," 59 *Stanford Law Review* (forthcoming).

incentives devoted to subsidizing socially beneficial activities (such as retirement saving, health care, education, and home ownership) should be dramatically overhauled. We argue that in the absence of evidence that high-income households are more responsive to the incentives or generate larger social benefits than low-income households, the subsidies should be delivered in the form of uniform, refundable credits, so that they do not vary by income – which would be both more efficient and more equitable than the current system. The efficiency benefits of uniform refundable credits are further magnified by their tendency to smooth household income and macroeconomic demand. The burden of proof should be on those who want to deviate from this uniform subsidy approach, to prove that a regressive approach is more efficient.

A final topic involves corporate taxation. As the world economy becomes increasingly integrated, the existing system of corporate taxation across the globe is coming under increasing pressure. Transfer pricing disputes abound. In my view, it is time to consider moving to a formulary apportionment system internationally, under which a company's global profits would be taxed at the national level based on perhaps a single factor, such as the share of the firm's total worldwide sales occurring in that country. The Hamilton Project is exploring this and other ideas to maintain some form of corporate taxation in a world with extremely mobile capital across national boundaries.

Conclusion

These are just a few of the ideas that are both warm-hearted and cool-headed that we are exploring through the Hamilton Project and other related efforts. While I am on the topic of cool-headedness, I'd like to make one point regarding the nature of evidence used to formulate policy. Too much of the economic research cited in policy circles is neither randomized nor behavioral. As a result, it is unable to distinguish convincingly between correlation and causation and is potentially misleading because it often doesn't even attempt to capture behavioral influences.

Much more emphasis must be placed on randomization, which allows a simple, clean, and highly credible comparison between the effect of a policy innovation and what would have happened if that innovation had not been introduced, and also insights from the emerging field of behavioral economics, which examines the potential importance of policy levers that a neoclassical economic approach would overlook. If we really want to learn what works and what doesn't, governments, academics, foundations, international organizations, and others should be investing substantially more in randomized, behavioral studies. The Poverty Action Lab at MIT is doing path-breaking work in this area in developing countries.[21] More effort is also required in developed countries.

Thank you once again for inviting me here today. President Teddy Roosevelt once remarked, "Softness of heart is an admirable quality, but when it extends its area until it also becomes softness of head, its results are anything but admirable. It is a good

[21] http://www.povertyactionlab.org/

thing to combine a warm heart with a cool head."[22] I hope that conferences like this one can help to move economic policy-making toward such a combination.

[22] Theodore Roosevelt, "Promise and Performance," *The Strenuous Life*, Published in the "Outlook," July 28, 1900, available at: http://www.bartleby.com/58/9.html.