Remarks by Laura D'Andrea Tyson
Chair of the Council of Economic Advisers
before the Committee on the Budget
United States Senate

Tuesday, February 7, 1995

Mr. Chairman, before I get started, I want to thank you and the Committee for the opportunity to testify today. It is indeed a pleasure to be here as a member of this Administration to discuss both the economic success story of the past 2 years and the encouraging prospects for the future.

Last year we witnessed an economic payoff to the tough fiscal decisions embodied in the Omnibus Budget Reconciliation Act of 1993 (OBRA93). The deficit shrunk by $52 billion in fiscal year 1994 due to the initiatives set forth in OBRA93 ($72 billion if special factors such as receipts from the sale of assets acquired from failed thrifts are excluded). And we anticipate a cumulative total of more than $600 billion in deficit reduction from the pre-OBRA93 baseline through 1998. Of this amount, $505 billion comes from spending cuts and revenue increases contained in OBRA93; the remainder is due to technical revisions and the improved economic climate which, in part, resulted from OBRA93. The Administration's 1996 budget package adds another $81 billion in budgetary savings through 2000. This Administration has clearly demonstrated to the American people that fiscal responsibility is not just political rhetoric but a linchpin of our entire economic agenda.

My testimony today consists of three parts: a review of the economy's performance in 1994; a presentation of the Administration's economic forecast for 1995; and an overview of the Administration's economic strategy -- embodied in its 1996 Budget -- for improving the living standards of all Americans.

The Economic Situation in 1994

The U.S. economy in 1994 enjoyed a balanced and broad-based expansion. Real gross domestic product (GDP) grew 4 percent, the highest annual growth rate since 1987. Payrolls increased by 3.5 million, the largest annual increase in employment since 1984. Consequently, the unemployment rate dropped over a full percentage point during 1994. Since the Administration took office in January 1993, about 5.6 million jobs have been created; of these 93 percent are in the private sector. The consumer price index (CPI) increased by only 2.7 percent, about the same rate of increase as for the past 3 years. When the volatile food and energy components are removed, however, the core rate of consumer inflation registered its smallest increase in 28 years. The combination of strong economic growth and low inflation makes 1994 one of the best macroeconomic performances on record.

This strong performance took place in an environment in which the Federal Reserve increased short term interest rates several times in an effort to moderate the economy's growth to prevent future inflation. While these rate increases should put a brake on economic growth, we are optimistic about the future prospects for the economy. Business confidence appears strong, as evidenced by high levels of business investment in 1994. Similarly, consumer confidence remains strong, as purchases of durable goods grew rapidly over the year.

While the overall economy appears to be performing well, we are concerned that many Americans are not full participants in the growing prosperity. For instance, real median family income in 1993 is about the same level it was in 1973, despite an increase in real aggregate income of 57 percent during the same time period. Additional evidence of the trend of stagnant incomes for many Americans is the fact that hourly compensation in 1994 (as measured by the employment cost index) increased only 3 percent over the year, barely outpacing the 2.7 percent increase in the CPI. The actual increase in hourly compensation was lower than expected, based on a statistical relationship between the unemployment rate and the growth rate in hourly compensation. This is statistical confirmation of the feeling of many Americans that they are working harder for less.

The stagnation of family incomes has been accompanied by an equally disturbing trend of increasing income inequality. In contrast to the years 1950-1973, when average real family incomes increased throughout the income distribution, between 1973 and 1993, the spread in income inequality has gotten larger. As an example of this fact, Chart 1 shows the share of aggregate income received by families in different parts of the income distribution in 1973 and in 1993 (the most recent year for which these data are available). This Chart indicates that each of the four lowest quintiles of the income distribution saw their share of aggregate income decrease, while the share for the 20 percent of the population with the highest incomes increased substantially (and much of this increase was concentrated in the top 5 percent).

Over the past 2 years, the economy has grown at an average annual rate of 3.6 percent, as aggregate demand rebounded from the 1990-91 recession and the lackluster growth that initially followed it. In part, the current expansion was accomplished through an increase in the quantity and quality of the labor force and through net additions to the capital stock. To a significant extent, output was able to meet strong increases in demand through re-employment of workers who had been unemployed or underemployed and through the utilization of capital that had been idle or underutilized. By the end of 1994, however, both labor and capital utilization rates were in ranges that suggested little remaining slack. When this happens, the economy's growth rate becomes increasingly constrained by the growth rate of the labor force, net additions to the capital stock, and the productivity of labor and capital. Over the long run, these factors determine the economy's potential for growth or what economists refer to as the growth rate of potential GDP. Based on current information and the economy's most recent historical performance, most mainstream economists believe that the economy's growth potential is around 2.5 percent per year. This estimate of long-run real growth potential is shown by most major economic forecasts and the Administration forecast reflects this view.

The Administration's Economic Forecast

This Administration prides itself on making realistic forecasts of economic conditions and we believe the evidence of the past 2 years suggests that our forecasts have been conservative as well as credible. In fact, when I testified before this committee last year, I said that "the economy is poised for a sustained expansion." Forecasting may be an inexact science, but it is definitely satisfying when your forecasts prove correct. Indeed, the major surprise in the performance of the U.S. economy in 1994 was that real growth exceeded the forecast by a significant amount, even though interest rates were much higher than predicted and inflation slightly lower than predicted.

This year's economic forecast continues the conservative tradition of our prior forecasts. We are forecasting a moderation of growth in 1995 as the effects of increases in interest rates spread more broadly through the economy. For 1995 as a whole, we are forecasting that real GDP will grow by 2.4 percent relative to 1994. Then in 1996, the economy is expected to settle onto a path consistent with its long-run growth potential of 2.5 percent, a so-called "soft landing". We forecast the economy to maintain real output growth in line with the growth of potential output through the year 2000.

Inflation is forecast to rise slightly during 1995. Consumer prices are projected to increase by 3.2 percent in 1995. Thereafter, consumer price inflation is forecast to remain at 3.2 percent through 1998, before falling to 3.1 percent in 1999 and 2000. More broadly, inflation as measured by the GDP price deflator is forecast at 2.9 percent this year and next. Then we expect inflation to settle at about 3.0 percent over the remainder of the forecast horizon.

The Administration forecast used in preparation of the budget predicts that the unemployment rate will average around 5.8 percent in each year between 1995 and 2000. Since that forecast was made in November, more has been learned about the behavior of the actual unemployment rate. In the upcoming Economic Report of the President, the Administration presents a forecast range for the unemployment rate of 5.5 percent to 5.8 percent for each year from 1995-2000. We forecast a range both because we are unsure about the impact of the 1994 improvements to the Current Population Survey used to compute the unemployment rate and because some structural change may be underway in the labor market. An important characteristic of our employment forecast is that it incorporates a belief that economic growth over the next several years will be sufficient to absorb all new entrants to the labor force. Therefore, we anticipate little upward pressure on the unemployment rate during this period.

Our forecast anticipated a 50 basis point increase in short-term interest rates (three-month Treasury bill rates) during the first quarter of 1995. As growth moderates during the year, we expect short-term interest rates to fall about 50 basis points by early 1996 and remain there throughout the remainder of the forecast horizon. The forecast for interest rates on 10-year Treasury notes was revised upward for 1995 to 7.9 percent from last year's lower level. Our forecast predicts a decline in these interest rates to an average of 7.0 percent between 1997 and 2000. This forecast reflects the belief that the spread between short and long term interest rates will return to a more traditional range than the one experienced in 1994, as the inflation and risk premiums built into long-term rate gradually shrink.

Table 1 attached to my testimony compares the Administration's economic forecast to the Congressional Budget Office and Blue Chip forecasts. While there are some differences between these forecasts, the differences tend to be small, and Table 1 indicates a high degree of consistency in these different forecasts.

There are always some risks to any economic forecast. The possibility exists that the interest rate increases engineered by the Federal Reserve will not dampen growth as quickly as anticipated. If this occurs, real economic growth in 1995 could exceed the predicted 2.4 percent rate. A higher than predicted growth rate in turn could result in higher than anticipated interest rates, which could slow future economic growth more than expected.

Similarly, there are risks that the economy may grow more slowly than forecast. For instance, the interest rate increases already in the pipeline may slow economic growth sooner than anticipated or by more than anticipated. Compounding this risk is the possibility that foreign economic growth may stall, reducing foreign demand for U.S. exports. In addition, the large inventory accumulation by businesses over the past year may not have been entirely intentional. If this proves to be the case, then production could be scaled back to reduce an inventory overhang, lowering growth. Finally, the course of the economy depends on budgetary and other policy decisions made by Congress. This year there is an especially high degree of uncertainty about future Congressional actions in matters that can affect output, growth, deficits, and interest rates over the short, medium, and long term.

A Strategy for Improving Living Standards for All Americans

The Administration's economic strategy for raising the living standards for all Americans has three components. The first is to establish a sound fiscal foundation for the Federal Government. Getting the Nation's fiscal house in order required a deficit reduction plan that is balanced and gradual, yet large enough to be credible and to have a significant positive effect over time. The Administration's initial budget plan enacted as OBRA93 met this test, and this year's budget follows up on that legacy by providing further deficit reduction. To see the effects of these deficit reduction initiatives, consider that in 1992, the Federal deficit had reached 4.9 percent of GDP. For fiscal year 1996, the deficit is expected to be about 2.7 percent of GDP. And, by 1998, we project it to fall to 2.4 percent of GDP, less than half its 1992 level.

Economists often prefer to focus on the structural budget deficit, which adjusts the deficit computations by eliminating the effects of the business cycle. By this measure, the burden of the Federal budget deficit has declined steadily since 1993, with much of the credit for this improved fiscal picture attributed to OBRA93. Chart 2 attached to my written testimony shows the structural budget deficit as a share of GDP and indicates the substantial effect that OBRA93, along with the additional deficit reduction in this year's Budget, has had on it.

The second component of the economic strategy is a set of policies to help American workers and businesses realize the opportunities that flow from changes in technology and the global economy. The common theme of these policies is investment: both public and private. On the public side, the Federal Government is shifting spending away from current consumption and toward investment in children, education and training, and science and technology. On the private side, the Administration supports targeted subsidies to complement market incentives and encourage investment by individuals and businesses in physical, scientific, and human capital. Throughout, the Administration recognizes that government must not only spend less, it must also spend better, by focusing more of its resources on the Nation's future.

A third component of the Administration's economic strategy is tax relief for working families. The Administration first focused tax relief initiatives on those working Americans with the lowest incomes. The result was the substantial expansion of the earned income tax credit in OBRA93. This refundable tax credit increases the after-tax income for many lower-paid workers and is an important step toward ensuring that families with full-time workers will not live in poverty. This year's budget includes a second round of tax relief, this one aimed at middle class families. The package of tax cuts introduced by the President in December will help Americans meet the costs of raising their families, acquire more education and training, and save for a variety of purposes.

The Role of Deficit Reduction

When viewed in the context of the three components of the Administration's economic strategy, it is clear that deficit reduction is not an end in itself, but rather a means to the end of greater national investment and higher living standards. Deficit reduction has the beneficial effect of increasing national saving (by reducing the negative saving of the Federal Government). This increased national saving is available to private entities for investment in physical capital like machinery and equipment, which in turn can increase labor productivity. But squeezing worthwhile public investments out of the budget to make room for private investment is the wrong way to reduce the deficit. Moreover, one should recognize that deficit reduction by itself is contractionary fiscal policy and constrains aggregate demand. Therefore, there are limits to the amount of deficit reduction that the economy can be expected to withstand in a short period without endangering economic growth. Over the long run, deficit reduction makes room for more private investment, but in the short run it depresses aggregate demand and can even depress private investment. For all these reasons, the Administration prefers to engage in gradual and measured deficit reduction. Our success to date in reducing the deficit is one reason why the Administration opposes a balanced budget amendment to the Constitution.

Shortcomings of a Balanced Budget Amendment

First, everyone should be aware that the proposed amendment by itself would not reduce the Federal deficit by even one dollar. All the hard choices about cutting expenditures or raising revenues (through either taxes or fees) would still remain. Congressional consideration of a balanced budget amendment without first specifying the changes to expenditures and taxes required to bring the budget into balance provides no evidence of the fiscal discipline necessary to achieve real deficit reduction.

One of the great fallacies behind the logic for a balanced budget is the premise that the size of the Federal budget deficit is purely the result of deliberate policy decisions. This is not the case; the pace of economic activity has a major role. An economic slowdown automatically depresses tax revenues and increases spending on programs such as unemployment and Food Stamps. Consequently, the deficit automatically widens and the additional disposable income made available to consumers cushions the effects of the recession.

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During economic expansions, the process works in reverse, and the deficit automatically narrows. These effects are termed "automatic stabilizers" because they act by themselves to moderate the effect of business cycles.

But a balanced budget amendment would throw these automatic stabilizers into reverse. Congress would be required to raise taxes or cut spending in the face of a recession, to counteract temporary increases in the budget deficit. Rather than moderate the ups and downs of the business cycle, fiscal policy would be forced to aggravate them.

With fiscal policy deprived of its counter-cyclical role, monetary policy, conducted by the Federal Reserve, would be the only tool available to stabilize the economy. But even well-executed monetary policy (which assumes the Federal Reserve promptly recognizes changes in the business cycle and aggressively acts to offset the effects) cannot completely compensate for the lack of fiscal policy flexibility. In part, the inability of monetary policy to fill the void reflects the fact that monetary policy acts with a long, and uncertain, lag. Moreover, the Federal Reserve could become handcuffed in the case of a severe recession, its scope for action limited by the fact that it can reduce interest rates no lower than zero, and probably not even that low in practice. Moreover, the more aggressive interest rate movements necessary to offset macroeconomic fluctuations could actually increase the volatility of financial markets -- something the Federal Reserve would probably try to avoid.

The role that fiscal policy can play in smoothing economic fluctuations is one of the great discoveries of modern economics. A balanced budget amendment to the Constitution would eliminate the automatic stabilizers from fiscal policy, and would essentially remove an important element from the economic policy toolbox.

The Role of Investment

The Administration is embarked on an ambitious agenda to increase investment in many types of capital. One aspect is to increase the stock of human capital, by improving the education and training prospects for all Americans. Examples of Administration initiatives in this area are: increased funding for Head Start, Goals 2000, the School-to-Work transition program, AmeriCorps (the National Service Program), and the income contingent student loan program. All these programs support human capital development throughout a person's lifetime.

In the area of science and technology, the market itself may not provide sufficient incentives for development of all socially desirable investments. This is because the benefits of research do not always accrue to the inventor, but rather to society as a whole through the dissemination of scientific and technological advances. The Administration recognizes the importance of scientific research, an area that has long received bipartisan support in budget decisions. While total discretionary spending remains approximately fixed in nominal terms, Federal spending on science and technology has edged upward during this Administration.

The Administration policy toward opening foreign markets complements its emphasis on investment. Exports play an increasingly important role in the livelihood of American workers since over 10 million American jobs now depend on exports and export-related jobs pay substantially higher than average wages. In addition, the reduction of barriers to trade raises the standard of living by providing a wider variety of goods to American consumers at lower prices. And foreign competition can lead to greater efficiency and productivity in U.S. businesses. Four examples of the Administration's commitment toward opening foreign markets to U.S. goods and services are: NAFTA, the Uruguay Round of the GATT, and the trade discussions that took place at the Summit of the Americas and the recent meeting of the Asia Pacific Economic Cooperation (APEC) forum.

The Unfinished Agenda

Over the next 2 years the Administration plans several major policy initiatives. One of these, middle-class tax relief, was announced by the President in December. There are three main elements to the initiative -- a child-based income tax credit; a deduction for some of the costs of post-secondary education; and an expansion of individual retirement accounts. All of these proposals are intended to help average Americans cope with the demands of today's economy. Secretary Rubin, in his testimony, will go over these in detail.

A second initiative was detailed by the President last week -- an increase in the minimum wage. This proposal reflects a determination to ensure that working families can lift themselves out of poverty, as well as a recognition that inflation has substantially eroded the real value of the minimum wage. The proposed increase of 90 cents per hour, phased in over 2 years, would go a long way toward reversing the effect of inflation, without any discernible impact on employment prospects.

Other Administration initiatives include welfare reform and health care reform. In both these areas, the Administration proposed legislation in 1994. We intend to work with the Congress in a bipartisan manner to ensure that progress can be made in each of these crucial areas this year.

One last ongoing Administration initiative is the effort to reinvent government -- the National Performance Review (NPR), under the direction of Vice President Gore. Through the end of 1994, the Administration's reinventing government reforms had reduced the Federal workforce by about 100,000 employees and had made substantial progress in the area of government procurement. A second round of NPR reforms was announced in December 1994, with projected savings of $26 billion over 5 years. While the NPR generates savings in Federal spending, this is not the only reason to undertake reinvention. The goal of the NPR reforms is to improve government and to provide services that are in the national interest. That is, we want to create a government that is leaner, not meaner.

Conclusion

As you know, 1994 was a very good year for the American economy. The solid economic growth, combined with a low rate of inflation and declining unemployment made for the best overall economic performance in a generation. But there are many challenges before us, the most fundamental of which is restoring the American Dream to all families in a world of changing technology and increasing competition.

Some important foundations to achieve the goal of higher living standards, broadly shared, have already been put in place. The fiscal 1996 budget represents another step. We look forward to working with you and the American people in this common endeavor.

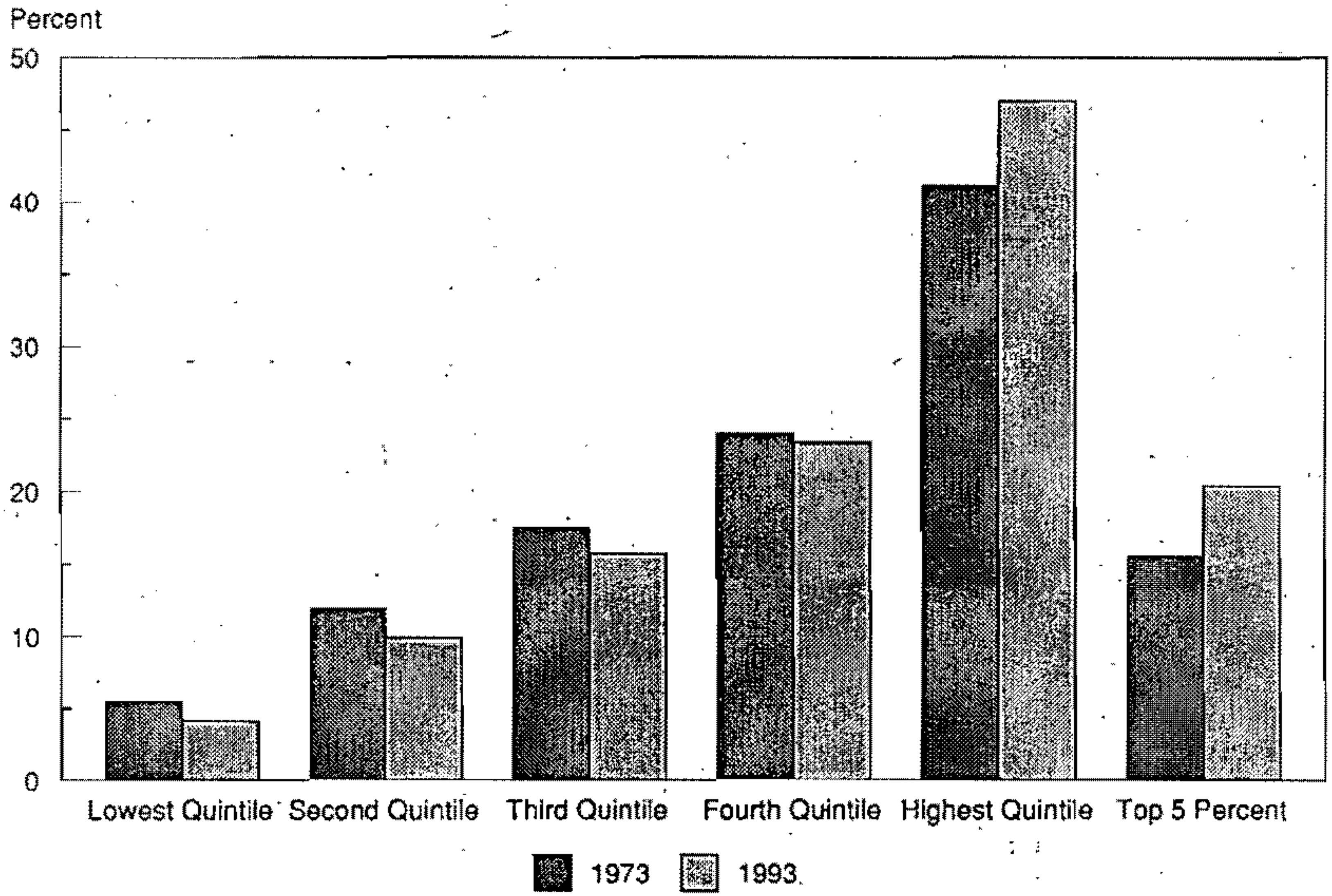
Table 1
1995 Forecast Comparison
Annual Detail

	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP, 4Q/4Q growth (%)	3.1	4.0						
CBO			2.5	1.9	2.4	2.3	2.3	2.3
Blue Chip			2.5	2.2	(2.2)	(2.3)	(2.6)	(2.4)
Mid-Session Review (July)......			2.7	2.6	2.5	2.5	2.5	NA
Administration Forecast........			**2.4**	**2.5**	**2.5**	**2.5**	**2.5**	**2.5**
GDP Deflator, 4Q/4Q growth (%)	1.8	2.3						
CBO			2.8	2.8	2.8	2.8	2.8	2.8
Blue Chip			3.1	3.2	(3.3)	(3.1)	(3.1)	(3.0)
Mid-Session Review (July)......			2.8	2.9	3.0	3.0	3.0	NA
Administration Forecast........			**2.9**	**2.9**	**3.0**	**3.0**	**3.0**	**3.0**
CPI-U, 4Q/4Q growth (%)	2.7	2.6						
CBO			3.2	3.4	3.4	3.4	3.4	3.4
Blue Chip			3.5	3.5	(3.7)	(3.6)	(3.5)	(3.4)
Mid-Session Review (July)......			3.2	3.3	3.4	3.4	3.4	NA
Administration Forecast........			**3.2**	**3.2**	**3.2**	**3.2**	**3.1**	**3.1**
ANNUAL AVERAGES								
Civilian Unemployment Rate (%)	6.8	6.1						
CBO			5.5	5.7	5.8	5.9	6.0	6.0
Blue Chip			5.6	5.7	6.2	6.3	6.2	6.1
Mid-Session Review (July)......			6.2	6.1	6.1	6.1	6.1	NA
Administration Forecast........			**---------------- (5.5 to 5.8) ----------------**					
Three-month T-bill	3.0	4.3						
CBO			6.2	5.7	5.3	5.1	5.1	5.1
Blue Chip			6.2	6.1	5.2	4.9	4.9	5.0
Mid-Session Review (July)......			4.7	4.8	4.8	4.8	4.8	NA
Administration Forecast........			**5.9**	**5.5**	**5.5**	**5.5**	**5.5**	**5.5**
Ten-year T-note	5.9	7.1						
CBO			7.7	7.0	6.7	6.7	6.7	6.7
Blue Chip			8.7	8.5	8.0	7.8	7.8	7.8
Mid-Session Review (July)......			7.0	7.0	7.0	7.0	7.0	NA
Administration Forecast........			**7.9**	**7.2**	**7.0**	**7.0**	**7.0**	**7.0**

* Numbers in parentheses are year-over-year figures.
* Blue Chip forecasts for 1995 and 1996 were made in January 1995, and forecasts beyond 1996 were made in October 1994.
* A Blue Chip forecast for the 10-year rate is not available. The corporate rate is given instead. The corporate rate is usually about 60 basis point above the comparable government rate.

Chart 1. Share of Aggregate Family Income by Quintile

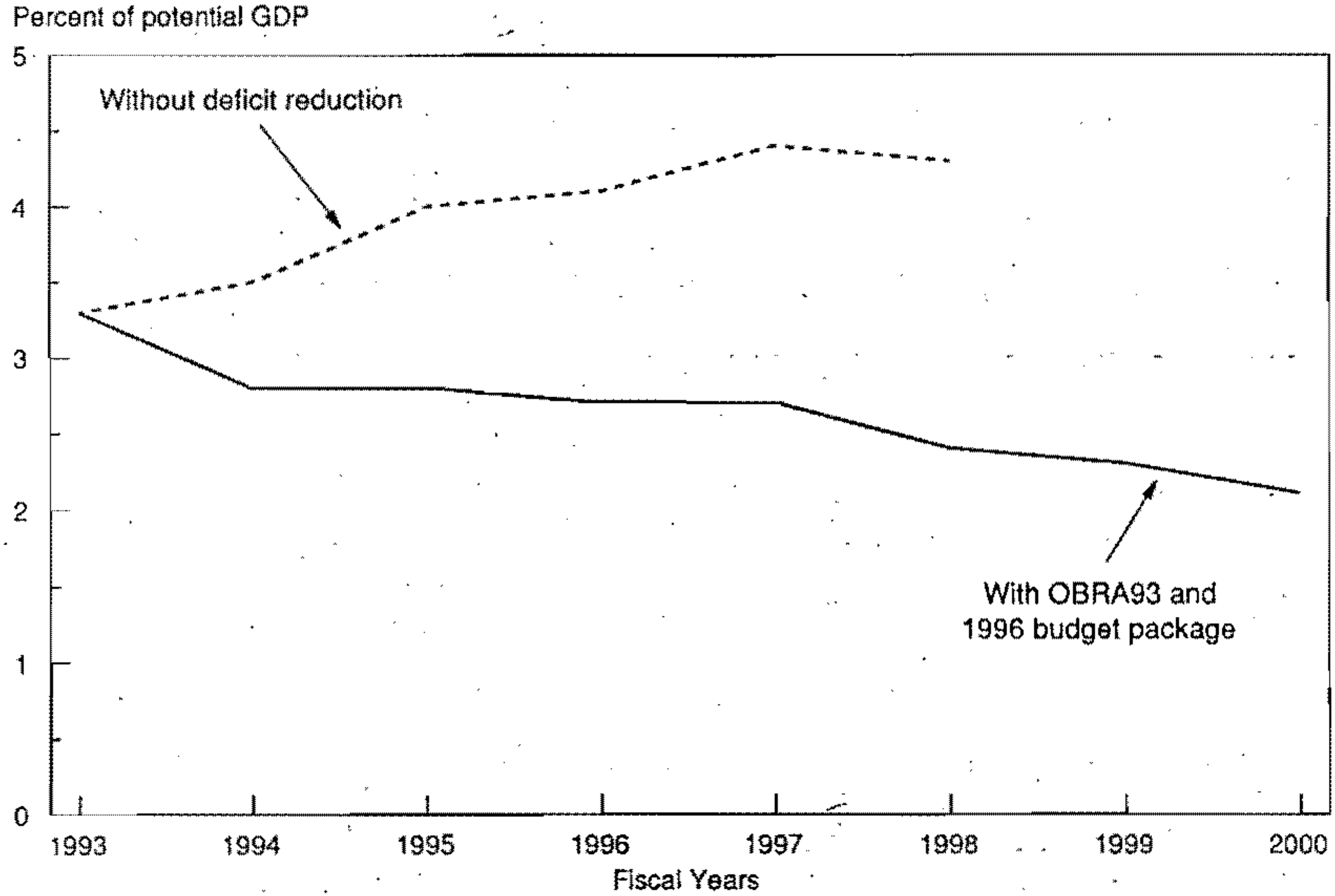
Between 1973 and 1993, the share of money income received by the 20 percent of families with the highest incomes rose substantially. The shares for all other quintiles fell.



Source: Department of Commerce.

Chart 2. Structural Budget Deficits

Policy changes enacted in 1993 arrested the upward trend of the deficit, and the President's proposed budget for fiscal 1996 will achieve even more deficit reduction.



Note: Structural deficit excludes cyclical revenues and outlays.
Sources: Council of Economic Advisers and Office of Management and Budget.

Remarks by Laura D'Andrea Tyson
Chair of the Council of Economic Advisers
before the Committee on the Budget
U.S. Senate

Thursday, February 10, 1994

Mr. Chairman, before I get started, I want to thank you and the Committee for the opportunity to testify today.

Just about 1 year ago, President Clinton proposed a multi-faceted economic plan to reverse the growth of the Federal budget deficits and to redirect private and public sector spending toward productivity-enhancing investment.

With the support of Congress, the economic plan proposed last year became the basis for OBRA 1993, the largest deficit reduction plan in our Nation's history. This plan strengthened the Budget Enforcement Act and extended the discretionary spending caps through 1998. It proposed specific spending cuts in a wide variety of both discretionary and mandatory programs. Approximately one-half of the total estimated deficit reduction is attributable to savings on the spending side of the Federal budget. The remainder comes from additional revenues. Over 80 percent of the tax increases contained in OBRA 1993 are borne by those with annual incomes over $200,000. In fact, the income tax rate increases contained in OBRA 1993 apply only to the 1.2 percent of households with the highest incomes. For those workers at the bottom of the income scale, OBRA 1993 substantially increased the earned income tax credit (EITC). The result of these changes is a tax system that is more progressive than at any time since 1977.

The Situation in February 1993

Let us recall where the economy was last year, when the President's economic plan was proposed. The recovery had a stop and go feel to it. Throughout 1992, the unemployment rate remained above 7 percent. Too few jobs were being created, and there was great uncertainty about the pace of economic expansion.

Federal budget deficits were large and growing, apparently on an unsustainable path. Large amounts of Federal borrowing throughout the 1980s led to a legacy of debt, transforming the United States from a net lender to the largest debtor nation in the world. High levels of Federal borrowing led to real long-term interest rates that were very high by historical standards. These high interest rates discouraged businesses from making productivity-enhancing investments.

As the Administration took office, the economy's long-term prospects looked quite poor. Labor productivity growth had tailed off to an anemic 0.9 percent per year over the 1973-92 period. The Federal Government, by running large budget deficits, made it more difficult for the private sector to invest for future prosperity. Measures of the quality and quantity of public infrastructure suggested that the United States was also under-investing in public capital. Millions of Americans were functionally illiterate and, on international test scores, American school children suffered in comparison to their foreign counterparts in mathematics and science education. On top of this, a rising chorus of isolationist sentiment called for America to turn its back on international trade agreements intended to open up world markets for our goods and services.

The trends were worst for low-income families. The 1980s saw a dramatic widening in the inequality of earnings. From 1977-1990, the share of national income received by the 5 percent of the population with the highest incomes rose from 18.6 percent to 24.5 percent. In contrast, the share of national income received by the poorest 20 percent of the population fell from 5.7 percent to 4.3 percent. A widening of the wage distribution caused much of this increase in inequality. Wages for those at the top of the income distribution significantly rose in real terms, while wages for those at the bottom of the income distribution actually fell in real terms. Wages for those in the middle 60 percent of the income distribution were virtually stagnant. Workers with little education or job skills were falling further and further behind. Many low-income families with children justifiably felt that work did not pay since after-tax compensation from working often barely exceeded the potential benefits that could be claimed through the welfare system.

The Situation Today

In February 1994, the economy is poised for a sustained expansion. Real gross domestic product (GDP) grew by 2.8 percent last year, with the second half of 1993 turning in a much stronger performance than the first half. In fact, the economic growth in the fourth quarter of 1993 was the strongest in 6 years. Long-term interest rates have declined by a full percentage point since Election Day in November 1992, and the interest-sensitive components of the economy have robustly responded to this decline. Overall, these interest-sensitive components of spending accounted for the lion's share of economic growth in 1993. Housing starts rose 25 percent from July to December 1993, producer durable investment increased by over 18 percent from the fourth quarter of 1992 to the fourth quarter of 1993, and consumers are purchasing more in the way of durable goods. Consumer confidence has been improving since the middle of 1993. All these are positive signs.

Inflation figures for 1993 indicate that price increases have moderated. The consumer price index (CPI) increased a scant 2.7 percent in over 1993, the smallest increase since 1986. The core CPI (excluding the volatile food and energy components) was 3.2 percent, the smallest increase since 1972. And the implicit GDP price deflator increased at a rate of 2.2 percent, the smallest increase since the Johnson Administration.

The decline in long-term interest rates since January 1993 has tracked very closely the fortunes of the Administration's economic plan. This is evidence that the financial markets view the deficit reduction proposals as substantial and credible. The credibility of our deficit reduction plan rests on four general premises. First, discretionary spending is fixed in nominal terms, an objective test that is hard to evade by budget gimmickry. Second, specific spending cuts are proposed, showing that it is indeed possible to achieve the spending targets in the proposal. Some of these proposed spending cuts take on budgetary sacred cows, demonstrating the Clinton Administration's commitment to reduced spending, regardless of past treatment of programs. Third, the revenues raised generally are permanent and real. There is little in the revenue raising component of the President's economic plan that simply accelerates revenues into the budget window or that pairs temporary (e.g., 5 year) revenues with permanent spending programs. Fourth, the economic forecasts on which the economic plan is based are credible. All four premises are important in convincing the financial markets that the Federal Government will become a smaller player in the debt markets of the future. This realization helps reduce the long-term cost of borrowing for all market participants.

In terms that are important to most Americans--jobs--the economy enters 1994 in a much improved position from that at the start of 1993. During the past year, payroll employment increased at a rate of over 160,000 jobs per month, nearly 2 million jobs in all. This is 1/4 of the way toward the Administration's goal of creating 8 million jobs in 4 years. After 1 year, private employment growth has exceeded the total for the entire tenure of the previous Administration. Moreover, the Council anticipates more than 2 million jobs being created in 1994, keeping the economy on track to meet the job creation goal.

It is true that most of the jobs created in 1993 are in the service sector. However, it does not follow that all of these are "bad jobs". For example, at the start of 1994, there are almost 200,000 more construction workers than at the beginning of 1993 and almost 400,000 more retail workers. Household surveys indicate 1 million more workers in managerial and professional specialty positions over the same period. And with the factory workweek and overtime at postwar record high levels, there is plenty of reason to expect that many of the jobs created in 1994 will be in the manufacturing sector.

The Administration's Economic Forecast

The Administration has been very concerned to keep its forecasts of key economic variables responsible and credible. Although practicing the art of forecasting economic performance is certainly a way to keep one humble, it is easier to adjust economic policy to situations in which the economy outperforms the forecasts than to situations in which the forecast outperforms the economy. And our forecasts are not unduly optimistic. Indeed, they are very similar to forecasts produced by the Congressional Budget Office, the Blue Chip consensus forecast, and leading private sector forecasters. All of these forecasts call for moderate real growth in the overall economy, declining unemployment rates, low inflation, and fairly stable long-term interest rates.

As shown in Table 1, the Administration forecasts real economic growth of 3.0 percent in 1994, tapering off slightly to 2.7 percent in 1995, and to 2.6 percent in 1998. Inflation, as measured by the CPI, is forecast to be 3.0 percent in 1994, gradually increasing to 3.4 percent in 1998. The civilian unemployment rate is forecast to average 6.3 percent in 1994, dropping over time to an average of 5.5 percent in 1998.

There are two things to note about the forecasts of the unemployment rate. First, this measure uses the old definition of the unemployment rate, computed using a survey method used by the Census Bureau until 1994. The new measure of unemployment is expected to be somewhat higher than the old rate, probably 0.3 - 0.9 percentage points higher on average -- the precise month-to-month discrepancy is impossible to know. We still forecast unemployment using the old definition because it makes comparisons with previous data easier and because models of the economy have not yet been adjusted to incorporate the new definition. A second thing to note is that the forecast of the unemployment rate presented here is somewhat lower than that contained in the Budget. This is because the Budget went to press using a forecast we made in early December. But the economy in the fourth quarter of 1993 exhibited stronger growth and a sharper drop in unemployment than expected. Incorporating this new information (as we do here) provides a slightly changed forecast for future unemployment levels.

Regarding interest rates, we forecast that long-term interest rates will remain just about at the levels they were when we made the forecast last month. Short-term interest rates (e.g., the 3-month Treasury bill rate) are forecast to increase somewhat over the 5-year budget window as the economy strengthens and moves closer to capacity. Last week's announcement by the Federal Reserve that short-term interest rates will increase slightly is consistent with our forecast, which calls for a 3-month Treasury bill rate averaging 3.4 percent in 1994.

As a measure of the effect of OBRA 1993, consider the projected size of the Federal deficit compared to Gross Domestic Product (GDP) for the next several years. (See Appendix.) In fiscal 1992, the Federal deficit was 4.9 percent of GDP, in fiscal 1993, it was 4.0 percent of GDP, in 1995 it is projected to drop to 2.5 percent of GDP, and, by 1996 is projected to fall still further to 2.3 percent of GDP, the lowest level since 1979.

Another way to measure the fiscal effect of OBRA 1993 is to examine the trend of public debt to GDP. (See Appendix.) In 1981, Federal debt held by the public equaled 26.5 percent of GDP. Over the next dozen years, this figure increased dramatically, nearly doubling to 51.6 percent in 1993. As a result of OBRA 1993, this trend will be first stabilized and then reversed. The relative level of Federal debt held by the public will begin to decrease over the next several years.

No one can accuse this Administration of incorporating rosy scenarios into its forecasts. In fact, for 4 out of the 5 years in the budget period, the Administration forecasts a higher deficit than CBO (though the differences are quite small). We believe it is critical for policymakers to craft economic policy based on credible data and not to be misled by (or to mislead with) smoke and mirrors. The Clinton Administration prides itself in using credible economic forecasts to craft its economic policies.

The Economic Agenda

The 1995 Budget was quite difficult to construct, as the discretionary spending caps began to constrain the activities of the various agencies. For the first time in memory, agency heads came to realize that increasing spending in any program meant that cuts in other programs had to be made. This was not a pleasant experience for the participants, and it will only get more difficult in future years. However, it is necessary to reorient Federal spending priorities. And this Budget does just that, by providing for several new and expanded investment initiatives, while scaling back or eliminating entirely programs that are less valuable.

Federal employment will be reduced under our 1995 Budget. President Clinton has issued an executive order calling for a reduction of 100,000 full-time equivalent employees. Our Budget exceeds that goal. Further reductions will be necessary to keep future Federal spending within the discretionary spending caps and to meet the personnel reductions recommended in the Vice President's National Performance Review.

However, while discretionary spending is held fixed in nominal terms and Federal employment is reduced, our Budget proposal calls for increases in much-needed public investments. These investments will complement the increased levels of private sector investment we are seeing as a result of lower long-term interest rates. They are intended to increase productivity in both the private and public sector and to help provide a strong foundation for future economic growth. Investment initiatives fall into three main categories:

(1) Physical capital--including full funding for the core highways program under ISTEA, additional resources for Clean Water State revolving funds, and additional funds for high performance computing and the information highways.

(2) Human capital--including increased funding for Head Start, the National Service Initiative, the innovative school-to-work program jointly sponsored by the Departments of Education and Labor, and the Workforce Security Initiative sponsored by the Department of Labor.

(3) Technological advances--including increased funding for the National Science Foundation to support research, expansion of the manufacturing extension programs, and reorienting the research priorities of the national defense and energy laboratories toward collaborative work with industry.

This year's Budget contains a number of these investment initiatives. All are intended to provide a new direction for Federal programs, one of helping the private sector provide the kind of economic growth that will improve the living standards of all Americans. Future Budgets will continue this trend.

In the State of the Union address, the President stated that he will propose a welfare reform program this spring. Since this plan is still under development, I am unable to discuss specifics. However, the spring package will be the third part of a comprehensive approach to end welfare as we know it. The first step was the substantial increase in the earned income tax credit (EITC) contained in OBRA 1993. When fully phased in (by 1996), the EITC increases will help meet the goal that families with children and a full-time worker shall no longer live in poverty. The second step toward welfare reform is the Health Security Act, which will eliminate the current perverse situation where a person receiving welfare could lose their Medicaid health care coverage by accepting a private sector job. Both these steps attempt to reach the simple goal of making work pay. The third step will be contained in the spring proposal. By enacting all three steps, Americans will have helped transform welfare into a program that moves people into private sector jobs where they can provide for themselves and their families.

The Balanced Budget Amendment

There has been much recent debate about the need for an amendment to the Constitution that would mandate that the unified Federal budget be balanced on an annual basis (with possible exceptions for times of war and under conditions where a supermajority of Congress approves an annual deficit). This Administration believes that such an amendment would be counterproductive and that there is no need to modify the Constitution in this manner.

By itself, an amendment to the Constitution would not reduce the Federal deficit by a single penny. All the hard choices about the appropriate amount and where to direct public resources would still remain. It takes leadership to make these difficult choices, the type of leadership President Clinton provided when proposing the deficit reduction plan that eventually became OBRA 1993.

On the economic front, a balanced budget amendment would put the fiscal policy of the Federal Government in a straitjacket that might imperil macroeconomic stability. The Federal budget acts as an automatic stabilizer, adjusting to changing economic conditions. When the economy is expanding, the tax system acts to take additional resources out of the private sector economy, preventing it from overheating and causing inflation. When the economy is contracting, the transfer system injects resources into the economy, moderating the economic downturn. When the economy is operating at less than full capacity, it is natural for the Federal budget to be in deficit: this is its stabilizing role. A balanced budget amendment would prevent this automatic stabilizer from operating as it has during the entire post-war period and would likely act to exacerbate recessions. Moreover, it is possible that a balanced budget amendment could push economic policy decisions to the courts, hardly the appropriate place for making macroeconomic policy.

The economic effects of a balanced budget amendment could be sobering. For instance, suppose we enacted an amendment that required the Federal budget have no deficit after 1999. In crude terms, this would require reducing the annual deficit by about $200 billion in 1999, on top of the deficit reduction amounts contained in OBRA 1993. Simulation analysis with macroeconomic models suggests that this would prove extremely detrimental to the economy. In the year 2000 real GDP would be about $85 billion lower; payroll employment over 2.5 million jobs lower; and the unemployment rate more than 2 points higher. And these numbers assume that the Federal Reserve acts to lower short term interest rates by 2 full percentage points below the baseline case. In short, even if monetary policy is eased sharply to cushion the effects of a balanced budget amendment, the required fiscal contraction could put the economy through the proverbial wringer and cost millions of jobs.

Finally, a balanced budget amendment would put a premium on budget gimmickry. You, on this Committee, hardly need to be told about the length to which decisions about resource allocation have been distorted by past budget rules. A balanced budget amendment would just raise the stakes for budget gamesmanship, leading to programmatic decision made on the basis of budget rules rather than on whether the initiative is actually good for the country.

Conclusion

In conclusion, let me reiterate the main points of my testimony. Our economic forecasts make clear that we believe the economy has entered a sustainable expansion phase, accompanied by low inflation and significant job growth.

The 1995 fiscal budget is one more step on the road toward fiscal responsibility. It makes progress toward reorienting government spending priorities in favor of investment and away from current consumption. This is a prudent strategy for us and for future generations.

Finally, we must avoid taking a detour off the road of fiscal responsibility by enacting the Balanced Budget Amendment. Last year, the Administration proposed about $500 billion of deficit reduction over 5 years. This was good economic policy, a credible plan that passed with the President's leadership. In contrast, a balanced budget amendment to the Constitution would be poor economic policy. Moreover, without the leadership necessary to ensure that the tough decisions about spending cuts and higher taxes are made in a responsible manner, it is unlikely that such an amendment would be viewed as credible policy.

This concludes my testimony. I would like to thank the committee for inviting me here today. I would be happy to respond to any questions that you may have.

TABLE 1

Administration and CBO Economic Assumptions

	Calendar Year						
	1993	1994	1995	1996	1997	1998	1999
Real GDP, 4Q/4Q growth (%)	2.8						
CBO assumptions................		2.8	2.7	2.7	2.7	2.6	2.4
Administration forecast........		3.0	2.7	2.7	2.6	2.6	2.5
GDP Deflator, 4Q/4Q growth (%)	2.2						
CBO assumptions................		2.8	2.6	2.6	2.5	2.5	2.4
Administration forecast........		2.7	2.8	2.9	3.0	3.0	3.0
CPI-U, 4Q/4Q growth (%)	2.7						
CBO assumptions................		2.8	3.0	3.0	3.0	3.0	3.0
Administration forecast........		3.0	3.2	3.3	3.4	3.4	3.4
Civilian Unemployment Rate (%) (Old basis, except where noted)	6.8						
CBO assumptions................		6.3	6.1	5.9	5.8	5.7	5.7
1995 Budget forecast...........		6.5	6.1	5.9	5.7	5.5	5.5
Administration forecast........		6.3	5.9	5.7	5.6	5.5	5.5
New basis................		6.6-7.2	6.2-6.8	6.0-6.6	5.9-6.5	5.8-6.4	5.8-6.4
Three-month T-bill	3.00						
CBO assumptions................		3.50	4.30	4.60	4.60	4.70	4.70
Administration forecast........		3.40	3.80	4.10	4.40	4.40	4.40
Ten-year T-note	5.88						
CBO assumptions................		5.80	6.00	6.10	6.20	6.20	6.20
1995 Budget forecast...........		5.80	5.80	5.80	5.80	5.80	5.80
Administration forecast........		5.70	5.70	5.70	5.70	5.70	5.70

TABLE 2

COMPOSITION OF GDP GROWTH: 1993 vs HISTORICAL AVERAGE
(Annual Percentage Change)

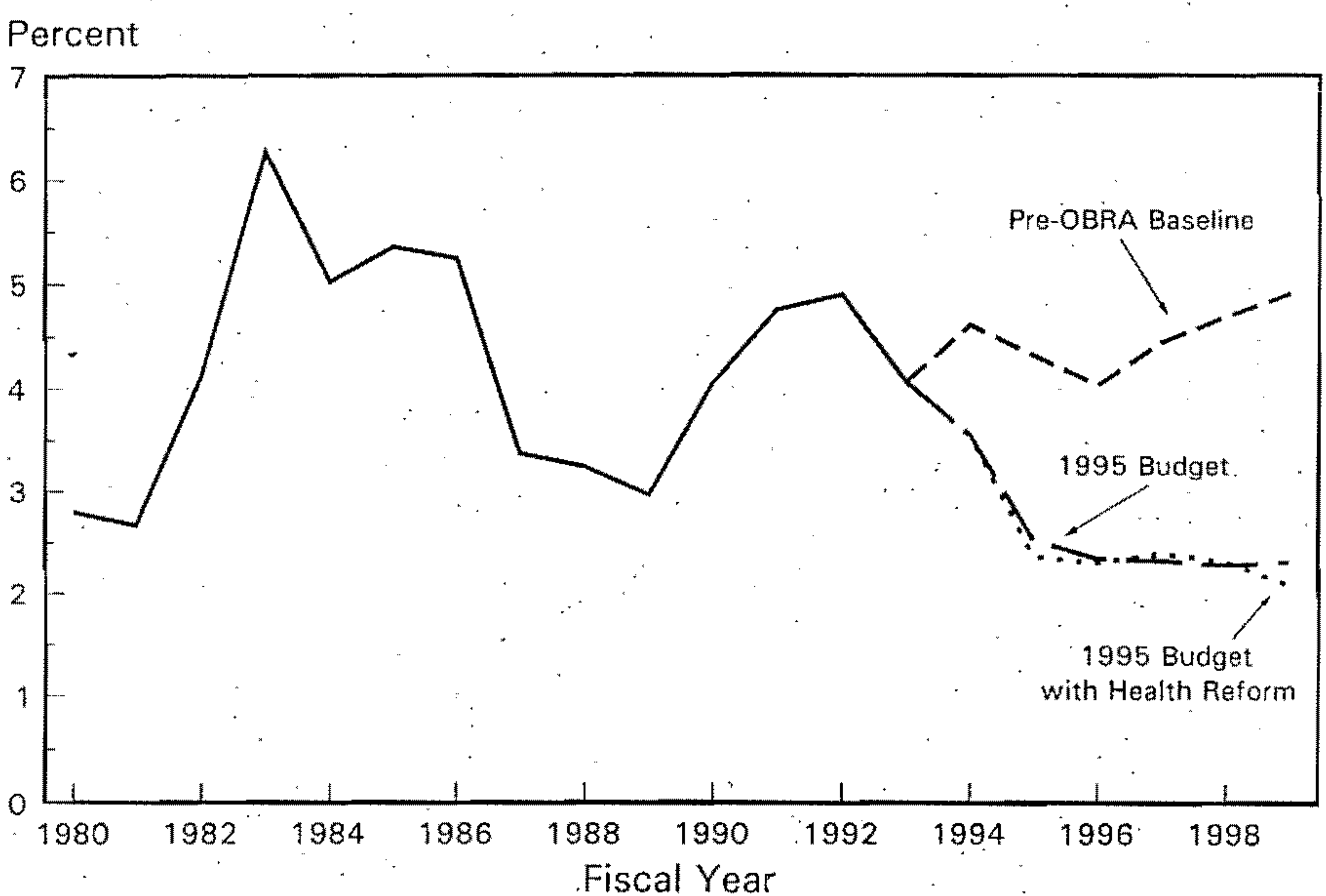
	Historical Average (1995-1992)	1992:4 to 1993:4*
Interest-sensitive components**	0.8%	2.6%
All other	2.1%	0.2%
TOTAL	2.9%	2.8%

* Preliminary

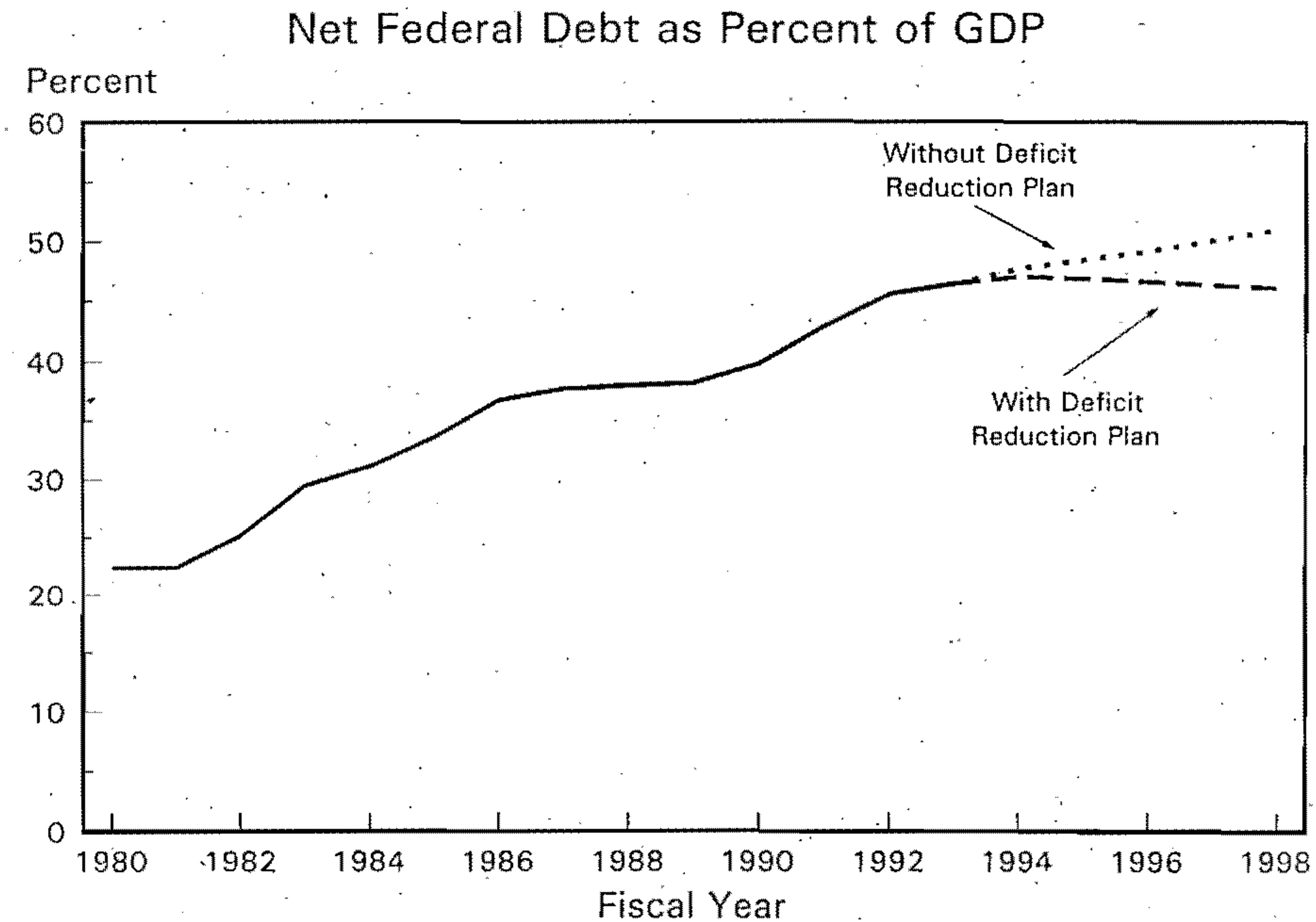
** Business fixed investment, housing, and expenditures on consumer durables.

Source: Bureau of Economic Analysis

Federal Deficit as Percent of GDP

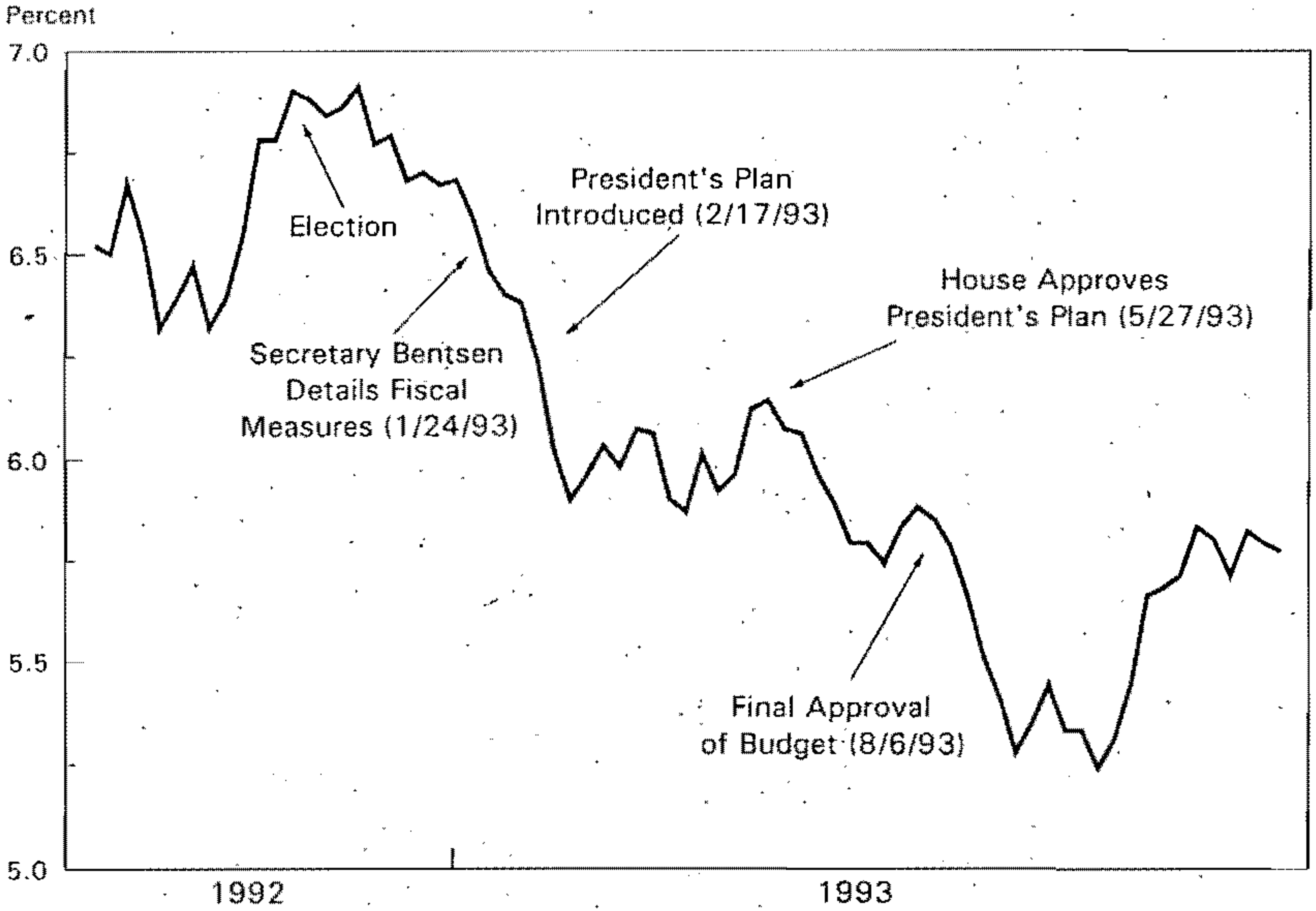


Note: Data for fiscal 1994-1999 are projections.



Note: Excludes effects of health care reform. Net Federal debt excludes debt held by the Federal Reserve. Data for fiscal 1994-1998 are projections.

Ten-Year Treasury Note Yields



Source: Department of the Treasury.

Statement of Laura D. Tyson
Chair
Council of Economic Advisers
to the
U. S. Senate Committee on Banking, Housing and Urban Affairs
October 26, 1993

S. 1527, The Fair Trade in Financial Services Act of 1993

I am pleased to be able to testify on S. 1527, the Fair Trade in Financial Services Act of 1993. The Administration is united in its support of the objectives of this legislation and expects to work closely with the Congress to see it passed.

The overarching goal of Administration trade policy is enhanced access to foreign markets for American exports. We seek open markets and active competition both at home and abroad.

We recognize the benefits we receive from keeping our markets open. The United States is an important financial center in the world economy. Our role benefits both domestic financial institutions and the U.S. firms and individuals that consume financial services provided by U.S. or foreign firms. Foreign financial firms are active in the U.S. market and the U.S. economy benefits from their presence. They are important providers of funds to U.S. firms and contribute to a vigorous and dynamic financial market. We must maintain open markets if we are to remain a major financial center.

The Administration also recognizes the importance of opening foreign markets to U.S. providers of financial services. Although U.S. financial firms enjoy open markets in many countries, they are denied the competitive opportunities enjoyed by local firms in other markets. Sometimes the barriers to equal competitive opportunities are de jure. Other times they are less formal.

The Fair Trade in Financial Services Act provides tools that will help us work to open those markets that are now closed to U.S. financial firms. We are currently working to open foreign markets both in bilateral negotiations such as those under the auspices of the United States - Japan Framework for a New Economic Partnership as well as in multilateral negotiations that are part of the Uruguay round. The Fair Trade in Financial Services Act will provide us with needed leverage in negotiations to promote further liberalization.

Although the Administration would prefer that our trading partners commit to open financial markets enabling us to undertake commitments on an MFN basis, progress in eliminating barriers faced by U.S. financial firms has been slow and uneven. Our negotiating efforts would be reinforced by adopting discretionary authority that enables us to deny, under carefully defined circumstances, certain benefits to countries that discriminate against foreign financial institutions.

The Act provides for negotiation unless the Secretary of the Treasury, after interagency consultation, deems such negotiations futile or against U.S. economic interests. The Act provides for the possibility of sanctions to assist these negotiations. It does so in a judicious way. The Administration believes that this is essential since the injudicious use of sanctions could disrupt U.S. financial markets and damage our status as a world financial center. There is intense competition in the world financial services industry and restricting the actions of foreign institutions might cause them to go elsewhere. If this were to happen, the harm to American economic interests could far outweigh any potential gain.

There are two critical features of the Act as it relates to the possible imposition of sanctions. The first is discretion. The Act accords first priority to effective negotiation. Sanctions limiting access to the U.S. market are available only as a last resort should negotiations fail. The Administration believes that it must be accorded maximum discretion to negotiate and that sanctions should be used extremely cautiously.

The second important aspect of the Act as it involves sanctions is the grandfathering of existing activities. Grandfathering is essential because it minimizes the possibility that the potential use of sanctions might disrupt U.S. financial markets.

I want to thank you again for the opportunity to express the Administration's support for fair trade in financial services. The members of the Administration look forward to working with you.

Testimony of Laura D'Andrea Tyson
Chair, Council of Economic Advisers
House Committee on Education and Labor
Subcommittee on Labor-Management Relations
October 21, 1993

THE ECONOMIC EFFECTS OF HEALTH CARE REFORM

Thank you, Mr. Chairman, for the opportunity to come before your Committee to discuss the economic effects of health care reform.

The United States is facing a health care crisis. The rapidly rising cost of health care hurts businesses, depresses wages, and contributes to fiscal imbalance. The average working American will be charged, directly and indirectly, over $7,000 for health care in 1994. The lack of health security makes many individuals afraid to leave their current jobs, discourages others from working for small businesses or becoming self-employed, and keeps people on welfare instead of working.

Reforming health care is a difficult challenge, but one that we must face. Let me first outline the problems that force us to take action, and then I will move on to the economic effects of the Health Security plan.

Why Reform Health Care?

There are five reasons why urgent health care action is needed.

The first problem is that our health care system does not provide security to individuals. When people get sick, the cost of their insurance can increase dramatically, or they can be dropped from coverage completely. This situation is a result of risk selection practices on the part of insurers. Insurers spend large amounts of money trying to select good health risks, and avoid bad risks. This practice is profitable for any one insurer but is socially wasteful. After all, someone must cover the costs incurred by people who get sick. The result is that many people cannot get coverage, and many more fear for their ability to get coverage in the future.

The second problem with our health insurance system is that it interferes with the employment decisions of individuals. Almost 40 percent of insurers exclude pre-existing conditions from their coverage of newly insured people, thus locking many people into their current insurance policies and jobs. Up to 30 percent of employees feel "locked" into their jobs. Others do not form small businesses or become self-employed because of the difficulty of obtaining insurance. Finally, many people remain on welfare because they will lose their Medicaid coverage if they take a job. If we are to adapt to changing domestic and international economic circumstances, we must not penalize people every time they change or lose a job.

The third problem with our health care system is that the number of people who do not have access to affordable insurance is large and expanding. Over 37 million people do not have health insurance. And this is not a predicament unique to the unemployed. Three-quarters of all uninsured people are in working families, and over one-third of the uninsured are in families with at least one full-time year-round worker. We have a system in which millions of people, many of them in working families, cannot afford the rising costs of health care coverage, and they face the risk of being financially crippled by events beyond their control.

It is a myth that insured people do not need to worry about the uninsured. Under our current system, when the uninsured face catastrophic costs, the insured pick up the bill. Currently, the uninsured pay only 20 percent of the health care costs they incur, while the privately insured pay 130 percent of their actual health care costs. According to recent estimates, there will be about $25 billion of "uncompensated care" paid for by the insured in 1994. Providing health insurance for all Americans could therefore lower premiums for the currently insured by over 10 percent.

The fourth problem with the health care system is that health care costs are high and rising. No other country in the world spends more than 10 percent of its GDP on health care. The United States spends 14 percent. American consumers spend more on health care than on fuel oil, electricity, natural gas, other household operations, oil and gasoline, local transportation, furniture, and other household equipment combined. Even though health care inflation has moderated recently, during the last quarter it was still three times as rapid as overall consumer price inflation.

Health care spending per working American will be over $7,000 in 1994. American workers will, on average, pay $1,864 directly for health care in 1994. Their employers will pay an additional $3,409. And Federal, State, and local taxes for health care will total $2,149.

Empirical research suggests that businesses generally respond to higher health care costs by lowering the wages they pay to their employees. Similarly, the taxes required to pay for government health spending are borne to some extent by workers in the form of lower wages. Thus, if employer contributions to health insurance had remained constant at their 1975 share of compensation through 1992, and if employers had passed these savings on to workers, real wages per worker would have been over $1,000 higher in 1992.

The fifth problem with our health care system is that it is riddled with waste, excess supply, and inefficiencies. Despite our massive commitment of resources to health care spending, the United States ranks 19th out of 26 countries in infant mortality and 18th in life expectancy. We lose an estimated $80 billion a year to fraud and abuse. Over 5 percent of our total health care spending--conservatively $45 billion in 1992--covers administrative expenses and paperwork.

As many as one-third of common medical procedures may be unnecessary and inappropriate. Hospital prices continue to rise even though hospital beds are in excess supply in many parts of the country. HMO experience indicates that the cost of medical care can be cut by as much as 10-20 percent without reducing the quality of care.

These diverse indicators paint a compelling picture of the inefficiency and waste in our current health care system. Perhaps the most important economic reason for reform is to improve the efficiency of this system. This in turn will make resources available to cover the uninsured and to address our other pressing economic and social needs.

The Economic Effects of Reform

The Health Security plan addresses these fundamental problems with the current system. It will lower costs, provide security, increase job opportunities and increase the efficiency of the economy. Many businesses will see their costs fall, and many others will have access to coverage previously denied them. Slower cost growth will allow workers to enjoy faster growth in their real wages, and reduced job lock will increase workers' ability to find better jobs. Let me describe what I believe to be the important economic effects of health care reform.

First, many employers who currently offer health insurance will see their costs fall immediately. Under the Health Security plan, every individual will receive health insurance. Eliminating uncompensated care in the current system will lower costs to businesses that provide care, thereby making resources available for increased wages or additional hiring. Eliminating corporate "free riders" will also reduce spending by companies that currently provide health benefits for their employees and for their spouses who are not covered by their own employers.

Second, the Health Security plan gradually lowers aggregate business spending on health insurance. Although the business sector as a whole will initially pay more for health insurance, the reduction in health care cost growth lowers the growth of premiums over time. In fact, by the end of this decade, preliminary estimates indicate that aggregate business spending on services covered by the Health Security plan will fall by $10 billion.

Businesses can do many things with the resulting cost savings. They can: hire more workers; raise wages or provide better benefits for existing workers; invest in more plant, equipment, education and training, and research and development; increase dividends to shareholders; or lower prices, thereby leaving consumers with more income to spend on other goods. Each of these outcomes will have a stimulative effect on the economy and will increase employment. Economic research has not reached clear conclusions about how to apportion the savings among these effects. Almost all models suggest that wage increases are a likely response, but they differ about whether all of the savings will flow into wage increases. Nevertheless, the effects of lower health care spending are clearly beneficial for the economy.

Small businesses will particularly benefit from the Health Security plan. Currently small businesses that provide insurance face administrative costs of up to 40 percent, while large businesses face costs of only 5 percent. Under reform, administrative costs for small firms will fall by up to 25 percent. Additionally, many of those currently insuring small firms will receive discounts on their premiums.

Although small businesses that do not currently provide insurance will pay more, they are likely to receive discounts to make health care affordable. There is a common myth that small businesses cannot afford to pay anything for health insurance. In fact, many small businesses report they would like to provide health insurance for their employees if it were more affordable. According to a recent study for the NFIB performed by Charles Hall of Temple University, 64 percent of small business owners would like to provide some or better insurance for their workers. When asked why they do not offer insurance, the most common response (65 percent) was that premiums are too high. Ninety-two percent of small business owners agree that the cost of health insurance is a serious business problem. Under the Health Security plan, with affordable health insurance and discounts for small businesses, this will no longer be the case.

Third, the Health Security plan will result in greater employment in the health care sector in the short run and a more efficient health sector in the long run. With the increase in the number of insured Americans and the decrease in the administrative burden of health insurance, there will be a significant expansion of employment of health care providers and a decrease in employment of health administrators and insurance workers. By 1996, as many as 400,000 net new jobs will be created in the health sector. As the cost savings of the plan begin to accrue, employment in the health sector will grow more slowly, although there will be no absolute decline in the number of employees.

Over time, the health sector will become more productive. This benefits all of us. We will be able to have the same or better health care as well as more investment, research and development, or just plain goods and services.

Fourth, the efficiency of the economy will also be increased by reducing job lock and welfare lock. By providing health care security, the reform will give workers the freedom to move to jobs where they might be more productive without having to worry about losing their health insurance. Small firms should particularly benefit from this, since they often have the hardest time attracting highly skilled workers. In addition, firms should be more willing to hire workers with pre-existing conditions because the new system does not penalize individuals with a prior illness. This allows for better, more efficient matches between employers and employees and increases the efficiency of the economy.

Some workers may decide to leave the labor force completely when there is continuous health coverage. Evidence suggests that about 350-600,000 people will decide to retire early under health care reform. This increase in voluntary retirement may increase employment opportunities for younger workers.

As you know, some have claimed that the Health Security plan will cause substantial damage to the economy. There is no denying that some firms and individuals will pay more than they did prior to reform. In particular, the Health Security plan will increase costs for some young, single individuals as well as for firms that did not previously offer health insurance. The vast majority of Americans, however, will benefit from the reduction in health insurance costs, the portability of coverage, the lower administrative costs, the reduction of job lock, the lower costs for small businesses and the self-employed, and the reduction in welfare lock. In addition, as already noted, many employers, both large and small, currently providing insurance will enjoy <u>lower</u> costs immediately and the business sector as a whole will enjoy lower costs within three years of the plan's full implementation.

<u>Summary Conclusions on the Likely Economic Effects of Health Care Reform</u>

Neither the models nor the data are available to yield a precise estimate of the employment effects of health care reform. In many other areas of economics, there are models that have been tried and tested for decades, and economists generally place a good deal of faith in the outcomes they predict. Standard macroeconomic models, for example, can make reasonably precise predictions about how a tax increase or a spending cut will affect aggregate output or employment.

But there are no existing models that allow us to predict the employment effects of health care reform with the same degree of precision. This is because the appropriate model for such an exercise would have to make distinctions both between firms that currently provide insurance and those that do not and among the many ways that firms in either group might respond to a change in their health care costs. Such a model would also have to predict how individuals might respond to new incentives in the plan, particularly those affecting small business creation, job mobility, welfare lock, and retirement.

In the absence of an appropriately specified model, one can generate either small net positive or small net negative effects on employment with existing models depending on the assumptions one is willing to make--demonstrating the old adage that you get out what you put in. Not surprisingly, several private-sector economists have concluded, as we at the CEA have concluded, that the net effect of our health care plan on the aggregate employment level is likely to be small--our internal estimates suggest a range of plus or minus one-half of 1 percent of the aggregate employment level. This is because although there are some factors in the plan that will tend to decrease employment, there are others that will tend both to increase employment and to change its composition. These offsetting factors are likely to cancel each other out, although over time as business spending falls below baseline, the factors encouraging an increase in employment are likely to strengthen.

On balance, I am certain that the Health Security plan is good for American business and the American people. It diminishes job lock and welfare lock and allows more people to become self-employed. It gets health care costs under control. It guarantees security to all Americans.

And it reduces waste and inefficiency in one-seventh of our economy. Reorganizing our health care system to use our scarce resources more efficiently will help us realize our goal of realizing higher living standards for ourselves and our children.

I will be delighted to answer any questions that you may have at this time.

STATEMENT BY

LAURA D'ANDREA TYSON, CHAIR

PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Before the

Joint Economic Committee

June 21, 1993

Technology Policy

I would like to thank you, Mr. Chairman, and members of the Committee, for inviting me to appear before this Committee to talk about technology policy and the economic competitiveness of the United States.

There is a popular perception that the United States competitive position is and has been weakening for some time, and that we have allowed our economic leadership to erode. As we shall see, this perception is partly supported by economic trends of the last two decades.

However, let me start with the good news first. Today our standard of living is the highest in the world; higher than such formidable competitors as Japan and Germany. We are also the most productive economy in the world. According to calculations by BLS, GDP per worker, the broadest measure of productivity, is nearly 26 percent higher in the United States

In the latter half of the 1980's the combination of a lower dollar and industrial restructuring made U.S. products more competitive in world markets. Our exports have more than doubled since 1985, and, once again, we have become the world's largest exporter.

Unfortunately, our improving trade performance has not translated into a higher standard of living for the average American family. Average real median family income fell in 1991, and was virtually unchanged from its 1978 level. For 13 years, real family incomes have stagnated, despite a large increase in the number of the two-earner households.

In the long run the generation of new knowledge and its translation into new and improved products and processes are the most important forces contributing to national growth. It is estimated that, in the 1980's, research and development contributed about 0.4 percentage point per year to the real GDP growth rate of 2.6 percent per year.

Technological change contributes to national competitiveness in two ways. First, new technologies drive productivity increases, which, in turn, allow companies to remain competitive even as they increase the wages of American workers.

Second, new technologies generate new products that compete on their quality and innovative features, not just on price. Companies that compete on innovation are often able to capture large shares of lucrative markets.

Past government policy has focused on the support of basic science and mission oriented research. Although this approach has served us well in the past, it is time we adjust our policies to our new international environment. Our goal must be not only to continue to be the world leader in innovation, but also to translate those innovations into successful products that are sold in the market.

Throughout the Cold War, the bulk of federal spending on R&D flowed to military research. At that time the applicability of military technology to civilian uses meant that our military preeminence translated into technological superiority. With time, however, the magnitude of these spillovers has diminished because technological advance is being driven by commercial applications rather than military ones in areas such as biotechnology, semiconductors, robotics, artificial intelligence, and high definition television.

Over the last two decades the United States has had one of the slowest rates of growth in civilian R&D of all industrialized countries. Indeed, relative to our GDP we spend far less than Germany (2.7 percent) and Japan (3.0 percent) on non-defense R&D (US:1.9 percent).

We must, therefore, dedicate a larger share of federal R&D to commercial applications rather than military uses. Today, only 41 percent of our Federal R&D dollars fund civilian research. By 1998 we hope that federal support for civilian or dual use R&D accounts for at least 50 percent of the total federal R&D budget.

ensure that these projects ar partially funded and designed by companies so that the resulting technology is used to develop marketable products and processes.

- The Administration is committed to improving our national information infrastructure, which is composed of high speed telecommunications and computer networks. The purpose is not to displace the rapid and successful private sector efforts in this area. Rather the government's role is to support private sector efforts by formulating forward looking telecommunications and information policies that promote investment and competition. Specific measures include:

  - Reforming government telecommunications policy to keep pace with the rapid developments in telecommunications and computer technologies.

  - Increased support for the High Performance Computing and Communications Program to develop more powerful supercomputers, faster computer networks, and more sophisticated software.

  - An Information Infrastructure Technology and Applications Program to develop advanced computing and networking technologies for manufacturing, health care, life long learning, and libraries.

  - Networking pilot programs funded through National Telecommunication and

- Expansion of the Small Business Innovation Research Program (SBIR) and the Small Business Technology Transfer Program (STTR). The STTR is provides grants to small businesses so that they can work with University and National Labs to move technology from the laboratory to the market place (FY94 funding $24 billion).

In order for firms to successfully innovate, specific technology programs must be supported by a general economic environment that is conducive to investment in both physical capital and human capital.

- Making the Research and Experimentation tax credit permanent will permit businesses to pursue R&D without fear of a sudden change in the tax law. In the past the credit has been extended periodically when it expired, raising the real possibility that it would not be extended, and in fact it expired during July 1992, and has not yet been reinstated. This uncertainty needlessly adds to the cost of a firm's R&D project, which, in turn, could lead to fewer R&D investments by U.S. industry.

- Reforming procurement practices of the federal government to purchase new products based on leading technologies.

- The administration is committed to developing world-class education and training programs. Our long-term competitiveness depends on the skills of our workers to innovate, to use new technology, and to bring newer and better goods and services to the

HEALTH CARE COSTS AND THE AMERICAN ECONOMY

TESTIMONY OF LAURA D'ANDREA TYSON

CHAIR, COUNCIL OF ECONOMIC ADVISERS

Senate Labor and Human Resources Committee

May 20, 1993

Thank you, Mr. Chairman, for the opportunity to come before your Committee to discuss the serious consequences for both individual American families and for the American economy as a whole if we do not act soon to change the way health care is financed and delivered in this country.

As you all know, the Clinton Administration is committed to reforming the American health care system. I am not here today to talk to you about the specifics of the plan we are preparing. However, I would be happy to return another day to discuss the plan after it is submitted. Today I want to make the case for change. Over 36 million Americans currently lack health insurance coverage, and many more are in danger of losing it if they become ill or switch jobs. Ever-escalating health care costs are impeding growth in American workers' wages, threatening our efforts to reduce the deficit, and limiting the ability of our economy to take advantage of new opportunities. Without comprehensive health care reform, we cannot expect that the economic future will look any brighter.

Let me first describe to you how our current health care system affects the economy and what the future will look like without health care reform. I would then be happy to take any questions that committee members may have.

What We've Inherited

In 1980, America's total health costs were $422 billion (in 1992 dollars), or 9% of our GDP. In 1992, a mere twelve years later, national health expenditures totaled $820 billion, nearly twice as high as the 1980 figure, and 14 percent of 1992 GDP. Let me put it in human terms. Health care spending is now $3100 per person. By comparison, we spend only $1700 per person on education (1991-1992) and $1200 per person on national defense (1992). Over the next eight years, as we enter the next century, the Health Care Financing Administration actuary predicts that per capita health spending will grow at an average annual real rate of 5 percent, and total national health expenditures will reach 18 percent of GDP -- or $1.7 trillion (current dollars) -- by 2000.

Escalating health care costs are not a new phenomenon. The real per capita cost of health care (after adjusting for economy-wide inflation) has been increasing at an average annual rate of over 4.5% a year since 1965, more than twice as fast as real per capita GDP. By contrast, the automobile industry has grown only 1.4% a year since 1965 and the manufacturing sector as a whole has grown only 2.8% a year since 1965. After so many years of neglect, it's time to bring health care cost growth down to a rate consistent with the growth of the whole economy.

Rising health care costs put a significant burden on the American economy. A dollar spent on health care is a dollar that cannot be spent on other goods and services that consumers would like to purchase. And because of the waste and excess paperwork that exists in today's health care system -- Americans' health care dollars are being thrown away. For example, according to one study, in 1987 Americans spent about $1 billion on unnecessary Caesarean sections alone. Another recent study estimates that fraud and abuse make up 10 percent of U.S. health care costs. These are just two examples of the unnecessary health costs that translate into a lower standard of living.

Finally, the United States spends about 1.5 times as much per capita on health care as Canada, about 1.7 times as much as Germany, and about 2.6 times as much as the United Kingdom.

Impact on Families

American families pay for rising health care costs through lower wages, fewer non-health related fringe benefits, and reduced consumption of other goods and services.

Health insurance premiums consume an ever larger share of workers' total compensation. The share of total compensation devoted to health insurance premiums more than tripled between 1965 and 1990 -- from 1.5% ($23.5 billion, 1990 dollars) in 1965 to 5.3% ($173.4 billion) in 1990.

As employers have to pay more for health insurance, less money is available to be paid out as real wages or other forms of fringe benefits. If health insurance cost growth had been held to the rate of growth of total compensation (8.3% per year) between 1975 and 1991 (and the savings from reduced growth were fully reflected in increased cash wages) the average full-time worker might have earned almost $1,000 more in cash wages in 1991. This is nearly one and one half times as large as the change in wages that actually occurred. Between 1975 and 1991, real wages per worker rose by 2.5%, while real health benefit costs per worker rose by 201%. If health insurance cost growth had been held to the rate of growth of total compensation, real wages would have risen by an additional 3.5 percentage points (6%).

Some of the cost of rising employer health insurance premiums is passed along to workers through reductions in other non-wage fringe benefits. During the 1980s, non-health care benefits were increasingly squeezed out of compensation packages, in part to make room for increasing health care costs. For example, retirement benefits alone as a share of total compensation have declined by 58% since 1980 alone.

American families also pay for higher health care costs through increased out-of-pocket spending on insurance premiums, coinsurance payments, deductibles and non-covered health care services. The share of American health care financed out-of-pocket, about 25%, is much higher than the corresponding fraction in other industrialized countries. During the 1960s and 1970s, out-of-pocket spending (including spending on premiums) grew more slowly than personal income. In the 1980s, however, the level of out-of-pocket health care spending grew faster than personal income. Between 1980 and 1992, the share of out-of-pocket costs in personal income increased by over 20 percent (from 3.2% to 4.1%).

Finally, American families pay for health care through the taxes that fund the Medicare trust fund and through other Federal and State taxes used to fund Medicare, Medicaid, and other government health programs. Slowing health cost growth would, therefore, also lower Americans' tax burdens.

Impact through 2000

Without a change in the existing health care system, American workers will continue to see low rates of wage growth as an increasing share of their total compensation is consumed by health care premiums. Their spending choices will continue to be narrowed by rising health care bills through the remainder of this century. Projections of private health care cost growth suggest that under the current system these costs will continue to rise about twice as fast as total compensation through 2000.

If present growth trends continue, nearly 8 percent of the average American's total compensation in 2000 will pay for health care, up from 6% today. That rate is in addition to the existing 2.9% payroll deduction that finances the Medicare trust fund. If health care cost growth could be held to the rate of growth of total compensation, however, real wages in 2000 would be 2.2 percent higher than currently projected.

That means that with comprehensive health care reform, real wages for each worker would be $655 higher. Furthermore, if we can slow health care cost growth, out-of-pocket spending will also stop climbing, and American households will have a cumulative total over the next 8 years of about $5,300 more in 2000 in personal income to spend on non-health goods and services, than currently projected.

Impact on the Labor Market and Productivity

The current method of financing and providing health insurance hamstrings the U.S. economy by reducing America's flexibility to respond to new economic opportunities both at home and abroad. Individuals and businesses alike make economic decisions that are distorted by today's health care system. For example, a recent economic study suggests that if workers did not fear losing their health insurance or being forced to change doctors when they changed jobs, about 33% more workers would have changed jobs last year than actually did. These workers could have switched to jobs better suited to their needs and skills. When jobs and workers are better matched, workers' skills are more fully utilized so that each employee can produce more output for each hour of work. Improvements in the productivity of the American workforce are the key to increasing Americans' living standards.

The structure of today's health care system also reduces productivity by encouraging people who would prefer to work to remain on welfare. Many current welfare recipients fear that taking a job would mean losing Medicaid without gaining private health insurance coverage. Estimates suggest that if AFDC recipients were assured of maintaining health insurance benefits equivalent to Medicaid if they went to work, the number of people on welfare might be reduced by as much as 25%. In this sense, health care reform may be an important first step toward reforming the welfare system.

In addition to adversely influencing the decisions of individual workers, health care costs also distort business decisions in ways that may reduce overall productivity. For example, firms often seek to avoid paying high health insurance costs for low-paid workers by employing contractors or by increasing overtime hours, instead of hiring new full-time workers. The 1980s saw an enormous growth in the number of firms that contract with other companies to provide janitorial and other business services. At the same time firms increased hours worked for their already-insured workers, rather than pay for insurance for new hires. Overtime hours in manufacturing increased from an average of 2.8 per week in 1980 to 3.8 per week in 1992.

Small businesses, who face higher administrative costs than large businesses for health coverage, are particularly hard-hit by rising health costs. The high cost to small business of providing health coverage makes it difficult for them to attract employees who expect decent health care as a benefit of employment.

Both large and small businesses could produce goods at lower total cost if their hiring decisions were not distorted by rising health care spending. Instead of contracting with a middleman to provide business services or paying high overtime wages to existing workers simply to avoid health care costs, large companies could hire new full-time workers. Small companies could compete more effectively in the labor market if they were able to provide health coverage at a reasonable price. When companies can choose workers based on their productivity, and not on their fringe benefit costs, they can produce products at lower total cost, and the productivity of our economy improves.

Finally, the asset value of many American firms has been reduced by the rising cost of retiree health benefits. In 1988, the present value of retiree health liabilities for current and future workers was between $227 billion and $332 billion. For some firms, the reductions in asset value that occur because of rising retiree health liabilities may reduce their ability to raise capital and make new, productive investments.

Health care reform can make our economy more adaptable and better able to take advantage of new challenges and opportunities. If employers can choose more efficient combinations of labor and capital, and workers can choose jobs that better match their skills, productivity will improve and our economy will grow faster.

Uninsured Americans

Although our Nation is the world's richest, we do not provide basic health coverage to tens of millions of our citizens, including over 8 million uninsured children. The share of people under 65 with private health insurance benefits has been declining steadily since 1988 from 75.1% to 72.3%. While the 1990-1991 rate of decline in the number of privately insured families slowed slightly, a 1992 survey still found more firms dropping insurance than adding coverage.

As the economy recovers from the recession and unemployment declines, some of the uninsured may gain insurance through employment. As firms currently offering health insurance begin to hire again, the fraction of people privately insured is likely to increase, while the number of unemployed persons receiving Medicaid is likely to fall. But consider this: most uninsured families today (53%) already include a full-time worker. A reduction in unemployment alone will not ensure that these workers are covered. Our estimates show that if the status quo is maintained, the number of uninsured Americans will continue to climb.

Health Costs and the Federal Government

A central goal of our overall economic program is to change the composition of government spending, while simultaneously reducing the level of government spending as a percentage of overall GDP. Our efforts are stymied by health care spending. The two largest Federal health programs, Medicare and Medicaid, are projected to grow 10% and 13% annually over the remainder of this decade, far in excess of growth in GDP. Health care spending currently accounts for about 19% of Federal expenditures or about $277 billion. That share is expected to increase to 24% -- or $406 billion -- in 1997, despite proposed health care spending reductions in the President's budget. Without reform, health care spending could consume as much as 27% of the Federal budget by 2000. By comparison, spending on education, training, and employment services comprises only 3% of Federal expenditures.

Looming increases in Federal health care spending make deficit reduction very difficult. If the growth in Federal health care spending were limited to the rate of growth in compensation, then even without any other spending cuts and without any tax increase, we could cut the projected year 2000 deficit in half. Without reducing Federal health care spending, the deficit will rise from $212 billion in 1996 to $311 billion in 2000 and as a share of GDP from 2.8% to 3.6%.

Increases in private health care spending also make it more difficult to balance the Federal budget. Private health care spending growth depresses Federal receipts because employer spending on health insurance premiums is not taxable income to employees. Growing health spending leads to a growing tax expenditure for these employer-provided benefits -- $44 billion in lost federal income tax revenue in fiscal 1993 alone. If we can slow the growth in private health care spending, the Federal government will also benefit through a reduced rate of growth in this tax expenditure.

As the government uses private savings to finance increases in the deficit, less and less remains for private sector investments in business plant, equipment, training, and research. By reducing the pool of available savings, the deficit makes it harder for American businesses to borrow the money they need to make these productive investments. Without a sustained level of investment, our economy cannot generate rising living standards.

The growing share of health care in the Federal budget limits the flexibility of our government to respond to the current economic situation and to invest in the future. Of the $222.5 billion increase in Federal outlays in President Clinton's budget proposal for 1993-1997, over $128 billion, or 58 percent, is devoted to Medicare and other health programs. With $149 billion going to Social Security, means-tested entitlements, and interest payments on the debt, only $74 billion remains to meet other important needs of the American people.

These increases in spending are not confined to the Federal level. State and local government expenditures on health care are also accelerating. By the turn of the century, state and local health care spending is projected to triple over 1990 levels. In 2000, state and local governments will spend 18% of their budgets on health care, a share just slightly lower than their current share of spending on elementary and secondary education.

Conclusion

The status quo is unacceptable. Without health care reform, American workers will continue to lack the security that they will always have health insurance, even if they lose or switch jobs; American families will give up a growing share of their disposable income for health care; and Federal, State, and local governments will be unable to respond to new opportunities and to make investments for the future. The Clinton Administration is committed to changing this dismal picture through comprehensive health care reform. The time for change is now.

I will be happy to take any questions you may have at this time.

STATEMENT BY

LAURA D'ANDREA TYSON, CHAIR

PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Before the

Committee on Science, Space, and Technology

Subcommittee on Technology, Environment and Aviation

U.S. House of Representatives

March 16, 1993

International Trade and Technology Policies

I would like to thank you Mr. Chairman, and members of the Committee, for asking me to appear before this Committee to talk about trade policy and technology policy.

Our goal as economic policy makers is to ensure real and sustainable increases in our standard of living for all Americans. Today our standard of living is the highest in the world; higher than such competitors as Japan and Germany. We are also the most productive economy in the world. According to calculations by BLS, GDP per worker, the broadest measure of productivity, in the United States is nearly 26 percent higher than Japan and over 10 percent higher than Germany in 1991.

That is the good news. Unfortunately, the story is not complete. While our economy remains the richest in the world, and despite the recent excellent results for GDP growth for the third and fourth quarters of 1992, economic growth has been decelerating for quite some time. Looking decade by decade, GDP per capita growth rates have been falling decade by decade since the 1950s. Just as worrisome, GDP per capita has grown more slowly in the United States than in other major industrial countries for nearly two decades.

The same trends hold true for productivity growth. The United States has suffered an overall slowdown in productivity growth since the 1970s, and it has had the lowest productivity growth among industrial countries for a substantial period of time. Overall our productivity growth has been below one percent for the last 20 years.

What was once considered an alarmist view has become a mainstream opinion: our economic competitiveness--defined as our ability to produce goods and services that meet the test of international competition while our citizens enjoy a standard of living that is both rising and sustainable--is in slow, but perceptible decline. Though the demise of American business is often overdone, there is no doubt that U.S. companies have lost market share to foreign competitors, in many global markets, even those in some critical high-technology industries.

Over the last several years we have witnessed a remarkable change in the world economic system. For the last 50 years the United States was the only economic superpower. But in the 1990s the world has become a tripolar economic world, with three relatively equal economic superpowers--the United States, the European Community, and Japan.

This tripolar world is a world which is much more interdependent because of trade and foreign investment flows, and it is a world that is increasingly competitive. In this highly competitive tripolar world, how does the United States maintain its competitiveness through trade and technology policies?

To strengthen our capacity to compete and to raise our overall standard of living, trade and technology policies must be embedded in an overall economic program that charts a course for the U.S. economy toward the next century.

This is exactly what this Administration has done. The Clinton plan weaves trade and technology policies into an integrated economic policy, whose fundamental goals are sustained growth in our standard of living and the creation of high wage jobs for American workers.

The first step that this Administration has taken, as it should have, is to put our own house in order. There is no doubt that businesses' ability to innovate and invest will benefit from the lower interest rates that the Administration's credible deficit reduction proposals have generated.

We need to supply our workers with modern capital and equipment and with advanced technology. To achieve this, we need to invest in plant and equipment. The Administration's program includes specific proposals to help businesses, especially small businesses, invest, such as a temporary incremental investment tax credit for large businesses and a permanent one for small businesses.

Our long-term competitiveness depends on the skills of our workers to innovate, to use new technology, and to bring newer and better goods and services to the market place. For that reason, this Administration has stressed the importance of improving our education system. A critical component of our technology policy is to achieve world leadership in basic science, mathematics and engineering.

Not only must we create high wage jobs, but we must retool our work force to fully utilize these jobs. A key component of the President's economic package is to make training accessible, especially for workers displaced by the rapid changes in our economic environment, ranging from the reorientation of our defense industries to pressures arising from international trade.

The last major element of the President's package is to change the composition of government spending away from consumption and toward investment, including investment in infrastructure. Public investment complements investment by private firms, and enables our private sector to be more competitive.

Technology Policy

However important these broad macroeconomic policies are to creating a dynamic and competitive American economy, they are not enough. They must be complemented by policies that focus on specific issues of technology and trade.

There are sound economic reasons why the government should focus on high-technology industries. First, research and development in general, and specifically in high-tech industries, benefits both the firms that undertake it and other producers and consumers. As a result of these spillovers, the social rate of return to R&D far exceeds the private returns. One 1988 study placed the social returns at 35 to 60 percent above the private returns.

Second, jobs in high-tech industries pay better than the rest of the economy. In 1989 average annual compensation in high-technology industries was 22 percent higher than all of manufacturing. If we focus purely on production workers, that is excluding most white collar scientists and engineers, average compensation in high-technology firms was 15 percent higher than in manufacturing as a whole.

Past government effort has focussed on the support of basic science and mission oriented research. Although this has served us well in the past, it is time we move on to polices appropriate to our new international environment. Our goal must be not only to continue to be the world leader in innovation, but to translate those innovations into successful products that are sold in the market. The technology policy introduced last month by President Clinton does just that.

Throughout the Cold War, the bulk of Federal spending on R&D flowed to military research. At that time the applicability of military technology to civilian uses meant that our military preeminence translated into technological superiority. With time, however, the magnitude of these spillovers has diminished. We must, therefore, dedicate a larger share of Federal R&D to commercial applications rather than military uses. Today, only 41 percent of our Federal R&D dollars fund civilian research. By 1998 we hope to have Federal support for civilian or dual use R&D be more than 50 percent of the total R&D budget.

Over the last two decades the United States has had one of the smallest increases in civilian R&D of all the industrialized countries. Indeed, relative to our GDP we spend far less than Germany (2.7 percent) and Japan (3.0 percent) on non-defense R&D (US:1.9 percent). In addition to allocating Federal dollars to civilian R&D, the Administration proposes to make the research and experimentation tax credit permanent to spur private sector R&D.

As this committee has called for in the past, we propose expanding the Advanced Technology Program in the Commerce Department. This program has been an example of successful government-business partnership. The ATP shares the cost of industry-led and industry-defined projects selected through merit-based competition. In addition, the Administration plans to increase the focus on dual-use technologies through the Advanced Research Projects Agency (ARPA), formerly called DARPA.

Other elements of the technology package to promote research include encouraging industry consortia to advance critical technologies; promoting partnerships with industry through cooperative R&D agreements (CRADAs) with the national labs; and improving interagency cooperation by strengthening the Federal Coordinating Council for Science, Engineering and Technology (FCCSET).

In addition, our package recognizes the importance of diffusing new technologies as well as the importance of creating them. To that end, the President proposes to create a national network of manufacturing extension centers; expand the manufacturing Experts in the Classroom Program; and assist companies in implementing the principles of high performance work organization.

Finally the competitive advantage of our companies will be enhanced through better access to information. The Administration is committed to supporting the development of efficient, high speed communications systems, or information superhighways.

Technology and Trade

Our ability to sell goods and services in the global market place is the crucial test of our competitiveness. We can have the most efficient producers in the world, and find that government restrictions impede their ability to sell in foreign markets. Because high-technology industries benefit from economies of scale and learning curve effects, access to foreign markets is crucial for American firms to develop the size necessary to become efficient and competitive producers in world markets. So we must pursue an active and forward-looking trade policy to open markets through multilateral trading arrangements, regional arrangements, and bilateral agreements. We must also use the Nation's trade laws, as they were designed, to deter or compensate for foreign practices that are not adequately covered by existing multilateral rules or trade agreements.

At the same time, we must recognize that an active trade policy is not synonymous with protectionism. Protectionist policies will not solve our competitive problems; most often they will only breed inefficient and high cost firms. An open trading system forces us to innovate, puts U.S. businesses in touch with new customers every day and provides market opportunities for U.S. exports and U.S. jobs. To put it simply the United States and every other nation that participates in an open and fair trading system becomes wealthier over time. As President Clinton has said, "we must compete, not retreat."

Remarks by Dr. Laura D'Andrea Tyson
Chair of the Council of Economic Advisers
before the
Joint Economic Committee

Monday, February 22, 1993

Thank you, Mr. Chairman, for the opportunity to testify before the Joint Economic Committee.

The election of 1992 was a clear mandate for change--in particular, economic change. No wonder voters expressed this preference. A number of disturbing economic trends have developed in recent years. Let me name just a few of them: median family real income has been stagnant--its 1991 level was actually below the level reached in 1979--despite more two-earner families; the poverty rate in 1991 was higher than in any year during the 1970s; a growing gap between the rich and the poor; a Federal Government that is borrowing to pay almost a quarter of its current bills; and escalating health care costs that are burdening firms and workers as never before. It is little wonder that the voters gave a mandate for economic change.

Underlying these disturbing trends are three fundamental problems in the American economy: a recovery so anemic it has been unable to support substantial employment growth; an erosion in the growth rate of productivity over the past twenty years; and an increase in inequality that has undermined the sense of fairness in our economic system.

The President's economic package--consisting of a short-term stimulus, an investment program, and a deficit reduction plan--is designed to correct each of these fundamental problems. The short-term stimulus is intended to ensure a sustained economic recovery that is strong enough to generate employment growth. The investment and deficit reduction components of the package are directed toward boosting productivity growth and living standards over the long-term. All elements of the package are designed with an eye toward restoring basic fairness to the system. Let me elaborate on the President's plan in the context of our fundamental problems.

<u>Economic Stimulus</u>

The United States economy has experienced a protracted period of poor performance. Since 1989, the average annual rate of GDP growth has barely exceeded one-half of one percent--inadequate to keep up with population growth. This period was marked first by sluggish growth in 1989 and early 1990, then a recession which lasted from July of 1990 until March of 1991, and finally a very slow recovery since March of 1991. The recovery has been so slow that most Americans barely noticed it was underway. In the third quarter of the recovery, the economy showed serious signs of falling back into recession--real GDP grew by only 0.6 percent and real gross domestic purchases actually declined. Only 500,000 jobs have been created in the 22 months of recovery--this is about 3 million fewer jobs than would have been created in the first 22 months of a typical economic recovery. Not surprisingly, the unemployment rate is still higher than it was at the bottom of the recession. Although there has been a recent stream of good economic news, signs of weakness and cause for concern about the recovery remain.

Many of the factors that contributed to recession or sluggish growth over the past four years are still acting to depress the economy. Many U.S. companies are in the midst of a painful restructuring process that will ultimately make them more competitive, but currently generates large permanent layoffs. This restructuring is manifest by the fact that the fraction of unemployed workers that have permanently lost their previous jobs reached an all-time high of over 45 percent in October of 1992. Ongoing and future reductions in defense spending will require a significant reallocation of resources that will continue to act as a drag on the economy. This process actually began in the late 1980s, and before it is completed may well involve a shift of over 3 percent of our GDP from military to civilian purposes. In several parts of the country the commercial real estate market remains considerably depressed, a consequence of overbuilding that occurred in the 1980s. There is little hope that commercial real estate construction will return to 1980s levels anytime soon. Also, a number of our trading partners are experiencing much slower growth in recent months and that reduces growth in our exports. Real GDP in both Germany and Japan, for example, declined in recent quarters. Furthermore, reduced withholding of taxes last year will reduce tax refunds this spring, which is likely to make consumer spending unseasonably low. For all of these reasons we cannot be overconfident about the continued strength of the recovery.

Given the fact that the recovery has stalled in the past, gains in employment during the recovery have been small to date, and many forces will continue to exert downward pressure on the economy, President Clinton's economic plan includes a stimulus package of spending increases and targeted tax cuts to spur investment and job growth in the near term. The short-term stimulus package is best viewed as an insurance policy designed to make sure that recovery does not falter again, and as a downpayment on the investment plan that will largely occur in subsequent fiscal years.

Three criteria have guided the design of this package: the potential for rapid spend-out rates; consistency with the investment program; and modest size. All of the items included in the package are fast-acting and job-creating. The unemployed have already waited far too long. All of the items included in the package are worthwhile on their own merits and are consistent with the basic long-run goal of shifting public expenditure toward investment. In that sense the package can be appropriately thought of as a downpayment on the Administration's overall long-run investment program. The size of the stimulus was limited by the deficit problem we have inherited--a problem that turned out to be much larger than we had been told--and by the fact that economic growth has picked up in the last two quarters. The modest size also reflects a desire to avoid overstimulating the economy in the event that the current recovery does continue at the pace of the last two quarters.

Our economic stimulus program comes to about $30 billion, composed of roughly 50% spending increases and 50% tax incentives. The spending side of the package includes increased funding for the following programs: extended unemployment benefits, highway construction, a summer jobs and training program for underprivileged youth, community development block grants, education programs, wastewater cleanup, and important environmental and technology programs. All of these programs are consistent with the philosophy of investing more in our people and our infrastructure.

The tax incentives are mostly in the form of investment tax credit programs for large and small businesses. The investment tax credit is incremental and temporary for large businesses (over $5 million in gross receipts). The basic rate is 7% (smaller for shorter-lived assets) on all equipment investment above 70% of a historical base (a three-year average) in 1993 and 80% of that same base in 1994. The credit applies to equipment put in place between December 3, 1992 and December 31, 1994. Small businesses, which would presumably find the recordkeeping of an incremental ITC burdensome, are given a 7% ITC from the first dollar for two years, dropping down to a permanent 5% ITC thereafter.

The Administration estimates that the stimulus package, taken by itself, will add about 0.3% to the annual growth rates of real GDP in 1993 and 1994, creating about 500,000 additional jobs by the end of 1994.

The Nation's Long-Term Problems

Sustainable increases in the Nation's standard of living can only be attained through rising levels of productivity. As the amount of output per worker increases over time, so does the potential consumption per worker. Because of this linkage, the rate of productivity growth is a crucial indicator of how living standards are changing over time.

From the end of World War II until 1973, productivity grew at an annual rate of about 2.5%, which implies a doubling in the standard of living in just under 30 years. The notion that each generation could leave its children a better place and a higher living standard was virtually taken for granted. Not any more. Since 1973, the average annual rate of productivity growth has fallen to about 0.8 percent, which implies that living standards will double every 90 years (down from 103 after adding 1992's high rate of productivity growth). The slowdown may be exaggerated to some extent by our inability to measure productivity growth in the rapidly growing service sector of the economy, as some observers claim, but a substantial portion of this slowdown is a consequence of adverse economic events and policy choices that promoted consumption rather than investment.

Intuitively, our productivity increases with improvements in technology or the skill of our workforce and with increases in the amount of plant, equipment, and infrastructure our workers use in the production process. All of these driving forces of productivity growth require that we make investments--investments in research and development to improve technology; investments in health, education, and training to improve workers skills; and investments in buildings, machines, roads, bridges, railways, airports and the like to increase our Nation's capital stock.

The amount of investment that the Nation achieves depends directly and indirectly on government actions. Many government programs contribute directly to the stock of public capital--health care, education, training, and infrastructure spending, for example. Other government policies, especially tax policies, indirectly influence the amount of spending on private capital--research and development, plant, and equipment--that firms choose to undertake.

Policies of the last twelve years have eroded productivity growth in the economy by undermining both public and private human and physical capital formation. Conventional measures of public investment as a share of GDP have fallen each decade since the 1960s. Furthermore, the large budget deficits required to finance growth in defense and other non-investment government spending programs during the 1980s have reduced the pool of resources available for private investments in human and physical capital. We must reverse the fiscal policies of the last twelve years in order to increase capital formation and the rate of growth in our living standards. The investment program and the deficit reduction plan are intended to accomplish such a policy reversal.

The Investment Program

The investment program includes a wide range of items that have benefits that will be felt over long periods of time, and thus, fit the conceptual definition of investment. The Clinton investment package delivers on all of the major public investment initiatives promised by the President during his campaign--initiatives to put people back to work; initiatives to facilitate lifelong learning from childhood through retirement; initiatives to reward work for those who work hard and play by the rules; initiatives to address urgent public health problems; and initiatives to encourage private-sector investments that provide technological gains and improved productivity.

The investment program totals $160 billion over four years, which redeems most of the President's campaign promises under the following headings:

REBUILD AMERICA: $48 billion over four years concentrated in six key areas:

- o Transportation infrastructure ($8.4 billion), which includes full funding of the Intermodal Surface Transportation Efficiency Act and investments in mass transit, high speed rail, and airports.

- o Technology ($17.0 billion), which will fund the National Science Foundation, science, engineering, and technology grants, high performance computing, and extension of the research and development tax credit.

- o Environment ($8.0 billion), which will fund water cleanup, environmental technology, weatherization grants, forestry research, and natural resource protection.

- o Energy ($3.0 billion), for energy conservation and renewable energy programs, fusion research, and more energy efficient Federal buildings.

- o Housing and Community Development (9.6 billion), for Community Block Grants, fifty enterprise zones, assisted housing, and extension of the low-income housing tax credit.

- o Rural Development ($1.5 billion), for priorities such as rural water and waste loans and grants and community and business development for rural areas.

LIFELONG LEARNING: $38 billion over four years for education and training of people from early childhood through adulthood. This includes some measures intended for defense conversion:

- o A National Service Program ($3.0 billion).
- o Full funding for WIC ($1 billion).
- o Full funding of Head Start by 1999 ($3.7 billion).
- o Education reform and initiatives ($3.2 billion).
- o Worker training programs ($4.1 billion).

- o Youth apprenticeship programs ($0.5 billion).
- o Parenting and Family Support ($0.5 billion).

REWARDING WORK: $25 billion over four years, mainly accounted for by a dramatic increase in the Earned Income Tax Credit (EITC). The EITC is simplified and greatly liberalized. It is extended for the first time to workers without children--at a 7.65% rate that offsets the employee portion of FICA taxes. And the credit for workers with children is enriched enough so that a family of four with a parent working fulltime at the minimum wage is lifted up to the poverty line. This category also includes emergency unemployment compensation benefits and a crime initiative.

HEALTH CARE: $26 billion over four years for AIDs, women's health, drug and substance abuse prevention and treatment, nutrition assistance, USDA food safety initiative, VA medical care, and improvements in Social Security disability insurance processing.

TAX INCENTIVES: $24 billion over four years to encourage private investment through investment tax credits, alternative minimum tax relief for corporations, targeted capital gains relief for small start-up businesses, and real estate investment incentives.

This program will stimulate private and public investment in order to increase our rate of growth in productivity and, ultimately, living standards. These new investments are a central part of the President's plan.

The Deficit Reduction Plan

Finally, in order to reduce government demands on credit markets, the President's economic package includes a credible deficit-reduction plan. The intent of deficit reduction is as a means to greater capital formation, productivity growth and living standards, not as an end in itself. Deficits require government borrowing--either from the private sector, reducing funds available to private investors and consumers and raising their cost of borrowing, or from the rest of the world, so that in the future a growing share of our tax dollars will be used to pay off foreigners who lent us money.

The President's proposal features a four-year (FY94-FY97) gross deficit-reduction program that is phased in gradually. By FY97 the plan will cut nearly $200 billion from the deficit,, with $112 billion in spending cuts (this scores the increased taxation of social security benefits as an entitlement cut) and $83 billion in revenue increases. After allowing for the $55 billion in new investment initiatives that will be introduced as part of the investment package, the program achieves a net deficit reduction of $140 billion from the baseline deficit in FY97 alone.

The budget has no plugs, caps, gimmicks, or magic asterisks. All cuts are identified in the OMB document "A Vision of Change for America." The 150 specific spending cuts reduce Federal government spending by $247 billion over 4 years (this counts $7 billion of increased taxation of social security benefits as a cut in entitlement spending, rather than a tax increase). The spending cuts are nearly matched in magnitude by specific revenue increases.

The spending savings in the President's plan are in six general categories: programs that don't work or are no longer needed; eliminating subsidies for wasteful programs and charging fees for government services; managing government for cost-effectiveness and results; controlling health care costs; adjusting defense spending to new post-Cold War realities; and asking for shared contribution from all Americans.

Some of the larger items in the long list of spending cuts are:

- o Defense spending reductions of $37 billion in FY97 and $76 billion over a 4-year period.

- o Reduction of federal pay, retirement benefits, the number of civilian employees, and administrative budgets of departments agencies for a total savings of $11.7 billion in FY97.

- o Higher taxation of social security benefits for taxpayers above $32,000 (joint) or $25,000 single: $6.9 billion in FY97.

- o Shorten average maturity structure of the national debt: $3.9 billion in savings in FY97.

- o Savings in Medicare and Medicaid (the sum of 33 programmatic changes, virtually all of which cut provider reimbursements); $17.7 billion in FY97.

- o Auctioning part of the Federal Communications Commission spectrum: $2.1 billion in FY97.

The additional revenues raised in the President's plan are attained primarily by increasing taxes on the very wealthy, who have benefitted most from the reduced taxes of the 1980s. This burden sharing is also consistent with the President's desire to reduce the growing gap between rich and poor.

Personal income tax rates are raised effective for approximately 1.2% of returns with the highest taxable income as follows:

- o A 36% bracket begins at $140,000 for joint filers ($115,000 for singles).

- o A 39.6% bracket begins at $250,000, regardless of filing status.

- o The maximum tax rate on capital gains remains 28%, as under current law.

- o The Alternative Minimum Tax (AMT) becomes two-tiered: 26% up to $175,000 of AMT income and 28% thereafter.

All these rate changes are estimated to raise $26.3 billion in FY97.

In order to raise revenue, encourage the conservation of energy, and reduce harmful emissions, the President's plan also includes an energy tax that is phased in gradually. When fully effective, the proposed new energy tax will be 25.7 cents per million BTU, with an additional 34.2 cents per million BTU on oil. These amounts are indexed, so that the tax rises slightly with the rate of inflation. The tax is phased in in three stages: one-third in July 1994, one-third in July 1995, and the final one-third in July 1996. Estimated impacts on retail energy prices are 3-8%, depending on the specific product. But the tax will be levied and collected at the source (production or import).

A higher tax rate is placed on oil for two reasons. One is as a national security surcharge. A hidden cost of dependence on foreign oil sources is the additional money that must be spent on foreign aid and national defense in order to protect our strategic interests. This surcharge makes consumers of oil bear part of that burden more explicitly. The second reason for the higher rate on oil is that a straight BTU tax would burden natural gas (a less polluting source) more heavily than oil (a more polluting source). In order to discourage consumers from substituting to the more polluting source as a result of the tax change, an additional levy on oil was required. Hence the oil supplement corrects two negative "externalities" associated with oil consumption.

The BTU tax is estimated to raise $22.3 billion in FY97, after netting out roughly $7 billion in reduced income and payroll tax receipts that Treasury revenue estimators assume will result from the tax. In addition, the Administration proposes additions to Food Stamps, the EITC, and the Low Income Home Energy Assistance Program (LIHEAP) to offset the burden of the energy tax for low and moderate income households. These additional programs cost roughly $10 billion, and ensure that families with incomes below $30,000 will face virtually no net tax increase.

The basic corporate tax rate is raised from 34% to 36%. In addition, a number of tax preferences and deductions are reduced or eliminated and tax enforcement is increased. Total revenue accruing to the government from these sources is estimated to be $14.1 billion in FY97. In addition, a variety of other changes in "business taxes" (which can appear on either personal or corporate returns) nets $8.4 billion in 1997.

The health insurance portion of the payroll tax will apply to all earnings, rather than being capped (as at present) at $135,000. The revenue yield from this change in FY97 is projected to be $6.8 billion.

A brief rundown of the key features of the President's deficit reduction plan verifies that these spending cuts and revenue increases are real and identifiable. But the budget game is a complicated one, and this is only the first step we have taken to make the package credible.

To allay any fears of "rosy scenarios," the budget projections are based on a highly unusual procedure: We use the pessimistic forecast of the CBO, rather than the Administration's more optimistic forecast--even though the latter virtually matches the current Blue Chip consensus (see Table 2). Under the CBO's pessimistic forecast, the deficit falls from 5.4% of GDP in fiscal 1993 to 2.7% in 1997. Under the Administration's forecast, the deficit falls even further--to 2.2% of GDP in fiscal 1997--because of the higher level of GDP that is attained and the increased tax revenues and reduced mandatory expenditures that accompany a healthier economy.

Finally, a credible plan requires an enforcement mechanism. Under the President's plan, we propose to extend the Budget Enforcement Act, with continued caps on discretionary spending, "pay-as-you-go" requirements, and sequesters when necessary.

The President's plan is a bold one, but of course it is only the beginning of a long budget process. We welcome your ideas about how to improve this package. While no one will be happy with everything in this package, let me underscore the President's view that our deficit reduction goals will never be attained unless we are willing to view these hundreds of specific proposals as a single package. If we are going to restore a proposed spending cut, we must propose specific alternatives to take its place. If we do not hold ourselves to some rule, then we will not serve the taxpayers and voters of this Nation well.

If the Congress enacts this deficit reduction plan, the results will be dramatic. But the reality is that deficits will begin to climb back up toward the end of the decade. The primary reason is skyrocketing health care costs. As a government and as a society, we must reform health care to ensure quality, affordable care for all Americans. Health care costs threaten the security of families, businesses, and government alike. We must also act to control health care costs if we hope to control deficits in the long term.

How the Package Promotes Fairness

All three elements of the package will help restore a sense of fairness. The stimulus will promote job opportunities for some of the 9 million unemployed members of our labor force. Since the investment program includes a number of programs, such as head start, WIC, health care, worker training and retraining, education and the earned income tax credit, that directly increase opportunities for the most disadvantaged members of society, it will also help level the playing field. Finally, the manner in which revenues are raised for deficit reduction will ask the most from those who can afford it--the top 1.2 percent of American income earners. All of these features of the total package will help restore a sense of fairness in our system and give meaning to the American dream for those members of society who were left behind by the policies of the past twelve years.

The Economic Outlook

Forecasting economic performance is not an easy task. As the budget process reminds us, there are many uncertainties which will have a great impact on the future path of the economy. What is more important than any specific predictions CBO or the Administration make about economic performance is that we make sound choices about policy that raise the our investment rate, our productivity, and ultimately, our living standards.

As noted in discussing the budget estimates, the Administration forecast for real GDP growth is slightly higher than the CBO forecast on balance. In 1993 and 1994, the Administration forecast of 3.1 and 3.3 percent growth, respectively, corresponds exactly to the private Blue Chip consensus forecast. This is higher than the CBO estimates of 2.8 and 3.0 percent. The Administration forecast assumes that the stimulus package provides some additional growth in real GDP in the early years. As the stimulus wears off and the ITC for large businesses is eliminated, the Administration forecast is actually below the CBO forecast in 1995.

From 1996 through 1998, the Administration forecast essentially assumes that the economy begins to feel some of the benefits of a higher capital stock as a result of the investment program and the tax incentives provided in the stimulus. Consequently, while the CBO assumes that growth falls off to less than 2 percent by

1998, we feel that a rate of 2.5 percent is more realistic. In these "out years," the Administration forecast is identical to the Blue Chip consensus.

Mr. Chairman, this concludes my testimony for this morning, but I wanted to take a moment to thank you and your committee for your invitation and for your welcome. I look forward to working with you during my tenure at the Council of Economic Advisers.. I know by working together we can all share in the effort to strengthen our economy by ensuring a stronger recovery, higher rates of public and private investment, and smaller Federal budget deficits.

Table 1. Comprehensive Budget Impact of the Package

	FY1997
BASELINE	$346
Spending Cuts:	-37
Nondefense discretionary	-20
Entitlement	-41
Associated debt service	-14
Subtotal:	-112
Revenue increases	-83
GROSS DEFICIT REDUCTION	-195
Clinton investment program:	
Spending	+39
Tax reductions	+15
Subtotal:	+55
NET DEFICIT REDUCTION	-140
DEFICIT WITH CLINTON POLICY	$206

Notes: This scores savings generated by increasing the taxation of social security benefits as a cut in entitlement. Some may prefer to count it as a tax increase.

Table 2. Comparison of Real GDP Forecasts

	Real GDP growth (Q4/Q4)					
	1993	1994	1995	1996	1997	1998
CBO	2.8%	3.0%	2.8%	2.6%	2.2%	1.8%
Administration	3.1%	3.3%	2.7%	2.5%	2.5%	2.5%
Blue Chip	3.1%	3.3%	2.5%	2.5%	2.5%	2.5%

The New Economy
Remarks by Martin N. Baily
Chairman, Council of Economic Advisers
At The
Conference on Old Rules--New Rules: Corporate Structures, Cultures and Governance of the New Economy
Munich, Germany

June 28, 2000

Why are we talking about a new economy in the U. S.?

The first reason is that productivity growth has accelerated from about one and a half percent a year 1973-95, to about 3 percent a year 1995-99.

This acceleration is heavily related to technology, both the investment in IT hardware and software (i.e., the use of the technology), and also the extraordinary productivity of the industries producing the technology.

Some part of this acceleration is surely temporary, the result of unusual growth in demand and it is only about four years in duration. But a substantial fraction appears to be structural and hence, potentially, will result in a sustained improvement in productivity performance. Moreover, the signs of information technology as an enabler of business system change have been visible for much longer than just four years

The second reason is that there has been a dramatic increase in the stock market valuation of U. S. corporations. The rate of increase was 16 percent a year from January 1993 through

May of 2000, resulting in nearly $18 trillion of wealth held by shareholders The increase in market valuation has been oriented to the high-tech sector. NASDAQ and Internet stocks accounted for a large fraction of U. S. market capitalization in March of 2000.

I am not going to comment on whether the market today is overvalued, undervalued or just right. But I note that even if someone (not me) believed that only a half of the growth in the market since 93 were just speculation, there would still have been trillions of stockmarket wealth added due to fundamentals, the accumulation of knowledge-based tangible and intangible capital.

The third reason is that there are direct signs of acceleration in the accumulation of knowledge and intangible capital. R&D spending has soared, so has the number of patents, and the number of trademark registrations. Use of the Internet and the Web is exploding. This type of evidence reflects only the tip of an iceberg, but it all points in the same direction.

A fourth reason is related to the others, but it is still worth noting. The new economy is generating a stream of new revenues, shifting the U. S. from large budget deficit to large surpluses.

Size and Innovation in the New Economy

The increased importance of information and intangible capital results in two countervailing trends with respect to size. There are centrifugal and centripetal forces at work.

First, since information has high fixed costs and low marginal costs of production, there are economies of scale and scope. Large firm size and first mover advantages become important, and the advantages of size are accentuated by globalization, which have resulted in new cross-border mergers and acquisitions.

But, at the same time, lower costs of communication and interaction allow small companies to compete by entering a market at a narrow point in the value chain. This can force large companies to outsource activities or downsize, to focus on core competencies. They may choose to globalize on only a sliver of their overall business. As one would predict from the work of Nobel Prize winner Ronald Coase, the boundaries of firms and industries are being changed by developments in IT. In the end, new competition will determine how the boundaries of firms and industries are changed.

One activity being outsourced is technology development. In large companies, burdensome review processes can stifle innovation, in part because innovation undermines existing vested interests within the firm. In the past, lack of financing has provided a barrier to innovation in small firms, but today's venture capital industry, and the active IPO market, have reduced this barrier and encouraged innovation by small firms. The two work together, with venture capital used to start new companies and the IPO market providing capital for growth at lower cost. Through stock options, the market has provided tremendous incentives to successful innovators.

Another facilitator of innovation in the U. S. has been access to talent. Higher education in the U. S. provides a flow of new-trained graduates. Immigration has also been important. Twenty-nine percent of the new start-up firms in Silicon Valley 1995-98 had CEOs from India or China.

The Interaction of the Old and the New Economies

The new economy is dramatically affecting the old economy. Farmers can use the Internet to check meteorology and soil forecasts based on satellite information. Nurses carry Palm Pilots that contain patient information from all parts of the hospital. Truckers get street directions from the GPS system and are tracked by their companies. They use the Internet to seek out new loads and avoid empty return trips.

These impacts may not always be visible in macro data. Productivity is poorly measured in many old economy industries. And the innovations companies are adopting may not boost market value when industry competitors are all doing the same thing. As Schumpeter noted years ago, excess profit comes from innovating ahead of competitors.

The old economy is driving the new economy. The interaction is two-way. For example, a dynamic evolving retail industry is using the new technology to communicate and coordinate its value chain from marketing and design, to customer check out, to transportation, to wholesaling, to purchasing and manufacturing. This creates demand for hardware, software and improved business systems. The same story applies over and over as traditional industries become the customers and end-users for the information sector.

It is appropriate to talk of a new economy. But recall that most of the jobs and most of the GDP remain in traditional industries. These are driving the new economy as they themselves are being changed by it.

Policy in the New Economy

1. We know from the macro data that investment has been a major part of the acceleration of productivity. Fiscal discipline and sound monetary policy have been vital parts of the low-interest-rate high-investment U. S. expansion of the 1990s.

2. I mentioned the strong higher education system in the U. S. It is important that students from all backgrounds have the opportunity to take advantage of the system. Moreover, in a world where steelworkers sit at computer consoles controlling giant machines, computer skills are often needed by high school graduates. Companies are looking for workers at all levels that can keep records, understand instructions and solve problems. These are skills that schools must teach in order that workers not be left behind.

3. Right now, some workers are struggling in the new economy. Old skills become obsolete. Jobs are lost. To deal with this problem, access to training and retraining is vital, plus a safety net that encourages work, including adjustment assistance and programs such as the Earned Income Tax Credit.

4. The private sector is the heart of the new technology. But at critical points the government has played a central role through support for basic and precommercial research. And while the new technologies have prospered in a freewheeling, free-market culture, there are times when government must set rules of the game—intellectual property protection, international trade rules, privacy, anti-trust policy, worker support. Government has a key role in the establishment of the infrastructure of the new economy.

5. Finally, however, I want to stress policies toward competition, open markets and change. New firms, new technologies and new business systems are springing up. The nature and pace of technology are new, but the importance of change is not. Studies of manufacturing plants and studies of industries in different countries have revealed that productivity growth depends on the entry of new establishments and firms, the expansion of the most efficient operations and the reduction or closure of the less efficient—in short, it depends on productive evolution.

To offer an analogy: At 4° Celsius water and ice remain in equilibrium. The proportions of each remain the same. But in actuality the ice is continuously melting and the water is continuously freezing. The apparent equilibrium conceals massive change at the micro level.

Similarly, an economy may appear to be growing steadily. But underneath there is massive change. Jobs are being created and destroyed. New firms are entering and old firms leaving. New technologies are developed that gain competitive advantage for a period, and then are overtaken.

Policies and regulations that encourage flexible labor and product markets, competition and openness are the policies that support economic evolution and change. These can and must be given a human face. They promote leading edge performance in traditional industries, which, in turn, drive innovation in the new economy.

One final comment on the spread of the new economy to other countries. Many of them have more to gain from the new economy because their traditional industries have not evolved as far, and the potential for performance improvement is greater. But the potential for social disruption is also greater. The adjustment to the new economy may be harder to manage in economies that have traditionally been more tightly regulated. Countries that want to embrace the new economy must embrace change in both the traditional as well as the newly emerging industries.

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THURSDAY, FEBRUARY 10, 2000 AT 10:00 A.M.

REMARKS
On the Release of the
PRESIDENT'S 2000 ECONOMIC REPORT
By

Dr. Martin N. Baily
Chairman
Council of Economic Advisers

To the
CENTER FOR NATIONAL POLICY

Thursday, February 10, 2000
10:00 am.
National Press Club, Holeman Lounge
Washington, D. C.

It is a great pleasure to come here to the Press Club to this event sponsored by the Center for National Policy and talk about the 2000 Economic Report of the President (ERP). I would like to thank CNP and its director, Mo Steinbruner, for their willingness to host this session. I want to acknowledge the tremendous contributions to the ERP from Robert Lawrence, Member of the Council, Kathryn Shaw, who has been nominated as a Member and Audrey Choi the Chief of Staff, who has contributed directly to the Report, and worked extraordinarily hard in coordinating the efforts of all of us. The staff of the Council is here today, and they have done the bulk of the research and writing. They have worked insane hours and done endless rewriting. There are too many for me to mention them individually, but I am deeply indebted to each and every one of them for their efforts. The statistical office, led by Kitty Furlong, and the support staff have done amazing work, under great time pressure. Let me also thank Cathy Fibich, the Administrative Officer, who made sure that even through the snow storms the Report was produced well and on time.

We have broken with tradition for the 2000 Report, the cover design is new and the font and format are different. I apologize to lovers of tradition, but the new millenium is a good occasion for a change and the designers, I think, came up with a modern and very attractive design.

One other thing we've done a bit differently this year, in honor of this being the 2000 ERP, is that one of the themes of the Report is a look back at the century past. I will not have time to do full justice to that part of the Report in my remarks today, but I hope you will look at some of the fascinating ways in which the economy has changed. There is even some art in the Report, as each chapter starts with an historical picture. Let me just take a minute to give you a flavor of the kinds of changes over the past century that we have outlined in the report:

At the turn of the century, fewer than 10 percent of homes had electricity. Fewer than 2 percent of people had telephones. A car was a luxury for only the wealthy. Health and sanitation problems, such as typhoid fever spread by contaminated water, were common. One in 10 children died in infancy. Average life expectancy was just 47 years. Eighty percent of children lived in a family with a breadwinner-father and homemaker-mother. Fewer than 10 percent lived in single-parent homes. Widowhood was far more common than divorce. Fewer than 14 percent of Americans graduated high school. More than 40 percent of the work force worked on farms. Average income per capita, in 1999 dollars, was about $4,200.

By contrast, today, electricity, automobiles, telephones and videocassette recorders, and computers are considered commonplace if not necessities. Life expectancy has increased by 30 years as infant mortality has plummeted. Only 24 percent of children live in what used to be the typical model of a breadwinner-father and homemaker-mother. Only 3 percent of the labor force work on farms, and average income per capita is now $33,740 – more than eight times what it was in 1900, adjusted for inflation.

Clearly, this past century has brought a number of amazing improvements in the quality of life and standard of living for Americans. And these past seven years have been a particularly fabulous era for the economy. I am in the fortunate position today of being able to release the 2000 Economic Report, that documents the extraordinary economy we now have. Back in the recession of the early 90s, no one foresaw that we would have the longest expansion ever, with soaring investment, unemployment at 4 percent, a core inflation rate of 1.9 percent and a budget surplus of $124 billion last year. Since 1993, nearly 21 million jobs have been created, there has been almost 4 percent GDP growth per year, real wages have grown, and average family incomes are up $5,000. Amazingly the economic news has become better and better over time. This expansion has gotten stronger, yielding lower unemployment, lower inflation and stronger growth (Chart 1). This contrasts with where things stood in 1992, with a fiscal year budget deficit of $290 billion, unemployment averaging 7.5 percent, and real average earnings lower than they were in 1981.

In my talk today I hope to identify the distinctive features of this expansion, understand the drivers of success in this record-breaking expansion and discuss the challenges that still lie ahead. Despite the stellar economic performance there remain important steps to be taken to ensure all Americans are sharing in the prosperity that abounds.

Distinctive Features of the Record Breaking Expansion

President Clinton came into office promising jobs and he has delivered on that promise, as the nearly 21 million new payroll jobs have pushed the unemployment rate to 4 percent. During the 1970s and 80s, the unemployment rate was much higher on average, even at cyclical peaks. And high unemployment and high inflation often went together—stagflation. You have to go back to the 1960s to see unemployment rates as low as they are today, and at that time inflation was accelerating sharply. This expansion has been unique in combining stable inflation with a high-employment economy.

As you see in Chart 2, this expansion is also unique in the pattern of productivity growth. Typically there is a surge of productivity growth in the first year or so of an expansion. This is the bounce back from the decline in productivity that occurs in the recession that precedes an expansion. All three expansions show this initial surge in productivity growth. But in the 60s and the 80s productivity growth fell after that initial surge, and by the time these expansions were 7 years old they were looking tired and listless. This is particularly so in the 80s expansion where productivity growth grew weaker and weaker. It averaged less than one percent in the last four years of the 80s expansion.

The 90s expansion shows a strikingly different pattern. This expansion has been gaining strength. Productivity has been accelerating. Productivity can be measured in two ways, based upon how much has been produced in the non-farm business sector. And on how much income has been generated by that sector. Based on a combination of those two approaches, growth of output per hour has averaged 2.9 percent a year since 1995. This is a sharp increase above the trend line of productivity growth over the previous twenty-two years and while it's still too early to tell definitively, it suggests that we may be on a path of faster productivity growth that will help us have faster, sustainable growth in the future.

Chart 3 shows a third distinctive feature of this expansion. There are encouraging signs that the fruits of growth are now being shared more evenly in contrast to earlier periods. From 1973 to 1993 real family incomes grew very slowly and that growth was very uneven. Only the top quintile of the income distribution moved up at a reasonable pace, while the bottom two quintiles actually faced declining real incomes over this twenty-year period, when adjusted for inflation using the consumer price index. Over the five years from 1993 to 1998, the picture is very different. All of the income groups have seen good rates of income growth, and the lowest quintile has actually grown most rapidly. There is similar good news in terms of earnings, starting in 1994. There have been several press reports recently suggesting that despite the great economy overall, inequality is still a growing problem. These reports neglect to mention the recent trends I have just described.

The drivers of the record breaking expansion: Technology, Pro-Investment Fiscal Policy, Competition and Trade, and Skills

Technology. The role of technology in driving growth in this economy needs no introduction. There are many ways one could illustrate the technology revolution taking place in this country. Chart 4 is taken from Chapter 3 of the Report and shows the rapid increase in patents granted in the U.S. The surge has been particularly strong in the past few years. Patent data do not provide a perfect measure of innovation, but in this case the upward surge in patents seen in the chart provides a correct visual story, showing a surge in technological opportunities.

In explaining this wealth of opportunities, the dynamism of the private sector in the U.S. economy gets a lot of credit. But Federal support for technology has played an indispensible role, providing the crucial funds for basic research and pre-commercial research, for example, in information technology and biotechnology.

Even after technological opportunities have been developed productivity has not always risen. Recall that prior to this expansion, there was a puzzle where people questioned why the boom in technology in the 1980's seemed to have no effect on the productivity data. In order to translate innovation into growth, companies have to change the way they do business, develop new products and services, and respond to changes in the competitive environment. Workers must master new skills and, in some cases, must move to different jobs. Making the transition from new ideas to realized economic performance always involves some form of investment—in physical capital, plant and equipment; in human capital, education and training, or in intangible business capital, the development of new business systems. Companies in the 1990s appear to be making those investments and reaping the rewards of the faster productivity growth.

Stimulating economic growth is like creating a chemical reaction. All the right elements have to be in place, the mix has to be right. Policy cannot grow the economy on its own. But growth from the private sector will not take off if the policies are not right. The key to the longevity of this expansion has been that the dynamism of the private sector has reacted with a superb monetary policy, and, crucially, the pro-investment fiscal policy. The chemistry has been right.

Pro-investment fiscal policy. Fiscal policy has a major impact on the amount of investment that takes place. Budget deficits are not always bad. They can help stimulate an economy where demand is weak. But when the goal is to stimulate and sustain a supply-led, productivity-led expansion, persistent structural deficits are very damaging. They drain savings from the economy, increase interest rates and discourage investment.

Chart 5 shows a dramatic picture of large and rising deficits in past expansions and of the turnaround in the 1990s. The structural budget balance adjusts for the effect of the business cycle. It estimates what the deficit or surplus would be if the economy were at its sustainable long run level of GDP, that is, at potential GDP. This expansion started out with massive structural deficits. Three and a half percent of GDP in fiscal 1992. But the situation has been transformed so that now there is a structural surplus, one that is projected to grow into the future. It is true that the budget agreement of 1990 took a step forward in fiscal responsibility and bipartisan credit is deserved for that first step. But it was only a small step. The structural deficit continued to increase in 1991 and 1992. The big shift occurred with the budget agreement of 1993 and with the subsequent strength of revenues and restraints on spending.

What you hope to see from a shift to fiscal discipline is lower interest rates and larger investment. That is exactly what we have seen. *Real interest rates have been 30 to 50 percent lower in this expansion than they were in the 80s expansion.* And investment has responded in force. Not all of the intangible investment in process improvement or in skills and training is measured in our investment data. But the investment we can measure provides a proxy for the total. We have seen growth of equipment investment and software at 12.3 percent a year since 1993 (Chart 6), much of it concentrated in the information technology and communications areas, allowing the economy to take advantage of the innovation opportunities. This rapid step up in investment has been a vital ingredient allowing the acceleration of productivity growth we saw a moment ago. There is a direct link from fiscal discipline to the key productivity driver of this longest expansion.

Strong investment not only improves productivity it adds to capacity. When capacity shortages develop, there is upward pressure on margins that can contribute to an inflationary spiral. So there is another direct link from fiscal discipline to the persistence of this expansion. In the 1990s, we have built capacity and helped hold down inflation. In the 1980s capacity growth slowed to a crawl as productivity growth slowed.

This should come as no surprise. The adverse effects of chronic deficits were anticipated by one of my predecessors. Martin Feldstein wrote in the 1984 Economic Report of the President (p.37) as follows: "The most important long-term economic effect of the prospective budget deficits would be to absorb a large fraction of domestic saving, and thereby reduce the rate of capital formation and the potential long-term growth of the economy."

In 1993, the Administration undertook a major shift in policy, away from exploding budget deficits and towards fiscal discipline. At the time, the decision to embark on a program of deficit reduction, which was then passed in Congress by the narrowest of margins, was hailed by the press, and by experts such as Paul Volcker. The bond market responded to the shift with a rally in the bond market. Subsequently, the President and Congress continued the steps towards fiscal discipline.

Today the same newspapers and newsmagazines that were demanding a change in policy and supported that change when it happened, now seem to be suffering from an extraordinary amnesia. It is time to remember what was said about the dangers of large persistent deficits and look at the benefits that we have gained from ending them. It is time to recognize the vital role that fiscal discipline has played in the chemistry of growth.

Competition and Trade. There is evidence that industries in which companies compete vigorously are more productive industries. Without the spur of competition, companies become complacent and keep doing things the old way even when new methods are available. Competition encourages change and forces companies to be more productive. Competing in the global economy adds additional benefits. The classical gain from trade comes as industries that have comparative advantage grow and those that lack it, contract. The resulting shift of resources raises overall levels of productivity. In addition, competing in the global economy also helps the spread of best practice production methods around the world. Chart 7 shows how the U.S. economy has become more open and more integrated with the world economy. Trade as a percent of GDP has increased rapidly, especially in this expansion. And as the international chapter of our report discusses, trade is only one element reflecting a broader integration with the global economy.

President Clinton has acted to enhance domestic competition, for example with measures such as the Telecommunications Act of 1996, and he has made engagement in the global economy a major policy thrust. Started by prior administrations, the Uruguay Round agreement and the NAFTA agreement were both ratified during this Administration.

Education and Skills. Chart 8 shows that the return to education is high and has risen over the past twenty years. Those with college degrees have, on average, earnings over 50 percent higher than high school graduates, and a substantial differential persists even after controlling for other determinants of earnings. The differential between high school graduates and high school dropouts is just as great. It thus makes eminent sense for our society to encourage young people, and not so young people, to acquire more education. This Administration has stepped up its efforts to provide loans and scholarships to allow any student who is able to benefit from college to have the opportunity to attend. And these policies have contributed to this expansion by adding to the pool of trained workers.

As well as education, perhaps the greatest growth benefit on the labor force side has been in training. The policies that have given us a high employment economy have encouraged employers to train workers to fill jobs that would otherwise be vacant. Companies complain about their inability to find workers with the skills that they need. But this is a problem with a silver lining. It gives these companies a great incentive to seek out workers and train them themselves. This upgrades the quality of the workforce and helps sustain a productive expansion.

Chart 8 gives one sign that this phenomenon is important. Even though college graduates are in high demand, and have, currently, an unemployment rate of only 1.8 percent, the figure shows that the college/high school earnings differential has stopped rising in this expansion. This suggests that high school grads are able to increase their skill levels and keep up with the earnings increases being enjoyed by college grads.
Questioning the Causes of Inequality. As I showed earlier, an important feature of this expansion is that all income groups have incomes rising at about the same rate. How does this fit with the drivers of the expansion that I have just described. We argue in the Report that this data suggest a re-evaluation of the conventional explanations that have been given for rising inequality. The two most-frequently cited explanations have been technological change and foreign trade. Technology, it has been argued, is biased in its impact on the labor market, holding down the wages of low-skill workers. Trade is said to put lower-skilled US workers in direct competition with very low-wage workers overseas. Of the two, technology has been seen as the larger culprit.

Those explanations were always rather problematic. In the 70s and 80s productivity growth was very slow, suggesting a rather modest impact of technology on the economy. And for trade, the proportion of US workers in direct competition with very low-wage workers overseas is very small.

But regardless of whether or not we can sort out correctly the reasons for the inequality trends of the past, there is one simple lesson that we can learn from this expansion. It is possible to have an economy where technology is moving rapidly, where trade is expanding, and yet there are also across-the-board income gains. An important reason for this is that rapid technology change and openness to trade are both factors keeping inflation down and allowing us to operate a high employment economy. When labor is scarce, the workers at the bottom of the wage distribution do better.
In Summary. This has been an extraordinary expansion so far and we expect it to continue well into the future. It has been driven by a dynamic private sector and the hard work of American workers. It has been kept on track by astute monetary policy that has given the economy room to run while keeping guard against inflation. It has been helped by deregulation that started in the 1970s and continues today. But while recognizing these important factors, we must acknowledge the contribution of the policies of the 1990s to the expansion of the 1990s. We need to guide policy in the future with the lessons of what has worked so well. Most importantly, turning around the fiscal mess has freed up the resources needed to invest in capacity and in productivity improvement. Maintaining an open and competitive economy and investing in technology, education and skills have added to growth now and helped pave the way for more growth ahead.

Challenges Ahead

Last year's Report analyzed the impact of the aging population. And the challenges this poses remain at the forefront of policy today. Protecting social security and Medicare are top priorities of the President's budget. In this year's Report we looked at some challenges in different areas. In our chapter on Work and Learning we look at how the nature of work has changed dramatically over the past 100 years and has lately put a premium on a new set of skills. Chart 9 highlights both an achievement and a challenge. If workers are to have access to good jobs today and in the future, they must acquire the technical and computer skills those jobs require. The achievement is that in terms of Internet access, the gap between high and low poverty schools has been almost closed. The challenge is that too many students emerge from our schools without the computer skills they need. The President's budget that was released on Monday contains several initiatives designed to meet the educational challenges.

The nature of work has changed over the past 100 years and so has the nature of the family (Chart 10). Today more and more women work. There are many more single mothers than there used to be, who go out to work to support themselves and their families. As we show in Chapter 5 of the Report, these mothers have a tough time, with family incomes concentrated in the low end of the distribution. Single mothers often find it hard to meet the bills each month--they have money crunch. These families are being helped by the Earned Income Tax Credit and the Child Care Credit and the Medicaid and State SCHIPs programs in health care. And of course the strong economy has given them better opportunities.

Dual earner families are often in the upper part of the income distribution. Incomes are higher than ever before, but many families judge that they need the income of both partners to provide them with the things that once were considered luxuries but now are seen as necessities. In addition, these families face a problem of time scarcity. Juggling two careers and children is a very tough assignment. And this time crunch can be exacerbated for families that care for elderly parents as well as children. The Family and Medical Leave Act and the long term care initiatives are directed towards the needs of these families.

One of the biggest challenges for the next century is to find policies that will help the environment and yet sustain growth. Chart 11 illustrates the progress being made and the challenge ahead. The amount of SO2 and NOX emissions per unit of GDP has gone down dramatically over the century. But of course the growth of GDP has been so great that total emissions are still too high. Chapter 7 of the Report details the benefits of using tradable permits as a way to minimize the cost of achieving environmental goals.

Conclusion

The challenges ahead are great but the strong economy has given us the resources and the confidence that we can deal with them. Chart 12 gives a projection of the growth of business to business e-commerce. This is one of the fruits of the new technology that promises continued economic growth ahead. With potential like this there is no need for this expansion to end soon. And finally Chart 13 looks again at productivity. I guess you can tell productivity is my field as an economist. I have talked a lot about it. Give a kid a hammer and everything looks like a nail.

But the productivity story really is an important one. There was a very persistent trend of slow productivity growth after 1973 that had negative implications for the economy, especially when the limited gains were distributed unequally. To go back to the earlier debate, this chart shows no sign of an 80s boost in productivity. Today, there does seem to be a new trend. We do not know for sure how long it will last, but by staying the course of the policy path we have been on, combining fiscal discipline with support for technology and the skills that are needed, we will give this economy its best chance. It is the best chance of getting the chemistry of growth right.

Remarks by Martin N. Baily Chairman of the Economic Advisers to the American Association for the Advancement of Science
Thursday, September 2, 1999

I. Introductory Remarks

Thank you. It is a pleasure to join you here today. I would like to thank the American Association for the Advancement of Science for inviting me to address this distinguished audience of young leaders, who I am sure will make valuable contributions to both the worlds of science and public policy.

As Science and Engineering Fellows with the AAAS, you will have a unique opportunity this year to gain a deep understanding of how scientific research and public policy interact and influence one another.

The research you do in the laboratory may seem far removed from the economics and national economic policy that is the concern of the President's Council of Economic Advisers. But, in fact, the two enterprises have significant long-term effects on one another: the products of your research lead to innovations and discoveries that spur competition and economic growth; in turn, the economic policies and funding priorities of the federal government can help seed and fuel further productive scientific inquiry. It is this relationship that I would like to discuss with you today – how science plays a role in economic growth and how policy makers can encourage science th~~rough vari~~ous ~~policy decisio~~ns.

II. The Economy and Technology

The U.S. is currently enjoying a fabulous period of prosperity. We have had 100 months of economic growth – marking the longest peacetime expansion on record. Inflation has been subdued despite strong real wage growth and, for the last two years, the unemployment rate has been stunningly low – well below 5%.

A major factor in powering this unprecedented period of growth without inflation has been a recent resurgence in productivity growth. In the period after World War II through to the early 1970's, labor productivity increased sharply, clocking increases of nearly 3% annually.

But in the two decades that followed, productivity growth slowed sharply and living standards stagnated. However, in this expansion, productivity growth appears to be accelerating. Most notably in the past 3 years, it has increased at about a 2% annual rate. This productivity is fueling the growth in real wages and the increase in the economic well being of all Americans.

Unfortunately, there is a lot of uncertainty about why productivity growth slowed in the 70s and how rapidly it will grow in the next few years. What is clear, however, is that the ability of American businesses and workers to take the advances made in science and turn them into productive new investments and jobs has been a contributing factor. And to insure continued growth, it is vital to encourage scientific progress and innovation.

The fruits of science and technology have played a central role in shaping this economic expansion. Technological advances are revolutionizing nearly all sectors of the economy and even creating whole new industries. Information technology now constitutes approximately 8.2% of GDP -- up from 4.9% in 1985. The IT sector accounted for one-third of real economic growth from 1995-97. Employment in the computer services has nearly doubled since 1994. And those jobs in the IT sector pay 80% above the average private wage. Supported by recent computer innovations, "just in time" inventories have revolutionized business practices, allowing the inventory-to-sales ratio to fall to historic lows. And, of course, the Internet is altering forever the way we do business and communicate with each other. Nearly 64 million American adults currently use the Internet up over 20% from only one year ago.

III. The Role of the Government

As we consider the role that scientific discovery has played in fueling our economy, it is important for us to consider how the policy decisions we make affects the scientific community's ability to continue that process of discovery and advancement.

for R&D

Certainly the private sector plays the dominant role: In 1997, approximately 63% of all R&D, or about 121 billion dollars, was spent by private companies on research and development efforts across a wide variety of industries. However, government policies designed to encourage innovation play a critical role in providing the right incentives to innovate.

In fact, many of the products and services we now consider indispensable – from communication satellites that bring us live television broadcasts to human insulin that saves and extends the lives of millions of diabetics – have been facilitated by US policies to encourage private sector investments in science and technology.

For many types of research, the costs of creating the first innovation are much higher than the costs of duplicating that innovation. In the jargon of an economist, the fixed cost is high, but the marginal cost is low. If duplication is relatively easy, there may be little or no economic incentive to innovate because the initial innovator cannot recover its investment in fixed costs. Therefore, one of the most fundamental roles of government is to provide rules that protect the intellectual property rights of inventors through patent and copyright law.

Government's role in R&D, however, extends beyond simply establishing the rules for the protection of intellectual property. New technology and new innovations often depend on advances in understanding promoted by "basic" scientific research.

By its very nature, much of that research, (including, no doubt, some that has been conducted by members in the audience) is not the type ~~of research~~ that corporations find immediately interesting. In part, this reflects the fact that the primary output of basic research is knowledge, not patentable innovations. Moreover, even if the new knowledge developed through basic research suggests a specific, patentable concept, there may not be any obvious economic return in the near future.

In these circumstances, while the social returns to pursuing basic research may be very high in the long run, the private return available to a particular company may not justify further R&D.

In areas involving basic scientific research, therefore, there is an important role for government to play in funding projects designed to advance the frontiers of science even – or perhaps especially – when there is no obvious, immediate commercial application.

Indeed, when the precursor to the Internet was invented, it was not envisioned as a project designed for commercial purposes at all. Rather scientists working for the Defense Advanced Research Projects Agency (DARPA) were looking for a way to share data and programs across different computers located in different parts of the country. From that early scientific and academic communication network evolved what is now a major driving force in new business ventures and new ways of doing business.

It's very important that we continue to support fundamental, curiosity-driven research in all science and engineering disciplines. Many areas of research that seem like they would have no practical application whatsoever turn out to be very important.

For example, who would have predicted that studying the extinction of dinosaurs would cause us to focus on near-earth asteroids, which could wipe out human civilization? Or that an obscure branch of mathematics would provide us with the tools for secure electronic commerce.

Moreover, the research enterprise is interdependent. Biomedical research, for example, is heavily dependent on advances in the physical sciences and engineering – such as CAT scans, gene chips, and supercomputers for more rapid development of new drugs. We can not simply cut off some fields of research just because we can't see its immediate relevance today.

In addition to funding basic research like the type that created the Internet, government can also be an important partner with industry to bring technology to the point at which commercial development becomes feasible.

Another example is the collaborative effort between the government and private industry called the Partnership for a New Generation of Vehicles. In this program, Ford, GM, and Daimler-Chrysler have joined together with the Department of Energy and other federal agencies and national laboratories to work on R&D efforts to advance automotive technology. Will the Partnership succeed? Maybe, or maybe not, but that may be the best reason for continuing to explore the concept to see if the technology can be developed to see if a cleaner, more environmentally friendly alternative to existing technologies is economically as well as technically possible.

IV. Administration Policies

It is clear that the partnership between the Federal Government and the scientific community has been a fruitful one. In recognition of the strategic, important role that scientific discovery plays in our long term economic welfare, President Clinton and Vice President Gore have pursued a comprehensive plan of investing in people, investing in technology and dramatically increasing our efforts in research and development, while continuing to be mindful of the fiscal discipline that has helped to make America's economy strong and stable.

The Administration's 2000 budget proposal reflects our continued support of science and technology, providing $78 billion for R&D investments. The centerpiece of the Administration's budget proposal is the 21st Century Research Fund.

This fund is intended to insure continued stability and growth for the highest priority research funds by providing a proposed $38.1 billion be dedicated to R&D. $18 billion has been dedicated to basic research and $239 million to the Advance Technology Program – a program designed to encourage collaboration between industry and government in the research and commercial development of new technologies. The Administration has also proposed an Information Technology Initiative that will invest in long term fundamental research in computing and communications and will increase development and purchases of extremely fast supercomputers to support a broad range of civilian R&D.

Any discussion of science and technology policy would be incomplete with out mention of the most important input into the production of new ideas and technologies -- human capital. The government has taken and will continue to take an active role in supporting the education of scientists so that there will be in the future, as in the past, a cadre of highly trained American scientists engaged in the pursuit of new and exciting technologies.

That's why the Administration is particularly concerned that the Congress has eliminated our proposed increase for the National Science Foundation – the only agency that has the mission of supporting all science and engineering disciplines.

As well as his commitments to Social Security and debt reduction, the President is committed to investments in the future, including investments in science and technology. By contrast, the GOP budget actions threaten cuts in science and technology in key areas. And the proposed GOP tax cut could result in a 50% cut in R&D funds by 2009. I have argued today that strong support for funding of basic science and pre-commercial R&D is important not only for the scientific community, but for the whole economy.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

THE CHAIRMAN

The 1998 Economic Report of the President

Dr. Janet Yellen
Chairman, President's Council of Economic Advisers
Center for National Policy
February 10, 1998

The Employment Act of 1946, which created the Council of Economic Advisers, requires the President to submit an *Economic Report* to the Congress each year. This Act, together with its later amendments, gave the Federal government responsibility for stabilizing short-run economic fluctuations, promoting balanced and noninflationary economic growth, and fostering low unemployment. One purpose of the *Economic Report* is to tell Congress whether we have met those responsibilities. I am happy to say, in this the fifty-second year after the Act, that the state of the economy is truly extraordinary.

I will elaborate on this point in a moment, but I would also like to note that the *Report of the Council of Economic Advisers*, has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains a chapter on the economic well-being of families and children, and a chapter on racial and ethnic inequality--two central concerns of this Administration. The report also contains two chapters on microeconomic topics, one focusing on improving economic efficiency in the areas of health and environmental policy, and one discussing recent trends in antitrust policy. Finally, the international chapter focuses on the benefits of opening international markets.

In the remainder of my remarks I will touch briefly on the current state of the economy, and then discuss the broad and lasting benefits of a "high-employment economy" -- which is one of the key themes of this year's *Economic Report*. I will then talk about some of the key challenges that still face our nation as we move into the 21st Century.

STATE OF THE ECONOMY

Our Nation's economy is the strongest it has been in a generation. In 1997, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent, and employment rose by 3.2 million, for an average rate of 267,000 jobs per month. The unemployment rate dropped below 5 percent for the first time in 24 years, yet core inflation rose just 2.2 percent. And, this occurred during a period of historic deficit reduction: the Federal budget deficit, which reached $290 billion in the 1992 fiscal year, declined to only $22 billion in fiscal 1997. And, as you know, the President recently submitted to Congress a budget for fiscal 1999 that projects a balanced budget for the first time since 1969.

As 1998 begins, the prospects for continued growth with high employment and low inflation are excellent. The economy is remarkably free of the symptoms that often presage an economic downturn -- that is, inflationary pressures remain well under control; inventories are lean in comparison with sales; and there is no evidence of any financial imbalance that could disrupt the expansion. Economic turmoil in East Asia , assuming that stability is restored, may work to permit continued U.S. growth and job creation with a more moderate outlook for interest rates. Our economy is in fundamentally sound shape and well-equipped to handle any unexpected bouts of rougher weather.

THE BENEFITS OF A HIGH EMPLOYMENT ECONOMY

The exceptionally strong economy that we are enjoying today is due in part to the sound and credible economic strategy put in place by the Clinton Administration. The Administration's strategy has focused on getting the fundamentals right -- reducing the budget deficit, investing in the American people, and opening markets at home and abroad. These were the right policies to stimulate the job creation needed to move the economy to full employment. And, they are the right policies for attacking the longer term problems of sluggish productivity growth and widening income inequality that have afflicted our nation's economy since the early 1970s.

The *Report* underscores the enormous economic and social benefits to a "high-employment economy." An economy with strong job creation and low unemployment can make a broad and lasting contribution to the well-being of the American people. Let me talk briefly about some of these benefits:

First, a high employment economy produces certain *direct and measurable benefits.* Returning the economy to full employment yields a direct and measurable benefit to our nation by ensuring that the economy's resources--human and material--are not squandered by needless cyclical unemployment. On average, reducing the unemployment rate by a percentage point raises output by approximately 2 percent; in 1997, 2 percent of GDP was $160 billion, or roughly $600 for every American man, woman, and child. Wasted resources from not producing at potential, together with the human cost of unemployment, are intolerable; the elimination of this waste is the principal benefit of a sustained return to full employment.

Second, a high-employment economy can *reduce long-term joblessness*. A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less skilled or younger and more inexperienced workers into the labor force. These new labor market entrants gain much-needed job experience, building the skills they will need to hold down a job in the future. The experience of some European countries illustrates this point: in Europe, the prolonged stagnation or recession may have led to a permanent increase in unemployment there, as the unemployed and the never-employed have seen their skills atrophy or become obsolete. For this reason, running a high-employment economy, may be one of the surest ways to ensure that an unacceptably large fraction of our citizens are not consigned to long-term joblessness and economic marginalization.

Third, it will *help move welfare recipients into the workforce.* Keeping the unemployment rate low and job growth high is necessary if we are to move current welfare recipients into the work force. Early, indirect evidence on this point is encouraging: employment and labor force participation rates among single women who maintain families--about two-thirds of whom have children under 18--have increased in the past few years. This is probably in part the result of recent welfare reform: the greatest acceleration in employment rates has occurred among those single women most likely to be affected by welfare reform, namely, those with young children. Nevertheless, it is obvious that fostering an economy in which job opportunities are plentiful plays a crucial part in aiding the transition from welfare to work.

Fourth, it *enhances personal economic security.* Knowing that work is available to those who seek it, at wages sufficient to keep them and their families out of poverty, is a key to personal economic security. A tight labor market increases the confidence of job losers that they will be able to return to work, lures discouraged workers back into the labor force, enhances the prospects of those already at work to get ahead, enables those who want or need to switch jobs to do so without a long period of joblessness, and lowers the duration of a typical unemployment spell.

And, finally, a high-employment economy *may help reverse the trend toward greater economic inequality.* From the 1980s until the early 1990s, the economy's ability to reduce poverty through growth alone was hampered by a strong headwind: for the poorest Americans, the benefits of an expanding economy were offset by the sustained declines in wages at the low end of the earnings distribution. Since 1993, living standards for all Americans are on the rise, especially for those at the bottom of the income distribution. The poverty rate fell to 13.7 percent in 1996, from 15.1 percent in 1993; the poverty rate for black Americans is at a historical low, and in 1997 unemployment among blacks fell to its lowest rate since 1973. Since 1993, household income has grown in each quintile of the income distribution, with the largest percentage increase going to the poorest members of our society. Maintaining a full-employment economy is essential if this progress is to continue.

CHALLENGES IN A CHANGING ECONOMY

Although our economy is strong and Americans are working in record numbers, our Nation still faces other, broader challenges as we move into the 21st century. In many ways the U.S. economy today is very different from that in which our parents and grandparents lived and worked. Today, 24 percent of families are headed by a single parent, compared with 14 percent 25 years ago. Three in five married mothers with children under 6 are in the work force--twice as large a share as in 1970. And the U.S. population is aging-- in the next century there will be fewer workers for every retiree, making issues related to retirement security more and more important. The nature of the workplace also has changed significantly: few American workers expect to be working for the same employer--or even to be in the same career--when they retire. Information technology is dominating industry: in the 1950s the information technology industry barely existed; today it employs a larger share of the labor force than the automobile industry did in the 1950s and 1960s. Because information and technology and global commerce are leading the transformation of the global economy, the new strength of a nation will be found in the skills, knowledge and imagination of its people.

The Clinton Administration's agenda is designed to deal with these changes and the challenges they pose. It is designed to equip the American people with the strength, the skills, the security and the flexibility needed to reap the rewards of our growing, changing economy. The President recently laid out this broad agenda in his State of the Union and again in his FY1999 budget In the remainder of my remarks, I will focus on 3 of the key agenda areas: retirement security, the challenges of childcare and racial and ethnic economic inequality.

First, let me talk about issues related to the aging of the population, which we address in Chapter 1 of the *Economic Report* -- reforming Social Security. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. A large share of elderly Americans, particularly those with low incomes, rely on Social Security as their primary source of pension income in retirement. The system has enjoyed dramatic success in reducing poverty rates among older Americans.

Today, however, many Americans fear that Social Security will not be there for them when they are ready to retire. This concern reflects the widespread recognition that, under current "intermediate" projections of the Social Security trustees, the system faces a long-term funding gap: beginning in 2012, unless the system is reformed by then, the government will be unable to pay current Social Security benefits in full out of current payroll taxes; it will then have to draw down the system's trust fund, and by 2029 those funds will be exhausted. If still nothing has been done, the government would then face several options which it could adopt singly or in combination: it could reduce benefits until they are in line with collections, raise payroll taxes to cover an unchanged level of benefits, or finance the shortfall from other parts of the budget, by raising other taxes, cutting expenditures on other programs, or borrowing and allowing the budget deficit to increase. One or more of these measures will have to be taken so long as no changes are made to the present system.

Although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. For example, even if nothing is done and the trust fund is exhausted, payroll taxes will still be sufficient to permanently finance roughly 75 percent of benefits. Put another way, the difference between the anticipated income and the anticipated expenditures of the OASDI (Old Age, Survivors', and Disability Insurance) program over the next 75 years amounts to around 2¼ percentage points of taxable payroll, or approximately 1 percent of GDP. These facts suggest that the problem of placing Social Security on a sound financial footing can admit of eventual resolution.

The President is committed to Saving Social Security First. He has proposed reserving 100 percent of any budget surplus until steps have been taken to reform Social Security. He has also proposed a process to devise an appropriate solution over the next 2 years.

A second major policy challenge involves children and issues related to childcare. Chapter 3 of this year's *Report* documents that there have been notable improvements in children's well-being over the past three years, although an unacceptable fraction of America's children still live in poverty. Children have shared in the benefits of the recent economic expansion: the official child poverty rate has fallen by 2.2 percentage points since 1993. And, under a broader measure of poverty which includes both taxes (like the EITC) and non-medical in-kind benefits, the poverty rate for children has decreased by 4 .7 percentage points from 1993 to 1996, and is now below its level in 1989. The primary reason for this drop is because more families were able to earn enough money to bring their incomes above the poverty line. Child poverty has also declined due to an expansion of the Earned Income Tax Credit.

Other measures of children's well-being have also improved. The share of children living in households without enough to eat has fallen since the early 1990s, and the share of households with children living in housing in poor physical condition has also declined since the late 1970s. There have also have been increases in low-income children's utilization of basic health care services, and continued improvements in mortality rates of infants and young children during the 1990s.

Despite these improvements, many children remain economically vulnerable. One in five children, and nearly one in two children in female-headed families, had incomes below the poverty level in 1996. Adequacy of family income is a critical predictor of both the present and future well-being of children. Children who grow up in low-income families score lower on standardized tests, complete fewer years of school and tend to have lower earnings. With respect to medical care, one in seven children did not have access to health insurance in 1996, despite substantial increases in Medicaid coverage since 1989, due to a concurrent decline in children's private health insurance coverage; one in nine children lived in households which paid more than half their income for housing in 1995. Finally, a large share of children are not attaining even a basic levels of proficiency in science, mathematics, and reading. Thus, too many children are at risk of current and future hardship.

For this reason, the President has developed a number of initiatives to strengthen the economic and social supports for America's children. This year, the Administration has begun to implement the Children's Health Insurance Program, which offers $24 billion over five years to States to expand health insurance for uninsured children. For fiscal 1999, the President has proposed to expand the supply of affordable housing for low-income families, through a 40%

increase in the low-income housing tax credit, and through continued expansions in the HOME Investments Partnership Program. The President has also proposed two major new initiatives to improve the quality of elementary and secondary education. The first would invest $12.4 billion over 7 years to bring down class sizes in public schools in grades 1 to 3 from a nationwide average of 22 pupils in to an average of 18. The second would provide tax credits to pay interest on nearly in $22 billion in bonds to support new construction and renovation of public school buildings.

Today, more American workers are faced with the need to juggle the demands of the workplace with the demands of family and home. In 1997, over 60 percent of married mothers with a child under six were working--compared to 30 percent twenty years ago. For most of these families, it is difficult to afford high quality day care. In 1993, child care expenditures represented 25 percent of annual income for those families with annual incomes below $14,400 with employed mothers and preschool children in paid care. Comparable families with annual incomes above $54,000 spent only 6 percent of their income on child care. There is also reason to be concerned about the quality of child care: A recent study of regulated child care providers found that 86 percent of child care centers surveyed provided mediocre or poor care when judged from the perspective of child development, and 12 percent were of such poor quality that the children's health and safety needs were only partly met.

The President's 1999 budget includes a $21 billion increase in funding for child care, to make it accessible to more families and to raise its quality. An important part of this proposal is increased tax credits for 3 million working families to help them pay for child care, as well as an increase in block grants to States that will directly subsidize child care for low-income families. In addition, the proposal calls for a new Early Learning Fund, along with support for the enforcement of State child care health and safety standards, scholarships for up to 50,000 child care providers per year, and funding for research and consumer education. Finally, the proposal includes $3.8 billion in additional funding over 5 years to help to reach the goal of expanding participation in Head Start to 1 million children in 2002.

Finally, I'd like to talk about issues related to the progress of different racial and ethnic groups. Chapter 4 of the *Economic Report* reviews trends in racial and ethnic economic inequality and concludes that this country's longstanding goal of achieving racial equality has not yet been attained. Although there has been progress in narrowing economic gaps among racial and ethnic groups in the postwar period, it has been very uneven, with rapid progress in the 1960s and early 1970s, followed by 20 years of stagnation between the early to mid-1970s to the early 1990s.

The current expansion has brought signs of renewed progress: since 1993, for example, the median income of black families has risen more rapidly than that of non-Hispanic whites; in 1996, black family income reached a new high, and the poverty rate for blacks fell to a new low. Data compiled under the Home Mortgage Disclosure Act show that between 1993 and 1996, conventional home mortgage lending to blacks rose 67% and to Hispanics, 49%--much larger than the percentage increase in conventional home mortgage lending overall during this period. Such developments raise hope for renewed and sustained progress toward economic equality.

Nevertheless, substantial disparities in economic status across racial and ethnic groups persist. For example, income gaps between black and white families are as large today as they were 30 years ago. The median wealth of white families is by some estimates 10 times that of black and Hispanic families. Poverty rates of blacks and Hispanics are almost triple those of non Hispanic whites; and differences in child poverty rates across racial and ethnic groups are stark, with about 40 percent of black and Hispanic children in poverty in comparison with about 16% for whites.

Because the largest share of most families' income is derived from earnings, labor market outcomes across racial groups are important determinants of economic inequality across racial groups. After increasing rapidly between 1965 and the mid 1970s, the wages of black and Hispanic men and women relative to those of non-Hispanic whites have stagnated or declined between the mid 1970s and early 1990s. Part of this erosion of relative pay reflects a society wide trend toward rising income inequality, due to an increase in the demand for more educated workers and an increase in the skilled-unskilled earnings differential. Because blacks, Hispanics and American Indians are less likely to hold a college degree than whites and Asians, these groups have been hurt disproportionately by changes in the economy that have raised the demand for college educated workers. Over the last 30 years, educational attainment has increased for all groups and blacks largely closed the high school attainment gap with whites; however, the college completion gap widened in the 1980s, as the reward to college educated workers rose.

Although differences in education across racial groups explain a portion of the trend toward rising earnings inequality since the mid-1970s, racial earnings gaps have also increased among individuals with similar educational levels, suggesting that other factors may also be at work. For example, since the mid-1970s the wages of young black college graduates have fallen relative to those of their white counterparts. Researchers debate whether this trend reflects unmeasured skill differences potentially related to school quality, to discrimination in the labor market, or to other factors.

Clearly, more needs to be done to promote equality of opportunity for all Americans. Many of the Administration's current and proposed policies, such as those that encourage community empowerment and those that promote improved quality and accessibility of education at all levels are intended to address these disparities. Furthermore, the Administration's 1999 budget proposal signals a renewed federal commitment to strong and effective enforcement of the Nation's civil rights laws. It increases funding for federal civil rights enforcement agencies by more than 16 percent. And, this January, in a Martin Luther King Day address, Vice President Gore announced the Administration's package of proposed civil rights enforcement initiatives. In addition to increasing funding, these initiatives place greater emphasis on the nonlitigation and prevention remedies for discrimination, and provide for better coordination across Federal agencies and offices. The President has also initiated and devoted great energy and resources to his Initiative on Race, an effort to further a national dialogue on race in America.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been extraordinary: strong growth and low unemployment combined with low and stable inflation. And there are enormous social and economic benefits to our high-employment economy. But that success--and the economy's present strength--cannot be taken for granted. Moreover, there are still long-term changes and challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era. We must finish the job of balancing the budget while investing in people and opening markets at home and abroad. At the same time, we must ensure that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

Racial and Ethnic Economic Inequality: How much progress?

Janet Yellen, Chair
Council of Economic Advisers
January 14, 1998
President's Initiative on Race Advisory Board Meeting

Before I begin, I am pleased to announce that as part of the 1998 *Economic Report of the President*, we will be including a chapter on racial and ethnic economic inequality. The *Report*, which the Council of Economic Advisers submits to Congress each year, will be released in early February. My presentation today will preview portions of the Chapter that pertain to the topic of today's Advisory Board meeting: racial and ethnic differences in economic well-being and labor market success.

My goal today is to give you the numbers -- to give you a sense of the economic standing of different racial and ethnic groups -- where we are today and where we have been. Of course, statistics are subject to interpretation, but I hope that my presentation will help set the stage for today's discussion.

Overview

I will begin with a snapshot of economic well-being of different racial and ethnic groups, including income, wealth, poverty, the emergence of the "middle class," and inequality. I will then turn to the labor market -- unemployment, earnings, educational attainment, and occupations.

But first let me just make a brief note about data availability: In my remarks today, I will mostly present data for blacks, whites, and Hispanics only, because the samples in our regular surveys are often not large enough to produce reliable estimates for smaller populations such as Asians and Pacific Islanders and American Indians. I have included information about these groups where it is available.

Themes

I will present a substantial amount of data, so let me give you an overview of the themes that I hope you will take from my presentation.

First, over the last half century, disadvantaged minority groups have made substantial progress, both in absolute terms and relative to whites. But that progress has been uneven. In the 1950s, and especially the 1960s, economic growth was strong and improvements in economic well-being were widely shared. The 1960s and early 1970s also witnessed substantial narrowing of economic differences between blacks and whites. But, this narrowing seems to have stalled some time in the early to mid 1970s. There are some hopeful signs of renewed progress in the 1990s, but it is really too soon to tell if these signal the beginning of a new period of declining racial and ethnic economic disparities.

On average, the economic status of Hispanics, relative to whites, is lower today than in the early 1970s. However, the Hispanic population has grown rapidly over this period, roughly doubling in size between 1980 and 1996. Therefore, in interpreting these trends, it is important to keep in mind the increasing number of Hispanic immigrants with lower education levels. Just to cite one example, college completion rates increased substantially among native-born Hispanics over the 1980s, even though college completion among all Hispanics was stagnant, and the relative economic status of Hispanics was deteriorating.

Unfortunately, our statistics for American Indians and Asian and Pacific Islanders are much more limited. However, it is possible to draw some broad conclusions. The economic status of Asians and Pacific Islanders is similar to that of white non-Hispanics. But there is great economic diversity within that group. For example, despite similar median incomes, poverty rates for Asians and Pacific Islanders are about 70 percent higher than those of non-Hispanic whites, although they are still far lower than rates for blacks, Hispanics, and American Indians.

According to the most recent data, American Indians had the lowest income and the highest poverty rates of all groups.

A second major theme is that large racial and ethnic disparities in economic status persist; so there is much to be done.

Income and Wealth

Now, let me begin my presentation of data with what is probably the most widely used indicator of economic well-being: income. The first chart presents family income since 1967. Inflation-adjusted family income has risen for whites and is highest among whites and Asians and Pacific Islanders. Black family income grew only slowly while median Hispanic income actually declined. Black family income as a fraction of white income rose in the 1960s, but this trend reversed in the 1970s and 1980s.

Income measures economic status in only one year. Wealth, which measures the net value of assets at a given point in time, may be a more complete measure of economic well-being because it is accumulated over lifetimes and transferred across generations. Wealth is important because it can enable a family to maintain its standard of living when income falls due to job loss, family changes such as divorce or widowhood, or retirement. Racial and ethnic disparities in wealth are even greater than for income. As you can see from the bottom chart, the median net worth of white households was more than ten times that of black or Hispanic households in 1993. And there are also large racial and ethnic differences in wealth among households with similar incomes.

Growth of the "Middle Class"

The emergence of a large middle class is one of the great accomplishments of the post-war economy. As you can see from the top chart, the proportion of blacks who were considered "very poor" -- which is defined here as family income below 50 percent of the poverty line -- fell dramatically between 1940 and 1970. By 1990, nearly 50 percent of blacks had incomes that were more than twice the poverty line. The bottom chart shows a similar emergence of a large white middle class. These charts use data from the decennial Census, so the precise turning points are a bit hidden. Other data indicate that, for both blacks and whites, the middle and upper income group taken together essentially stopped growing in the early to mid 1970s, and family income growth has picked up again in the 1990s.

Poverty

Poverty rates fell markedly in the 1960s, but stagnated starting in the early to mid 1970s. However, here again there are signs of renewed progress in the 1990s as the black poverty rate--and the difference between the white and black poverty rate -- fell to new lows in 1996.

As I noted earlier, despite median income comparable to that of whites, the Asian and Pacific Islander population has a higher poverty rate than the white population.

The Hispanic poverty rate is high and has generally risen since the early 1970s. It surpassed the black rate in 1994 and has fallen gradually in this expansion. Finally, the latest data for American Indians from the 1990 Census indicate that poverty rates among this group were the highest of all the groups considered -- 31 percent.

Inequality

It is helpful to put the data on income and poverty in the context of more general trends in income inequality. This chart shows a widely used index of inequality. Family income inequality has been rising fairly steadily since the early 1970s. Increasing inequality generally means those at the bottom will become worse off relative to those in the middle or top. Since minorities are over represented at the bottom of the income distribution, widening inequality is expected to widen income gaps between minority groups and whites.

Now, let me turn to the labor market. The link between labor market success and economic well-being is obvious. For example, wage and salary income makes up over 80 percent of the income of people between the ages of 15 and 65, and the poverty rate among workers is less than one-third that of nonworkers.

Role of Education

It is important to understand that changes in racial inequality--and overall inequality-- are intertwined with broader changes in the economy and labor market. I have already mentioned how the general trend of rising income inequality is likely to exacerbate inequality across racial and ethnic groups. One of the most important recent developments in labor markets in the past 15 years is the rising demand for more-educated workers.

Economists have emphasized that technological changes in production processes, such as the increased use of computers, have increased the demand for workers with a college education. This change has increased the pay of college-educated workers compared to those with less education. From the top chart, you can see that the earnings of college graduates compared to those with only a high school degree rose rapidly in the 1970s and 1980s.

So how does the increased value of a college education affect race differences in labor market outcomes? Well, as you can see from the bottom chart, blacks and Hispanics are less likely to hold a college degree than whites and Asians. American Indians also have lower rates of college attainment. Therefore, these groups have been hurt disproportionately by changes in the economy that have raised the demand for college-educated workers.

Unemployment

An important indicator of success in the labor market is the unemployment rate. The economy is doing extremely well right now and the unemployment rate has been below 6 percent for more than 3 years. The unemployment rate in Arizona is currently under 4 percent. A strong economy benefits nearly everyone, especially those at the bottom of the earnings and income distribution who are most likely to lose jobs during economic downturns.

Unemployment rates have fallen dramatically for all groups in the present recovery, and in 1997, the black unemployment rate fell to it lowest level in over 20 years. But large disparities are still apparent: in 1997, black and Hispanic unemployment rates were about twice those of whites. Unemployment rates for minority teenagers remain high, currently around 30 percent, and can exceed 50 percent in severe recessions. And, as you can see from the chart, unemployment among blacks and Hispanics is not only higher, but also tends to rise more in recessions.

So there is reason to celebrate the strong economy and low unemployment. But other indicators of success in the labor market -- such as earnings -- also influence racial and ethnic differences in economic status.

Earnings

Research has shown that, particularly in the 10 years following the passage of the Civil Rights Act in 1964, differences in wages between blacks and whites narrowed markedly. What has happened since then? The upper chart shows the ratio of black and Hispanic male earnings to white male earnings. As you can see, relative earnings of Hispanic and black men have generally fallen since 1979. Evidence suggests that the decline began some time in the mid 1970s.

Black women nearly reached pay parity with white women by the mid 1970s. However, as the bottom chart shows, this earnings gap has widened again. Again, you can see that the relative status of Hispanic women has declined.

Earnings & Education

We have seen that earnings are lower for minorities than for whites, on average, and that education has become increasingly important. It is also interesting to look at earnings gaps for workers with similar educational attainment. This slide shows that earnings ratios for people with similar levels of education are much higher than the overall ratio. This pattern suggests that a substantial fraction of the gap in wages between blacks and whites, and particularly between Hispanics and whites, is due to differences in educational attainment. But even for workers with similar education, disparities remain, suggesting that education is important, although not the whole story.

Earnings Gaps

There is considerable debate about how to explain the remaining earnings differences. A number of factors may play a role, and this slide lists some possibilities. This list is by no means exhaustive, and the causes of earnings gaps are complex. Let me mention some of the leading potential explanations: One possibility is that there may be differences in labor market skill. These skill differences could be linked to the quality of schools, other investments in human capital, and disadvantaged family backgrounds. Secondly, there is undeniable evidence that discrimination is a continuing problem in the American workplace. A critical question is the extent to which racial and ethnic earnings gaps are due to discrimination or to other factors. These are subjects that our panelists have all studied, so I suspect that we will be hearing more about this soon.

Education & Experience

Let me offer a couple of additional possible explanations for the trend in earnings differentials between black and white women. The earlier chart shows that black women made extraordinary progress relative to white women in the 1960s and the early 1970s, but the trend then reversed. As you can see from the top chart, attainment of a college degree among white women has risen quickly, faster than for black women, and this occurred at the same time that the demand for college-educated workers was rising. This may explain some of the increase in the black-white earnings gap since the mid 1970s. It is clear that education is not the whole story, however, because earnings gaps for people with the same education level also widened during this period.

Another possible explanation relates to labor market experience. The bottom chart shows that labor force participation has grown more rapidly for white women than for black women since the 1970s. This means that their work experience was also growing more quickly. And experience is rewarded with higher earnings.

Occupations

Like wealth, occupations may tell us more about long-term economic status than wages or unemployment in a single year. There were significant improvements in the occupational status of blacks in the 1940s, 50s, and 60s. For example, black men moved out of agricultural work into higher-paying, blue-collar jobs in large numbers, and black women shifted out of domestic service and into other service, clerical, and blue-collar occupations during this period.

More recently, growth in the higher-paying managerial and professional occupations has been strong, and over the past 15 years, the increase in managerial and professional employment has been especially sharp for women. These charts show that a far higher fraction of whites than blacks or Hispanics work in managerial and professional occupations. Hispanics are much less likely to be working in managerial and professional occupations, and there has been little improvement in the percent of Hispanics employed in these occupations over the past 15 years. Since 1990, there has been noticeable growth in the proportion of black men in managerial and professional positions, although they still lag far behind whites and black women.

Themes

So, let me sum all this up by saying that, when it comes to racial and ethnic economic inequality, we see major achievements over the last 50 years, but there was clearly a slowing of progress from the mid 1970s to the early 1990s. Recently, we have seen some signs that progress may be picking up, but it is too soon to tell. In any case, it is clear that unacceptably large economic disparities remain.

USA-ROC Economic Council Plenary Session

Remarks by Dr. Janet Yellen
Chairman, Council of Economic Advisers

December 2, 1997

INTRODUCTION

It is truly a pleasure to be here with you in San Diego representing the people of the United States. It is an honor to share the podium with my fellow Keynote Speakers--Richard Rosenberg, Chairman Chiang, Chairman of the Council for Economic Planning and Development and a fellow economist; Minister Wang, a former Business School professor like myself and so many other distinguished individuals who are here today. I want to particularly thank our two Chairmen, Jeffrey Koo and Bill Clark. They personify the dynamism which has been the hallmark of these Councils and of the relationship between the United States and Taiwan.

In preparing for my presentation today, I looked back at addresses given by some of my predecessors to these Joint Business Council meetings. One common theme was that all of them paid homage to the "East Asian Economic Miracle," and offered analyses of what produced it. Over the last several months, however, as the shadow of financial problems has spread over the East Asian region, a new cottage industry of commentators and critics has developed reinterpretations of the economic model which has been the basis of the remarkable growth in the region. While some seem sure that the Asian Model has been eclipsed, I am not prepared to join that Guild. In my view, the achievements of the last 20 years have not been obliterated by the turmoil in Asian financial markets and the devaluations of the last several months.

Today is neither a time to pay homage nor a time for euologies. Rather it's a time for a sober-minded review of the policies that the East Asian economies have pursued that provide the solid foundation for recovery and future growth, and it is a time to particularly stress the importance of a continued commitment to openness and economic integration.

I do not need to remind this group why this all matters to Taiwan. The linkages among the economies of the region are extensive. Taiwan is a major investor in Southeast Asia, in China, in the Hong Kong Special Administrative Region. Changes in the value of Taiwan's currency immediately preceded a sharp downturn in Hong Kong's stock market. Problems that began in Thailand have spread out of Southeast Asia into Northeast Asia. While each economy in the region has its own unique characteristics -- and certainly this applies toTaiwan -- the interrelationships of the region's economies require each to pay attention to the successes, and the failures, of its neighbors.

So, this afternoon I will briefly discuss the fundamental economic conditions that I believe have been -- and will continue to be -- the foundations for growth in East Asia, and then turn briefly to some of the corrective policies that will be necessary to put Asian economies back on track to solid growth.

THE FOUNDATIONS OF EAST ASIA'S GROWTH "MIRACLE"

As you know the East Asian economies have faced serious challenges in recent months. We have seen financial market problems arise -- first in Thailand and then spread -- that could have important impacts on other emerging markets not only in Asia but around the world.

During these months of turmoil, it has been clear that each of the East Asian economies has faced its own unique set of circumstances. But, it is also clear that there are common strengths which have fueled rapid growth in the past and which will provide the foundations for solid growth once financial stability has been restored.

Among these common strengths are:

First, a **stable business environment**. This included low inflation, fostered by sound monetary policy in many cases, and also stable and predictable rules of the game for business, that are an essential prerequisite for a vibrant market economy.

Second, **high rates of saving and investment**. There's no miracle here: many economies grew rapidly in large part because they invested heavily. And, governments contributed by running sustainable budgets and by raising the returns to private saving. But it was not only that successful governments had sound budgets--they made choices about how to spend their limited money in ways which enhanced economic growth. They had a clear sense of priorities.

For instance, and this is really the **third** ingredient, the most successful governments placed a high priority on investing in **education.** There was a particular emphasis on primary and secondary education, but there was also a strong concern to make sure that there was widespread access to education, for women as well as men. This experience showed that egalitarian policies could enhance growth. One didn't need to rely on trickle down economics.

Fourth, the most successful economies were characterized by a basic **openness to technology**, and strong efforts to learn from, and adapt, foreign best practices.

And, finally, policy makers in the most successful East Asian economies demonstrated an ability to know when government should get in and where government should stay out. Achieving that delicate balance between doing what supports growth -- such as investing in infrastructure and R&D and providing appropriate banking system supervision -- and not intervening too heavily is a very difficult task. The most successful East Asian economies were able to find that appropriate middle ground, a middle ground which so many countries, both developed and less developed, have found difficult to locate.

To be sure, East Asian governments have made some mistakes. In particular, where they have protected uncompetitive industries from competition; where they have excluded foreign investment or foreign competition; and, where they have failed to protect intellectual property. But on balance the five strengths that I just described have laid a foundation upon which these economies can build and return to solid growth and healthy development when stability has been restored to their financial markets. To achieve this return to growth, however, it is critical for the East Asian economies to first work to address the vulnerabilities which have helped fuel and prolong the financial crises.

RESTORING SOUND FINANCIAL CONDITIONS

Just last week in Vancouver, leaders from the 18 economies of the Asia-Pacific Economic Cooperation forum -- or APEC -- embraced a common approach to restoring financial market stability. They agreed to strengthen the three lines of defense that protect an economy from the type of financial market instability that we have seen in recent months.

An economy's first line of defense is sound domestic policies; sound policy regimes are a necessary precondition to restore confidence and calm financial markets. These include the basics: a sustainable exchange rate regime, sound fiscal policy, and sensible and consistent monetary policy. But it also includes adequate supervision of banks and other financial institutions and timely, accurate reporting of economic statistics to gain the trust of investor both at home and abroad. For that reason, APEC leaders recommended that technical assistance on banking and financial regulation should be expanded and strengthened.

The second line of defense is provided by the international financial institutions. President Clinton's economic team has been working closely with our partners in the region and with international financial institutions such as the IMF and the World Bank to help re-establish financial stability in Southeast Asia. Building on the "Manila Framework" developed by the Deputy Finance Ministers, APEC leaders agreed that the IMF must continue to be the centerpiece of any international response to financial crises. For that reason, they recommended strengthening the capacity of the IMF to respond rapidly and effectively to financial crises, for instance by establishing a new short-term financing facility.

But the regional reverberations of the financial turmoil in Asia have also pointed to the importance of a third line of defense: regional cooperation. Recognizing that neighbors have a disproportionate interest in each others' financial soundness, APEC leaders agreed to establish a regional surveillance forum to provide a mechanism for expressing concerns frankly and openly. They also agreed to a rapid-response mechanism for identifying additional resources to supplement IMF programs on a case-by-case basis as needed.

Together, these three lines of defense -- if implemented rapidly and steadfastly -- should help to restore confidence and stability to the region's financial markets, creating conditions for the restoration of growth.

Finally, there is one last ingredient that has been a central part of the region's past recipe for success that I believe will continue to figure prominently.

IMPORTANCE OF CONTINUED INTEGRATION

Perhaps more than any other region in the world, East Asia has benefitted from close trade ties with other economies in the region and in the world. Over the past few years, the economies of East Asia -- as well as the APEC region more broadly -- have become increasingly integrated. Intra-regional investment, subcontracting, and trade in finished goods occupy a growing share of the total trade for these economies, and, at the same time, trade with APEC as a whole has grown rapidly.

Today's economic changes and challenges all point to the importance of larger and more integrated markets: larger markets provide necessary economies of scale; intra-regional investment provides the presence that is so often necessary for the delivery of modern services; and, greater integration makes possible those instantaneous communications that are the heart and core of our most dynamic, creative industries.

And trade ties between East Asia and America are deep and growing fast. The statistics are telling:

* Eleven Asian APEC economies accounted for about one-third of America's merchandise trade in 1996. That is 60% more total trade than between the United States and Western Europe.

* Taiwan is a key player in this ever expanding trade relationship. As Chairman Wang noted, Taiwan is our <u>7th</u> largest merchandise export market; our 6th largest source of merchandise imports and our 8th largest trading partner overall.

With the recent financial market turmoil, some in East Asia may have been tempted to turn inward, to retreat from international markets. Instead, at the recent meeting in Vancouver, APEC Leaders agreed to embrace increased integration -- opening trade in nine new areas covering $1.5 trillion in goods and services -- everything from chemicals to environmental technology to medical equipment.

It is critical for the East Asian economies to continue this progress: increased economic integration is necessary for the continuation of growth and development in East Asia. .

CONCLUSION

It is the people in this room and others like you who will be the driving force for future integration in the APEC region. You -- the business men and women of America and East Asia -- are the source and the energy for the changes and developments in our economies. You can help ensure that the East Asian economies continue to look outward and move forward.

We hope and encourage--and indeed, challenge--the members of these two Councils to maintain your strong participation in trade and investment that has contributed so much to the economic vitality of the Region. For 21 years you have understood the importance of the economic and commercial relationship between the United States and Taiwan. Together business men and women from Taiwan and the U.S. have created an important link between our two peoples. The Joint Councils have been the anvil where that link has been forged. I salute you for your accomplishments and look forward to your continued leadership and success.

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