The Continuing Importance of Trade Liberalization

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The basic goals of the Clinton Administration's economic policies are simple and uncontroversial. First, to secure rising living standards now and in the future. And second, to ensure that the benefits of a rising standard of living are extended to all Americans. To attain these ends, the Administration's economic agenda has been based on three key policy initiatives: deficit reduction, investing in people through education and training, and opening markets worldwide to U.S. goods and services.

It is this third initiative--promoting free and fair trade--that I will focus on today. From his first days in office, President Clinton has advocated an outward-looking, "internationalist" trade policy. During the first four years of the Clinton Administration, over 200 trade agreements were ratified and implemented, some relatively large in scope--such as NAFTA and the Uruguay Round of GATT--others relatively small, but all vital to our nation's competitive future. President Clinton intends to extend and build upon this record during the Administration's next four years.

The single most important next step in the Administration's effort to open markets abroad and expand trade is for Congress to renew the President's authority to negotiate trade agreements on a "fast track" basis. This so-called "fast-track authority" allows the President to negotiate trade agreements with other countries, and then requires Congress to take an up or down vote on the *entire* agreement. In other words, Congress cannot in effect reopen negotiations by adding or deleting individual provisions of a trade agreement by amendment during Congressional debate. Instead, Congress must vote on the agreement as a whole. Of course, the final decision as to whether the trade agreement--in its entirety--is approved or disapproved is still in the hand's of Congress. Fast-track authority simply allows the President to seek approval or disapproval for the agreement as a whole.

Every President since 1974 has gotten fast-track authority from Congress. Why is it so important? The answer is that fast track lends credibility to trade negotiations. Under fast track, the parties to a trade agreement know that any provisions that are agreed upon cannot later be renegotiated individually, nor can such renegotiation be threatened.

History tells us that fast-track negotiating authority is critical: in the early 1970s, Congress failed to ratify the Kennedy Round GATT agreement in its entirety, and, as a result the Europeans refused to negotiate further trade agreements with the United States. For this reason, in 1974, Congress developed and passed legislation providing the President with fast track negotiating authority, and giving the President the credibility he needs to negotiate international trade agreements.

So, why do we need fast track authority today? And, what would the Administration use it for? The Clinton Administration would focus on three key areas for its use.

The first use for fast-track negotiating authority would be to complete the agenda that was established in the Uruguay Round of GATT negotiations. At the end of the Uruguay Round negotiations, the United States, along with other countries, pushed for a timetable at which negotiations in different areas would resume. We did that, as did Europe and other countries, because we wanted more out of the Uruguay Round than we got. This year, we begin again the negotiations on government procurement; next year, we will begin intellectual property rights discussions; then we will begin talks on agriculture; then on services. Government procurement is a trillion-dollar market for the United States in Asia alone over the next decade; agriculture, a $600-billion market globally; services, $1.2 trillion market. The United States wants better access to those markets. And, we must have fast track authority before beginning discussions in these areas, otherwise countries will not put meaningful offers for market access on the table.

The second major use for fast-track authority is to extend the information technology agreement or ITA. The recently concluded ITA will reduce to zero tariffs on a range of information technology products: semiconductors, computers, telecommunications equipment, faxes, phones, integrated circuits -- a huge array of products in which U.S. firms tend to be highly competitive. The U.S. tariff barriers in those areas are either very low or zero. Asia's tariffs in these areas averaged 30 percent. With the ITA, the United States agreed -- with 43 other countries -- that tariffs on information technology products should be brought to zero across the board in all countries, by roughly the year 2000. We already have agreement among our trading partners for an ITA-2 -- which would expand the scope of the products encompassed by this extremely ambitious initiative. And, fast-track authority would be needed to expand that arrangement.

We are also considering seeking similar kinds of agreements in a number of other individual sectors where the United States is very competitive but global barriers tend to be high -- areas such as environmental equipment and services, medical equipment and technology, and transportation equipment. In all of these areas, it would be necessary to have fast track authority to negotiate a reduction of trade barriers.

Finally, the third area that fast-track will be used is for more comprehensive market access agreements with individual countries. Thus far, Chile has been identified as the first and most likely country for this kind of arrangement. Today, every major economy in this hemisphere--save the United States--has a preferential trade agreement with Chile. In practice, this means that U.S. firms face tariffs in Chile that make their goods 11 percent more expensive than those of competing firms from other countries. This is a serious competitive disadvantage.

The pace with which preferential trade agreements are being negotiated between and among countries around the world is fast. The United States could easily be left behind through inaction. Since 1992, other countries have negotiated 20 preferential trade agreements in Latin America and Asia that exclude the United States. The European Union has begun a process that will culminate in a free trade agreement with Brazil, Argentina, and other MERCOSUR nations; President Chirac of France has even gone so far as to declare that the economic interests of Latin

America "lie not with the United States, but with Europe." And within South America itself, the four MERCOSUR countries are attempting to extend their preferential trade arrangements to encompass the entire continent. Moreover, other countries are aggressively pursuing expanded foreign trade. For example, China has targetted a number of Latin American countries--including Chile, Mexico, and Brazil--for increased bilateral trade.

It is clear: now, more than ever, continued engagement with the global economy will require an active effort on the part of the United States. And, an extension of fast track authority must be an integral component of this effort. But, let's go back to a fundamental and important question: why is free trade so important? Why should we be concentrating so much effort in pushing for more open foreign markets, and how does freer trade contribute to the Administration's goal of securing higher living standards for all Americans? In short, what are the benefits of free trade for the U.S. economy? I will use the remainder of my time to address this question--which, in fact, speaks to my own comparative advantage as an economist.

I would begin by first saying that one of the benefits of free trade is not, as is sometimes supposed, an improved overall current account or trade balance. The Administration's policies do indeed affect the current account, but it is its budget, saving, and investment policies, not its trade liberalization policies, that do so. The current account is a macroeconomic phenomenon that reflects the gap between what we as a nation invest and what we save. The large budget deficits of the 1980s and early 1990s reduced the amount of saving that was available to cover the nation's investment in plant and equipment (investment was choked off too, but not by as much), and this shortfall had to be filled by importing goods from abroad. In an important sense, the nation was overconsuming in the 1980s, financing its consumption binge by borrowing output from foreigners. The result was a large and persistent trade deficit.

Today, we still face a trade deficit, but for a very different reason. Reducing the government's budget deficit has left more room for investment in plant and equipment by the private sector. And invest it has: since 1993, real business fixed investment has grown nearly nine percent per year on average, a much faster rate than that of the preceding ten years. This rate of investment is above the rate at which Americans save--even with the federal government dissaving less by virtue of its smaller budget deficit. So, once again the shortfall is made up for by borrowing output from abroad, with the result being a current account deficit. But there is a big difference between borrowing in order to invest--as the economy is doing now--and borrowing in order to consume, as we did in the 1980s. In fact, running a trade deficit in order to expand the nation's productive capacity is not new to American history--in the 1800s, we did much the same thing in order to build up the nation's infrastructure, most notably during the railroad construction boom a century ago.

So, it is not the gap between imports and exports that is relevant as far as trade policy is concerned. But the level of trade--the "openness" of the U.S. economy--does matter. In recent years, the United States has seen rapid growth in its degree of exposure to the world economy: real U.S. imports of goods and services grew at an average rate of 11 percent over the past four years, while real exports grew at an average rate of 10 percent per year. In the current recovery, export growth has been responsible for roughly a third of overall GDP growth. The United States now exports an amount equal to 13 percent of its GDP every year and imports an amount equal to 15 percent of GDP; to put these figures in perspective, the corresponding figures for the 1960s were four and five percent, respectively. The American economy is now more open than at any time in its history.

What are the benefits of an open economy? Economists generally recognize two broad classes of benefits, the first being static, the second dynamic. I would like to discuss each in turn.

Ever since the work of Adam Smith and David Ricardo, economists have recognized that trade helps an economy by allowing it to specialize in what it does best. Adam Smith argued that specialization--the division of labor--enhances productivity, but noted that the degree to which an individual or a nation could specialize depended critically on the extent of its market. We all know the story of Robinson Crusoe, who, alone and isolated, had to do everything for himself: farm, weave cloth, build shelter, and so on. But if a group of Robinson Crusoes can trade amongst themselves, each can specialize in the production of what he or she is best at doing--thus producing more than would be possible were their attentions divided among goods which they are less skilled at making--and then can trade with his or her neighbors for the goods which they in turn are good at producing.

It might even be the case that one individual (or country, to drop the Robinson Crusoe analogy) is better than anyone else at producing *every* good. Such an argument is often invoked in order to "prove" that the U.S. cannot benefit from trade with a country such as Mexico. But it turns out that the argument in favor of free trade still carries the day. All that is required is for a country to be *relatively* less skilled than another in the production of some good in order for it to benefit from trade. This is, of course, the doctrine of comparative advantage--the fundamental (if perhaps counterintuitive) principle that underlies the theory of international trade.

This, in a nutshell, is the "classical" view of the benefits of free trade. It is important to note that the benefits from trade under the classical doctrine are primarily static in nature--that is, they affect the *level* of output. Moving from a situation in which there is less trade (or no trade) to one in which trade is freer raises output, but this is more along the lines of a one-time increase (even though it might take a number of years for the benefits from trade to be fully felt). This is not to dismiss the significance of these static benefits: for example, some economic historians have argued that most of the economic growth that occurred in the classical world was rooted in the expansion of markets that took place as a result of increased sea trade around the Mediterranean.

Recently, a new view of international trade has emerged which argues that increased trade actually raises an economy's *rate of growth*. If this is in fact the case, it makes the case for trade liberalization an even more compelling one. Raising the growth rate of the nation's economy, even by a few tenths of a percentage point per year, has vastly more significance for long-run living standards than even a relatively large one-off increase in the level of output; the reason, of course, is that a small increase in the economy's rate of growth cumulates over time to yield large gains.

What is the rationale behind the new trade theory--in other words, what is the source of the "dynamic" benefits from trade? Well, we know that economic growth has two sources: either we can increase the amount of inputs (capital, labor, and raw materials) that we feed into the productive process, or we can make those inputs more productive, through innovations in technology, better education and training, and so on. (In fact, this latter factor is necessary if the economy is to grow in per-capita terms in the long run, as sooner or later simply accumulating more inputs will run up against the law of diminishing returns.) The static benefits of trade represent a one-off increase in this latter factor: specialization lets us allocate labor and capital to the production of goods that we are relatively good at producing, making a given amount of labor and capital more productive in a manner that is not unlike an improvement in managerial technique.

The new view of international trade also focusses on this second factor, but argues that international trade can actually increase the rate of innovation and technological change. One economist has summarized the argument with the following catena:

- International trade leads to greater competition;
- Competition induces greater innovation; and,
- Innovation (*i.e.*, technological change) drives economic growth.

(It's a simple notion once you think about it--though it will probably win the economists who thought it out a Nobel prize some day.)

In a sense, the emphasis of the new trade theory on the dynamic benefits of international trade comes full circle to Adam Smith. Although Smith's contribution to trade theory is generally seen as providing an argument in favor of free trade that highlighted the role of specialization in raising productivity, he also pointed out that specialization, by acquainting workers with a specific productive process, could give them insight into how such processes might be improved--thus fostering innovation. New trade theory also incorporates elements of Joseph Schumpeter's theory of "creative destruction," in which the competition that is a fundamental feature of a capitalist economy serves as a motive force for the economy's progress.

The new view of international trade represents a valuable contribution to academic economics. But theory alone cannot provide an airtight argument in favor of trade liberalization. There is, however, a large body of empirical literature which attempts to determine what drives economic growth across countries. Unsurprisingly, investment in physical capital--plant and equipment--and investment in human capital--education, for instance--are two factors which have a profound influence on economic growth. But these same studies have also found that an economy's degree of openness--as proxied, say, by the amount that it imports and exports relative to its overall output--has an effect on its rate of growth.

In an ideal world--the world in which economists live--free trade unambiguously benefits the economy *taken as a whole*. This is true in the real world as well, although the ideal case masks the fact that some will gain from freer trade, but others may lose--even though on net the winners could compensate the losers and still have something left over. In practice, increased globalization will induce reallocations of labor and capital across sectors as the focus of

American industry moves to the production of those goods and services which we are relatively good at producing. Because our economy is not frictionless, these adjustments sometimes involve lengthy periods of dislocation until the reallocation of labor and capital across industries is complete.

Policymakers advocating freer trade must be aware of this fact, and the Clinton Administration has realized from the beginning that it is the government's duty to minimize the impact of this dislocation by speeding up the adjustment process however it can. For example, one of the key provisions of NAFTA involved monitoring those industries that were in danger of being adversely affected by the free trade agreement, and the Administration committed itself early on to providing for dislocated workers through retraining programs. And, more generally, the Administration's commitment to investing in people through education and training serves as a strong complement to its policy of trade liberalization: since freer trade tends to benefit skilled workers most, the United States enjoys greater benefits from trade to the extent that more of its workers are highly skilled. In the end, though, those who would point to the short-term adverse effects of trade liberalization should not lose sight of an important point: Trade liberalization might adversely affect a small fraction of American workers in their role as producers, but it benefits all workers in their role as consumers.

Bottom line is: the benefits of increased openness and increased international trade are wide ranging -- more efficient utilization of resources, faster productivity growth, higher quality goods, and lower prices, all of which raise living standards.

Finally, in closing, I would note that I have said nothing of the benefits of trade that arise simply from the fact that it links the economic interests of nations more closely. John Maynard Keynes once argued that the greatest tragedy visited upon Europe by the First World War was the disruption of the system of international trade that was a hallmark of the European economy before 1914. The eventual breakdown in the world trading system and resulting deterioration of Europe's economy was a proximate cause of the Second World War, and kept living standards in Europe and the U.S. much lower for much longer than was necessary by prolonging the Great Depression. It is only in recent years that the scope of international trade has returned to the level seen before the Great War.

The United States is now more closely tied to the rest of the world by trade than at any other time in its history. How the U.S. economy performs relative to the economies of other nations will depend critically on how we promote our commercial interests abroad. Aggressive pursuit of trade liberalization, for which fast track authority is a prerequisite, is the best way to ensure that the U.S. maintains its position as the strongest and most innovative economy in the world.

Making Welfare Reform Work

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Eli Segal Breakfast

I would like to begin by thanking Eli Segal and all of the other CEOs that are participating today. You are all playing a very important role in our bold welfare experiment. Over the next years we face the challenge of moving millions of people off the welfare rolls. The factor that will probably most affect the number of people that escape from welfare is the overall state of the economy: a strong economy means more jobs available for welfare recipients. Federal policies can also contribute by providing the individuals with the tools they need and the proper incentives to take advantage of a booming economy. By themselves, however, the economy and Federal policy may not be sufficient to meet the ambitious goals we have set for welfare reform. We will also need your help, the help of the private sector, to provide sufficient employment and training prospects to break the cycle of dependency and give less-skilled welfare recipients a helping hand in entering the labor market.

We have spent a lot of time thinking about these issues at the Council of Economic Advisers. Many of these efforts culminated in our release last week of a White Paper titled "Explaining the Decline in Welfare Receipt, 1993-1996." In my remarks today I will be talking about what we learned from this study and our other work on the vital question, making welfare reform work.

THE CONTRIBUTION OF MACROECONOMIC PERFORMANCE

I would like to begin by discussing the contribution of macroeconomic performance to the large reduction in the welfare caseload we have seen in the last four years. In 1992 the unemployment rate averaged 7.5 percent; almost 10 million people were looking for work. In the last four years the unemployment rate has come down to 4.9 percent. The economy has created over 12 million new jobs. Macroeconomists usually think about job creation and declining unemployment rates as something which boosts GDP growth. That is certainly correct: high unemployment is very inefficient, and increasing employment increases growth. The reduction in the unemployment rate is one reason why the economy has grown 2.9 percent over the four years of the Clinton Administration.

But today I want to focus on another important consequences of rapid job creation and low unemployment: creating opportunity. In the last four years, we have begun to see the gains of growth translated into improved living standards for all Americans -- especially those at the bottom of the income distribution. Between 1993 and 1995, the most recent year for which data are available, the poverty rate fell from 15.1 percent to 13.8 percent -- the largest 2-year drop in over 20 years. Poverty rates for elderly and for black Americans reached their lowest levels since these data began to be collected in 1959. The relentless increase in inequality that began two decades ago at least has been stalled if not stopped in the last few years. Not only have the incomes of *every* quintile of the income distribution increased, but the largest percentage increase has been seen by the poorest in American society.

The increase in incomes for the bottom quintile and the decline in the poverty rate have been mirrored in the dramatic decline in the AFDC caseload that we have witnessed over the last

4 years. During the first four years of the Clinton Administration, from January 1993 to January 1997, the number of individuals receiving welfare fell by 20 percent, or 2.75 million recipients -- the largest decline in over 50 years.

The decline in welfare receipt that mirrors the decline in the unemployment rate is not unique to the last 4 years. Welfare caseloads tend to fluctuate over the business cycle, rising when the economy moves into recession and declining once a recovery is underway and the economy is expanding. We saw declining welfare rolls in the expansion in the late 1970s and then a rise as the economy went into recession in 1980. Similarly, between 1989 and 1993, the proportion of the population receiving welfare shot up 25 percent, reaching its highest level ever. The recession of 1990-91 and the weak labor market through 1992 certainly contributed to this increase, hindering the efforts of those welfare recipients seeking work. What is new, however, is the very large magnitude of the reduction in the welfare caseload, much larger than one would have expected given what we have seen during past economic expansions.

WHY HAVE THE WELFARE ROLLS DECLINED

At the Council of Economic Advisers we have done a lot of research attempting to explain this dramatic decline in the welfare rolls. We started out with the question, how much of the decline in the welfare rolls is due to the strong economic performance of the last four years, in particular the decline in the unemployment rate. Our initial efforts to answer this question were frustrated by our reliance on data for the economy as a whole. As a result, we switched to using the experience of individual states. The 50 states (plus the District of Columbia) provide an ideal laboratory for testing different theories as to why the welfare caseload has declined. Each state has had different unemployment rates, different welfare policies, and differential success in reducing its welfare rolls.

In particular, we used statistical techniques to assess the three potential explanations of the decline in the welfare rolls:

- First, the declining unemployment rate I talked about earlier;

- Second, Federal welfare waivers: between January 1993 to January 1997, the Federal government granted states a variety of waivers to experiment with innovative approaches to ending welfare dependence. The Clinton Administration granted waivers to 43 states between 1993 and 1996 that included provisions which may require work and/or training, sanctions for those who do not comply with these requirements, and limits on the duration of benefit receipt, among other things.

- And third, other policies. These include policies which increase the return to work, like the 1990 and 1993 expansions of the earned income tax credit (EITC); policies to make it easier to leave home in pursuit of a job, like the increase of Federal and state spending on child care; and expansions in Medicaid eligibility, which have not only increased the coverage of poor children but also have allowed some low-income individuals to work without losing Medicaid benefits for their children.

The results of our study indicate that over 40 percent of the decline in welfare caseloads can be attributed to economic growth. This is quite a lot, and it suggests that continued economic growth is a prerequisite for further progress in moving people from welfare to work. But it is certainly not everything. We also found that almost one-third of the reduction in welfare caseloads is related to statewide waivers, particularly those that sanction recipients who do not comply with work requirements. A GAO report released just the other day supports our findings on the importance of these policies in reducing the welfare caseload. The remainder of the decline is due to other factors that we do not specifically identify, but could plausibly be ascribed to policies like the expansion of the EITC and increased Medicaid eligibility.

FEDERAL POLICIES TO HELP PEOPLE MOVE FROM WELFARE TO WORK

This Administration's effort to reform welfare did not begin with the signing of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 last August. It began with all of the policies I have been discussing: allowing states to experiment with their own solutions, expanding the EITC, providing support for child care, and not penalizing welfare recipients for finding jobs by making it easier for their children to keep their Medicaid coverage.

The 1996 welfare reform bill was, however, a dramatic step forward. It took those policies which had proved their success in several states, including work requirements and time limits, and mandated them for all states. This radical experiment, called Temporary Assistance to Needy Families (TANF), is an attempt to break the vicious cycle of welfare dependency. But moving welfare recipients into jobs takes more than just forcing people off the welfare rolls and hoping that they will end up in the many newly created job openings. Access to transportation, child care, and other infrastructure support will be needed. Many job seekers will also need to acquire the critical "soft skills" -- a habit of punctuality, low absenteeism, and so forth -- that will make them effective members of the labor force.

The welfare bill that the President signed into law last summer was very strong on incentives to find jobs, but much weaker on helping provide people with the tools they need to find and succeed in these new jobs. The recent budget agreement is an attempt to rectify that shortcoming. It provides $3 billion, the full amount requested by the President for the Welfare-to-Work Jobs Challenge, to the TANF block grant to fund welfare-to-work efforts in high-poverty, high-unemployment areas. A share of the funding will go to cities and counties with large numbers of people in poverty. In addition, the President and the Congressional leadership have agreed to seek a welfare to work tax credit to encourage employers to give welfare recipients the chance to work. This credit will give companies that hire long-term welfare recipients a 50 percent credit on the first $10,000 of wages paid over two years.

In addition, the budget agreement rectifies some of the harshest provisions of the welfare bill: its treatment of legal immigrants. These policies were <u>not</u> designed to improve the welfare system, reduce dependence, or help people find jobs. They were included purely to save money. The President has gotten the Congressional leadership to agree to restore full SSI and Medicaid benefits for disable legal immigrants currently receiving assistance; and for legal immigrants in the country prior to August 23, 1996 who are not now receiving benefits but subsequently become disabled.

THE ROLE OF THE PRIVATE SECTOR

By themselves, however, these Federal policies will probably not be enough to accomplish the President's goal of moving millions of people from welfare into work. They need to be supplemented by efforts by the private sector to hire people off of the welfare rolls. I will briefly discuss three economic reasons why public-private partnerships are crucial to the success of the welfare reform effort.

First, the private sector does many things much better than the government can. A case in point is training programs. Studies consistently find that on-the-job training is substantially more effective than classroom training programs. These conclusions are based on the results of controlled experiments in which welfare recipients are assigned to control and treatment groups and the treatment consists of different methods to move welfare recipients from welfare to work. Simple comparisons of job-finding rates between the two groups provides ample evidence that on-the job training works. Successful programs have led to roughly a 25 percent increase in employment at the end of three years among those who receive on-the-job training compared to otherwise identical workers who received no additional services.

Second, the government's main policy tool is incentives. Our policies have helped to increase the incentive for welfare recipients to find jobs by enhancing their incomes with the EITC, raising their wages with the minimum wage, and making it difficult to stay on the welfare rolls for extended periods of time. At the same time, the work opportunity tax credit helps increase the incentives for employers to hire welfare recipients. Even though I am an economist, I have to acknowledge that incentives can only go so far. Without active efforts on the parts of employers to seek out, hire, and train welfare recipients the welfare reform program will be a failure.

Finally, the last argument for public-private partnerships is that they have been proven to be effective solutions in other policy areas. Examples include the Advanced Technology Program, which provides funding for research and development; and the Technology Literacy Challenge Initiative, which is connecting all the classrooms in the country to the Internet. These programs allow the government to set overall objectives and contribute the initial resources. These resources are then leveraged by the private sector, and targeted to their most efficient uses. This new economic strategy -- which sees the government and the private sector as complements, rather than alternatives -- is ripe for use in the area of welfare reform.

You are the people who will make these public-private partnerships work. The 100 companies represented here today are just the first of what we hope will by a 1,000 companies to join with the President in the Welfare to Work Partnership.

DOES WELFARE REFORM DISPLACE OTHER LOWER-SKILLED WORKERS?

I have discussed the three pillars of our welfare reduction strategy: (1) ensure the economy continues to perform well; (2) use well-designed Federal policies, particularly policies to increase both the incentives and opportunities to find work; and (3) the responsibility of the private sector to help ensure the success of this experiment.

One important question that remains regarding the effectiveness of this three pillar strategy is its impact on other less-skilled workers who have "played by the rules" and stayed off the welfare rolls. Some have argued that the labor market operates like a game of musical chairs and if new players enter the game, the new players who find seats will be taking them away from others. This view of the labor market ignores the fact that the economy has created millions of new jobs and a continued economic expansion will likely lead to millions more, increasing the number of seats, if you will.

Determining whether any currently employed workers will lose their jobs is a difficult proposition, and in the very short-run some may. Several historical episodes suggest, however, that surges in labor supply from one group does not necessarily reduce employment opportunities for other groups. These examples include:

- The baby boom: The baby boom cohort represented a huge increase in the supply of labor when its members reached working age. Yet employment among those in the pre-baby-boom cohort was not significantly reduced.

- Female labor supply: Women's labor force participation has been rising for decades. For instance, between 1975 and 1996, the fraction of women aged 25-54 who were employed increased by almost 50 percent. Yet the fraction of employed men in that age group hardly changed apart from cyclical fluctuations.

- The Mariel Boatlift: In 1980, Fidel Castro allowed 125,000 Cubans to emigrate to the United States and the majority of these individuals moved to the Miami area. These new immigrants increased Miami's labor force by 7 percent. Yet research shows that the employment prospects of native-born workers were unaffected by the inflow of these immigrants.

Even if former welfare recipients are able to obtain employment without displacing other workers, their entry into the labor market may lower wages for low-skilled workers to some extent. Research suggests, for example, that the entry of the baby boom into the labor market may have depressed wages for some groups of workers. Although large reductions in wages would be troubling, some degree of wage flexibility enables those with no other means of support to find jobs.

CONCLUSION

In conclusion, I think that the policies that we have been pursuing over the past four years have set us on the right track. We are not embarking, as many think, on a bold new experiment. We are continuing a bold new experiment. The 20 percent reduction in the welfare caseload is just the first fruit of the sound macroeconomic policies and innovative welfare experiments of the last 4 years. The 1996 welfare reform bill and the changes we are now seeking this year are just a continuation of that process. With your help, I am confident that it will work.

Cyclical Successes and Structural Challenges: The Clinton Administration's Economic Agenda in Retrospect and Prospect

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French-American Chamber of Commerce of Washington, DC

Thank you. I'd like to use the opportunity provided by today's talk to sum up the economic developments of the last four years and to give an indication of where I think the economy is heading today. In particular, I will assess the role that the Clinton Administration has played in the economic success of the last four years, and discuss the challenges and opportunities that face us over the next four years.

THE SUCCESS OF THE LAST FOUR YEARS

Using the economy to its full potential

The first rule of economics is that inefficiency is bad, and the underutilization of resources is one of the most glaring examples of inefficiency. In 1992 the unemployment rate averaged 7.5 percent. Almost 10 million people were looking for work -- which is a lot of unused productive potential, to say nothing of the human costs involved. In the last four years the unemployment rate has come down to 5.2 percent. Not only has the economy created almost 12 million new jobs, but our research at the CEA shows that these are overwhelmingly good jobs: over two-thirds of recent employment growth has been in industry/occupation groups paying wages above the median.

At the same time inflation has remained under control, and the underlying inflation rate has even edged down. In January 1993, inflation as measured by core CPI (which excludes the volatile food and energy components) was 3.5 percent. Last month, core inflation was only 2.5 percent. We have not crossed the line into stretching the economy past its potential.

Economic growth has been strong and sustainable. The economic expansion has been marked by a healthy balance among the components of demand. Private, not public, demand has been the engine of growth. The Administration's initiatives to bring down the deficit and to reinvent government have slown the growth of government purchases and freed savings to finance domestic investment. Investment and exports have boomed -- both growing at a more-than-7-percent annual rate over the last 4 years. Not only has investment been the strongest component of demand for the past 4 years, but the new structures and equipment that it represents will remain part of the Nation's capital stock, promoting growth and productivity for years to come.

Insuring that everyone shares in the gains

Not only has our overall economic performance has been strong. But, we are also beginning to see gains in the opportunities and living standards for all Americans -- especially those at the bottom of the income distribution. Between 1993 and 1995, the most recent year for which data are available, the poverty rate fell from 15.1 percent to 13.8 percent -- the largest 2 year drop in over 20 years. Poverty rates for elderly and for black Americans reached their lowest levels since these data began to be collected in 1959. Not only have the incomes of *every* quintile of the income distribution increased, but the largest percentage increase has been seen by the poorest in American society. Our work at the Council of Economic Advisers suggests that these improvements are probably larger than can be accounted for by the normal cyclical behavior of the economy. The relentless increase in inequality that began two decades ago has been stalled if not stopped in the last few years.

WHERE WE ARE TODAY

Although the last four years have been very impressive, the question on everyone's mind today is whether or not it will continue. The Blue Chip consensus forecast is for growth to strengthen in 1997 and then fall back slightly in 1998. In my assesment and that of many observers, "none of the normal excesses or imbalances that usually appear by this time in the business expansion can be seen." Although I believe that the very strong growth we have recently seen should lead us to be cautious about the possibility of overheating leading to a rise in inflation, I also believe that few if any reasons justify the belief that the expansion is likely to come to an end anytime soon. Let me explain why I think this is so by discussing the health of three cyclically sensitive sectors of the economy.

First, I'll talk about the **labor market**. As recently as 1989 when unemployment was at its current rate of 5.2 percent, inflation rose. In this current expansion, however, the underlying inflation rate has been falling slightly, not rising. Not only have we not seen inflation increase, but also the evidence is that inflationary pressures are not as great as many fear. One measure of inflationary pressures comes from the rate of compensation increases in the labor market. Real product wages -- a measure of the real hourly labor cost faced by firms -- increased 0.9 percent last year, which is exactly the rate at which productivity increased last year. We have seen no evidence of pressures on firms profit margins. And, there is also an additional cushion between wage growth and the necessity for price rises in the fact that profit as a share of GDP was 8.6 percent last year, as high as its been since the 1960s.

By almost any measure, inflation is lower today than it was two years ago, and insofar as we have seen inflationary pressures, they are certainly milder than in previous periods when unemployment was this low. The reason for this is clear: the NAIRU (or natural rate of unemployment) has fallen. Unlike the experience with the late 1980s, inflation no longer starts rising when the unemployment rate falls below 6 percent.

The second important sector is **households**. Consumer spending is two-thirds of demand, and thus essential to keeping the economy producing near its full potential. Consumption growth was strong last year and all the evidence indicates that consumers are in a fundamentally sound position. Incomes are rising: real disposable personal income (that is, after tax income) grew 2.9 percent last year. Overall, the financial condition of households looks quite strong with the ratio of net worth to income above 5, the highest its been in 28 years. Consumers are not only wealthier and earning more than in the past, but they are confident as well: in the last quarter consumer confidence (as measured by both the University of Michigan and the Conference

Board) was higher than anytime since the 1960s. All together, these provide the structural underpinnings for strong consumption growth in the near future.

Finally, let me talk about the **financial sector**. History shows that fragile financial institutions are one of the surest ways that minor economic shocks are propagated into systemic slowdowns. This is why evidence on the health of the financial system is so important. The average capital-asset ratio in banking is now 8 percent, up from 6.2 percent in 1988. There has been much talk recently about record levels of credit card delinquencies. I think this needs to be put in perspective: much of the increase in delinquencies is due to companies extending their credit cards to people previously considered credit risks. Also, the deliquency rate on residential mortgage loans, which account for about two-thirds of household debt, has trended down in recent years, reaching the lowest levels seen in more than a decade. Furthermore, measures of business bankruptcies and failures remain relatively benign. The level of business bankruptcies remains more than 25 percent below its 1992 peak.

To summarize, the analysis of some key sectors of the economy leads us to expect the expansion to continue. Evidence from the labor market shows that we are not producing above capacity; evidence from households leads us to expect demand to continue to expand. Finally, the excellent health of the financial sector indicates that the economy is resilient enough that small shocks will not lead to a recession. Overall, these factors create an economy in which individuals can better meet the inevitable perturbations of life.

THE CHALLENGES AHEAD

Now let me talk about the challenges ahead because although we are seeing good economic times, our Nation still faces a number of troubling economic trends. Productivity, for example, has been growing more slowly over the last quarter century than it did in the previous quarter century. Also, even though we have made enormous progress in reducing the deficit over the last four years -- it is now 1.4 percent of GDP, the lowest it has been since 1974 -- it will still be a challenge to balance the budget by 2002 and to keep it in balance, as the ageing population puts strains on our major entitlement programs. Finally, the increase in income inequality might be the most challenging trend of all.

Productivity growth is not an abstract economic concept. The only way for wages to increase is for workers to increase the amount that they produce per hour. Before 1973, output per worker rose 2.8 percent per year; from 1973 to the present, productivity growth has averaged 1.1 percent. As a result, compensation has grown at about one-third the rate it used to. Many Americans simply do not feel that they are making any headway.

Earlier I talked about the improvements in the income distribution since 1993. In a longer perspective, however, these gains are small compared to the large rise in inequality over the previous two decades. Over this period as a whole, not only have wages and incomes grown more slowly but the distribution of the income gains have been very unequal.

Between 1979 and 1993, the bottom 60 percent of families saw their real incomes fall, not rise. The only families who saw their incomes rise were the upper 40 percent of Americans. As I said earlier, this direction of change has been reversed in the last few years. These reversals, however, have still left the income distribution substantially more dispersed than it was in 1979.

FEDERAL ROLE IN INCREASING GROWTH AND REDUCING INEQUALITY

The question then is what can be done to reverse the trend of slow and unequal wage growth. In particular, what can and should the Federal government do? Let me start by pointing out what the government should not do. It cannot and should not hold back the growth of new technology. Technological change is a major determinant of productivity growth over time, and, as I said before, productivity growth is a major determinant of growth and living standards. Second, the federal government cannot and should not try to insulate our market from global competition. Protectionism has always been a recipe for economic stagnation, higher prices, and lower living standards.

Rather than holding back, the federal government should pursue policies that facilitate change and growth. That means policies that allow the private sector to expand, hire and invest, and policies that cushion transitions for today's workers and ensure that tomorrow's workers are able to compete in the new high-tech global environment.

The pro-growth agenda

What does a pro-growth agenda look like? It has four parts:

First, **maintaining a stable macroeconomic environment** that is conducive to private sector growth. In the last four years we have made great strides towards balancing the budget. Since 1992, the budget deficit has been cut by 63 percent -- from $290 billion to $107 billion in FY 1996. As a share of GDP, the deficit has fallen from 4.7 percent of GDP in FY 1992 to 1.4 percent now -- the lowest in over 20 years. In 1992, the budget deficit in the United States was a larger share of the economy than in Japan or Germany; now it is lower than in any other major industrialized economy. The dramatic decline in the deficit over the past four years is the result of many factors. But by far the most important are the fiscal policy changes adopted in the 1993 deficit reduction package and the stronger economic performance to which it contributed. These two factors account for fully *three-quarters* of the difference between the actual 1996 budget deficit ($107 billion) and the deficit forecast before the 1993 package was adopted ($298 billion). Even uncompromising observers give President Clinton "a lot of credit" for deficit reduction. The 1993 deficit reduction package put the country solidly on the road to fiscal responsibility.

To illustrate the importance of deficit reduction, I like to discuss a counterfactual: what would have happened if we had stayed on the deficit path from the last pre-Clinton projection. First of all, the Federal debt today would have been half a trillion dollars higher. With more accumulated debt and a higher deficit, interest rates would certainly have been higher. It is hard to imagine that our stupendous 10 percent annual increase in producer's durable equipment investment that we have seen since the beginning of this Administration could have survived these interest rates.

Deficit reduction has also had a very important indirect effect: it has restored the confidence of Americans in the ability of our government to keep its economic house in order.

After 12 years of fiscal mismanagement, the government has finally shown that it can handle its own finances.

From the perspective of 1992, we are more than halfway towards balancing the budget. Currently the President has proposed a plan to balance the budget by 2002 while protecting our priorities. We are all actively working with Congress in an effort to get a compromise agreement.

But, in pursuing an agreement it is important to remember that deficit reduction is not an end in itself, it is a means to an end. That end is strong long-term economic growth and higher living standards for all Americans. Reducing the deficit by eliminating important investments would be counterproductive.

The second part of this pro-growth agenda is to <u>invest for the future</u>. The private sector does most of the nation's investing, but in a few key areas carefully targeted government efforts can help. One is education and training.

The payoff to education -- as measured by the gap between wages for the more skilled and less skilled -- has increased enormously in this high-tech world. Each year of education increases annual earnings by between 5 and 15 percent. So education is important for the individual. Education is also an important determinant of economic growth. Empirical studies suggest that increases in education accounted for about 20 percent of the growth of income over the last 30 years. This is not surprising given that a well-educated workforce can implement new ideas and innovations more quickly.

The Federal government can play an important role in advancing opportunity by helping to provide greater access to education and training programs in order create a more uniformly high-skilled workforce. Between fiscal year 1993 and 1997 we have increased spending on education and training by 19 percent. There have been large increases in funding for programs targeted at every stage of a person's life ranging from Head Start (up 43 percent) to training and employment programs (up 19 percent). The President's new balanced budget plan includes large increases for education and training programs like Head Start, Goals 2000, Technology Literacy Challenge, Pell Grants, America Reads Challenge, the Hope scholarship, and the school construction initiative. In an era of budget stringency the expansions of these programs -- both past and proposed -- represent a truly remarkable achievement.

The other investment area where government has a role is research and development. Research and development produces technological change, and technological change has accounted for more than half of the growth in output per capita. This reflects the fact that Research and development yields high private returns for the investor, and even higher returns for society at large. The fact that the social returns exceed the private returns means that individual firms will tend to underinvest in Research and development. That is why the government has a role to play.

The Federal government has long played a critical role in promoting Research and development. It has financed growth in telecommunications, for instance, from that industry's inception, with the Baltimore-Washington telegraph line, to its latest major development, the Internet. The Administration has placed public-private partnerships at the center of its research and development policy. The Advanced Technology Program, expanded substantially under this Administration, is a good example. ATP awards matching funds to industry, on a competitive basis, to conduct research on cutting-edge technologies and processes that, despite their great economic potential, might otherwise not have been pursued. The firms themselves set much of the research agenda, but this pairing has been an effective way to leverage government funding into larger increases in research and develoment.

The third part of the growth agenda is **opening markets at home and abroad**. At home, one cornerstone of the Administration's economic strategy has been an aggressive policy of reforming regulatory structures in key sectors of the economy, including telecommunications, electricity, and banking. On the environmental front, the Administration has shown that regulatory policies that recognize the importance of incentives can be both cheaper and more effective than traditional regulatory controls.

And abroad, trade agreements, such as NAFTA and the Uruguay Round of GATT will continue to increase exports. The first major fruits of the WTO are now on the horizon, with the December 1996 agreement in Singapore to reduce tariffs on a wide variety of information technology products to zero. Exploiting our comparative advantage will promote economic growth and produce higher income for the nation as a whole. Wages for jobs supported by goods exports are 13 to 16 percent higher than the national average.

In the future the Administration will continue to pursue its outward-oriented, protrade agenda through multilateral, regional, and bilateral means, expanding on and bringing to fruition initiatives like the Asia-Pacific Economic Cooperation group and the proposed Free Trade Area of the Americas. In order to accomplish this, however, we need fast track authority for the President to be able to negotiate effectively. Every President since Ford has had this. The absence of procedural authority to implement trade agreements is the single most important factor limiting our capacity at this time to open markets and expand American exports and trade opportunities in the new global economy.

The fourth and final part of the growth agenda is to **improve the efficiency with which the government itself does its job**. By freeing up resources for potentially more productive uses in other sectors, and by reducing the overall cost of regulation, government reform can raise economy-wide productivity. The Vice President's reinventing government initiative has been doing just that. Thousands of pages of Federal regulations have been eliminated, and thousands more are being streamlined or improved in other ways. Hundreds of obsolete Federal programs have been eliminated, and red tape has been reduced dramatically. The Federal civilian workforce has been cut by more than 250,000, and as a percentage of the Nation's total employment it is now smaller than at any time since the New Deal.

Summary

Let me summarize. Creating a stable macroeconomic environment, encouraging investment in Research and development and education and training, opening markets at home and abroad, and ensuring efficient government are the four major parts of a growth agenda that should increase wages and incomes.

PROTECTING WORKERS CAUGHT IN THE TRANSITION

But as I said at the beginning, new technology and global competition produce not only opportunities but also challenges. Individual workers can get trapped in the transition. So at the same time that we promote long-term growth, we have to take steps to protect those who, through no fault of their own, lack the requisite skills or training to compete.

Enhancing the returns to work

One part of this strategy is enhancing the returns to work. The EITC and the minimum wage are two important aspects of this. The EITC is a refundable tax credit of up to 40 percent of earnings. It was expanded in 1990 and 1993. Over this period the number of families receiving the EITC rose by almost 50 percent to 18 million; and the average credit more than doubled. In 1995 almost 3.3 million people were lifted out of poverty by the EITC, more than twice as many as only a few years before.

At the same time the minimum wage plays an important role in reducing inequality. This Administration worked hard to get an increase of the minimum wage to from $4.25 to $5.15 enacted. Despite concerns that this wage increase would cost jobs, I am pleased to report that since the first stage of this increase was enacted last October, we have not seen any noticeable declines in employment growth in industry-occupation groups whose employment is disproportionately composed of minimum wage workers.

The expansion of the EITC combined with the rise in the minimum wage have increased the return to work for low-wage workers to the point where, after the next scheduled increase in the minimum wage, a full-time, year-round minimum wage worker with two children will make about $14,000 a year -- well above the 1981 level in real terms.

Easing the transition between jobs

Similarly, we have a package of provisions that ease the transition from one job to another for those who find themselves in industries adversely affected by changing technology, globalization or even simply idiosyncratic shifts in demand and supply. The Administration has proposed providing unemployed workers with 6 months of health insurance through the existing unemployment insurance system. At the same time, it is important to help the unemployed find jobs through job retraining centers and "one-stop shopping" career centers. Finally, the Administration has worked hard to make benefits more portable between jobs. For instance, the Health Insurance Portability and Accountability Act of 1996 (the Kassebaum-Kennedy bill) ensures that as many as 25 million workers will not be denied health insurance, including coverage of preexisting conditions, at their new jobs. Similarly, pension simplification and improved portability also make it easier to maintain crucial benefits when changing jobs.

By making the economy more supple, able to respond quickly to changes in markets and technology, these policies to ease the transitions between jobs are themselves an important part of the pro-growth strategy.

CONCLUSION

In conclusion, the first four years of the Clinton Administration have set us on the right track towards restoring confidence in government by reducing the deficit, opening markets at home and abroad, and investing in education. We have already begun to see the payoffs of these policies in terms of low unemployment with continued low inflation, sustained growth, and improvements in the income distribution. The second term will provide the opportunity to consolidate and extend the already considerable progress we have made in these areas. I am very enthusiastic about what this will bring. Thank you.]]

Trends in Inequality and Policy Responses

Janet Yellen, Chair
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National Policy Association, Washington DC

Thank you for inviting me to present some of my views on income distribution. As you know, our economy has made great strides over the past 4 years. The unemployment rate is down to 4.9 percent, more than 12 million new jobs have been created, inflation is low and stable, and the deficit has been cut by more than 75 percent. But our Nation still faces a number of challenges and troubling economic trends. Productivity, for example, has been growing more slowly over the last quarter century than it did in the previous quarter century. Also, even though we have made enormous progress in reducing the deficit over the last four years -- it is now less than 1 percent of GDP, the lowest it has been since 1974 -- it will still be a challenge to balance the budget by 2002 and to keep it in balance, as the ageing population puts strains on our major entitlement programs.

The trend I am going to talk about today -- the increase in income inequality -- might be the most challenging trend of all -- although the relentless increase of inequality has been stemmed in the last few years, something I will discuss later in my speech. Ultimately, economic growth only matters to the extent that its fruits are shared by all Americans. And balancing the budget would not be a proud achievement if it came at the expense of unbalancing the distribution of income. There is a second reason that the increase in income inequality is a particularly worrisome trend: we do not fully understand why it has occurred. We have very good explanations for some of the rise in inequality, but much of the rise is still very puzzling.

My remarks today have three parts. First I will discuss the measurement of inequality at a point in time. This is an important topic -- all too often people rush into discussions of income inequality without stopping to ask just what is meant by income. In the second part of my talk I will discuss the dimensions and causes of the rise in inequality over the last two decades, and also the experience of the last few years. Finally, the third part of my talk concerns what I believe are the proper policy responses to the rise of inequality.

THE MEASUREMENT OF INEQUALITY

"PRE-GOVERNMENT" VS. "POST-GOVERNMENT INCOME"

First, let me begin with the question of how we measure "inequality." Most discussions of inequality focus on income, in particular "money income" as measured by the Bureau of the Census. Money income, however, is a concept that is somewhere between what I will call "pre-government income" and "post-government income." At one extreme, we might be interested in measuring the income generated by the market: "pre-government income." This includes income from labor earnings, interest, dividends, and other private payments. Money income includes all of these -- indeed, on average, labor earnings alone represent 80 percent of money income, and they represent 100 percent of money income for many Americans. It also, however, includes cash payments from the government in the form of Social Security, Supplemental Security Income (SSI), veterans benefits, and other transfers. Money income, however, does not fully represent "post-government income" because it does not include the effect of government taxes (including the earned income tax credit, EITC) and noncash transfers like food stamps. As a result, the featured measure of money income capture only some of the "post-government" income distribution.

Because taxes and transfers are themselves functions of income, the scope defined for money income has a substantial impact on the measurement of income inequality -- as well as on the assessment of the efficacy of government policy. Economists sometimes measure inequality with something called a Gini coefficient. Based on this measure, taxes lower inequality in "pre-government income" by 6 percent. The inclusion of transfer payments -- including both cash and noncash payments -- is even more important, lowering this measure of inequality by around 20 percent.

Another illustration of the scope of this definitional issue can be seen by looking at another measure of inequality: the proportion of people living below the poverty line. In 1995 the before-tax-and-transfers poverty rate was 21.9 percent. If the effect of all taxes, the EITC, and government transfers were included, the poverty rate would have been 10.3 percent. All told, about 30 million people -- more than half of all those who are reckoned poor on a before-tax-and-transfers basis -- escaped poverty with the help of government policies. Some of these policies -- like Social Security -- are incorporated into the official poverty rate of 13.8 percent. Other policies -- like the EITC -- are not.

INCOME INEQUALITY VS. CONSUMPTION INEQUALITY

Beyond definitional questions of what is included in income is the question of whether income is really the correct variable to focus on in the first place. From an economic perspective it is consumption, not income, that is the ultimate determinant of well being. Beyond this theoretical justification, there are important substantive justifications for focusing on consumption rather than income. Income undergoes both high and low frequency fluctuations that are smoothed out, to some degree, in consumption. Some fraction of inequality, for example, is just between people at different stages of the life cycle -- students earning little or no income and middle age people in jobs -- whose consumption expenditures are probably closer than their income expenditures.

As our intuition suggests, consumption is distributed substantially more equally than income. The Gini coefficient for consumption is about one-quarter lower than the Gini coefficient for income. Also, although Gini coefficients for consumption and income tend to move together, they diverged from around 1989 through 1993 when consumption inequality flattened out and even declined a little while income inequality continued to rise.

TRENDS IN INEQUALITY

In the question "inequality of what?" the "what" has a substantial impact on the assessment of the level of inequality and some impact on the assessment of trends in inequality. It does not, however, overturn the starting point of all contemporary discussions of inequality: by almost any measure, economic inequality is greater today than it was 20 years ago. So in the second part of my talk -- trends in inequality -- I will ignore some of the caveats I just elaborated and focus mainly on the featured measure of money income.

Over thirty years ago, President John F Kennedy commented that "a rising tide lifts all the boats." Indeed, the events of the decade preceding his Presidency and the decade following it supported this statement (see Chart 1). Tremendous economic growth brought increasing incomes for all families, including the poor. Income inequality fell dramatically. Evidence since the late 1970s, however, suggests that not all boats are necessarily lifted by a rising tide. Chart 2 shows how dramatically the situation changed: during the 1980s and early 1990s, more than half of the households saw their real incomes fall. If the CPI were biased upward there would not be as many losers in *absolute* terms. However, the *relative* picture that the richer the group the greater the gains would not be changed. Another metric for measuring the increasing inequality is the Gini coefficient which has risen steadily since 1968 (see Chart 3).

What has caused this increased dispersion in household incomes? About half of the increased inequality comes from increasing labor earnings inequality. Ratios of annual earnings between the 90th and 50th percentile and the 50th and 10th percentile for full-time, full-year male workers are shown in Chart 4. Note the increased earnings power of higher-paid workers since 1979. The top workers are better paid relative to the middle, and the bottom workers are worse off relative to the middle.

Much of the trend in earnings inequality is the result of rising premiums earned by some classes of workers, especially the well-educated and high-skilled. The returns to education grew tremendously during the 1980s and early 1990s, as shown in Chart 5. In 1980, a male college graduate earned one-third more than his counterpart with only a high school education. In 1993 the college premium had grown to more than 70 percent.

There are a number of explanations for this dramatic increase in the returns to college. We can rule out changes in the supply of workers: with large increases in the college-educated workforce, supply effects should have decreased the premium. Instead, the most promising explanations center around increases in the demand for skilled workers. As new technologies have been integrated into the production process, firms have increased their demand for workers capable of using this technology. Evidence indicates, for instance, that workers who use a computer on their job earn significantly more than those who do not. One recent paper finds that "the spread of computer technology may 'explain' as much as 30 to 50 percent of the increase in the rate of growth of the relative demand for more-skilled workers since 1970."

Skill-biased technological change can certainly account for the rise in earnings inequality *between* different groups. Interestingly, even more of the overall increase in earnings inequality is the result of greater inequality *within* groups that share the same education, experience, and demographic traits. Within group inequality is on the rise and in fact accounts for about two thirds of the total increase in earnings inequality. Although a number of creative theories have been advanced to explain this fact, none of them is very convincing.

The increase in earnings inequality, as I said, only accounts for about half of the overall increase in household income inequality. Much of the other half is due to changes in the composition of households. Divorces, out of wedlock births, and later marriages have all exacerbated income differentials between households. The share of family households headed by women has risen rapidly, from just over 10 percent in 1970 to about 18 percent in 1995. These households are more likely to have lower incomes because they lack a second wage earner, because women earn on average less than men, and because some of these women to do not work at all. In addition to the changing composition of households, evidence suggests that nonlabor income also contributed to the increase of inequality during the 1980s.

From the early 1970s through 1993 the trend of increasing income inequality was clear and pervasive. Since 1993, however, this seemingly relentless trend toward increasing inequality has apparently stalled, and may even have started to be reversed. The poverty rate fell from 15.1 percent in 1993 to 13.8 percent in 1995, marking the largest two-year reduction in poverty since

1973. And this is based on the official poverty rate which is before taxes. If we include the effects of the EITC, the reduction in the poverty rate has been even more dramatic.

Incomes at all points of the distribution have increased since 1993, and the gains have been largest for low-income households (this is shown in Chart 6). This probably represents a genuine change and not just accidental movements in the data: The last two-year period during which households in the bottom quintile have seen their income rise more rapidly than households in the top quintile was in 1973. Also, a glance back at the Gini coefficient in Chart 2 shows that the decline in the last year is more than one usually sees in this relatively smooth series -- in fact it is the largest decline in any year since 1968, again without even taking the EITC into account.

These reversals, while dramatic and important, do not undo the twenty years of increasing inequality. Also, it would be somewhat rash to declare definitively an end to a twenty year trend based on two years of data. This is especially the case for a complex phenomenon like inequality whose causes we do not fully understand. Still, our best information suggests that these developments are significant.

Some explanations for the reversal of the trend toward increasing inequality also suggest that we might be seeing the beginning of a decline in inequality. Part of the progress is due to good macroeconomic conditions, in particular falling unemployment. The evidence, however, suggests that poverty and inequality have fallen by much more than would be predicted from these aggregate variables alone. More tellingly, the college wage premium has begun to fall (Chart 5). This has translated into a narrowing of the earnings gap between the median worker and the workers at the bottom of the distribution (Chart 4). If this is the consequence of the increased supply of college graduates, we can expect to see further reductions in this premium in the future.

POLICIES TO AFFECT THE DISTRIBUTION OF INCOME

The final subject of my remarks today is policies to affect the distribution of income. Regardless of our interpretation of the last few years, a question still remains: what role does government policy play in reducing income inequality.

MITIGATING THE INEQUALITY PRODUCED BY THE MARKET

First, government policies play an important role in mitigating the inequality produced by the market. As I have already discussed, through its taxes, and more importantly its transfers, government policies have a large affect on the consumption possibilities of individual households. Taxes and transfers eliminate about one-quarter of "pre-government" inequality, as measured by the Gini coefficient, and more than half of the "pre-government" poverty. The programs for the aged -- Social Security, Medicare, and parts of Medicaid -- have been so successful that poverty rates for the elderly fell to 10.5 percent last year -- the lowest level since the data has been collected and less than half the level that predominated in the 1960s. Understanding the contributions of these programs, and ensuring that they can continue to provide the same income security, is one of the most important income distribution policies.

ENHANCING THE RETURNS TO WORK

Mitigating inequality, however, is only one step. A second step is enhancing the returns to work. The EITC and the minimum wage are two important aspects of this. The EITC is a refundable tax credit of up to 40 percent of earnings. It was expanded in 1990 and 1993. Over this period the number of families receiving the EITC rose by almost 50 percent to 18 million; and the average credit more than doubled. In 1995 almost 3.3 million people were lifted out of poverty by the EITC, more than twice as many as only a few years before.

At the same time the minimum wage plays an important role in reducing inequality. Between 1981 and 1990 the national minimum wage remained constant at $3.35 an hour even as inflation eroded its value by 44 percent. The 1990 increase did not restore the minimum wage to its real 1981 level. This Administration worked hard to get an increase of the minimum wage to $5.15 enacted. Despite concerns that this wage increase would cost jobs, I am pleased to report that since the first stage of this increase was enacted last October, we have not seen any noticeable declines in employment growth in industry-occupation groups whose employment is disproportionately composed of minimum wage workers. At the same time, although wages have accelerated in these industry-occupation groups, the effect on overall wage or price acceleration has been relatively muted.

The expansion of the EITC combined with the rise in the minimum wage have increased the return to work for low-wage workers to the point where, after the next scheduled increase in the minimum wage, a full-time, year-round minimum wage worker with two children will make about $14,000 a year -- well above the 1981 level in real terms.

CREATING OPPORTUNITY

Although mitigating inequality and enhancing the returns to work are important elements of the strategy to address inequality, this Administration's most important emphasis is on creating opportunity. One of the most important contributions that any Administration can make to the

Nation's economy is to help ensure that every American seeking work can find it. The decline in the unemployment rate from over 7 percent in 1992 to 4.9 percent last month was a major step forward not only for growth, but for opportunity.

In the long run, a strategy to expand opportunity will only work to reduce inequality if it changes both the access to skills and the distribution of rewards to skills. In particular, the government can help provide greater access to education and training programs that help create a more uniformly high-skilled workforce. Between fiscal year 1993 and 1997 we have increased spending on education and training by 19 percent. There have been large increases in funding for programs targeted at every stage of a person's life ranging from Head Start (up 43 percent) to training and employment programs (up 19 percent). The new balanced budget agreement between the President and the Congress includes large increases for education and training programs like Head Start, the Technology Literacy Challenge, Pell Grants, the America Reads Challenge, the Hope scholarship, and the Job Corps.

In an era of budget stringency the expansions of these programs -- both past and planned -- represent a truly remarkable achievement. There is not, however, a simple production function that translates money spent on education and training programs into more productive workers and a more equal economy. In the private sector competition ensures that, subject to some caveats, the returns are equalized across different investments. No similar force to automatically ensure the productivity of government programs exists. We do, however, have a large and high-quality body of research by labor economists and others to draw on in designing these programs. I want to briefly discuss what we have learned in policy areas ranging from pre-natal care to lifelong learning programs.

- Pre-natal care and ages 0-3: A large body of research, much of it recent, has emphasized the importance of care, both pre-natal and during the first years of a child's life, to a child's subsequent development. Often very small investments -- like immunization for polio or home-based smoking cessation programs -- yield large benefits. But, this is not just a public health issue. Family income is an important contributor to children's well-being. Children of low-income families, for example, are 1.2 to 2.2 times more likely than the average child to be low birthweight. Children who were low birthweight babies are more likely to have learning disabilities, attention deficit disorder, repeat grades, and be enrolled in special education programs. Later in life these can translate into lower earnings and increased inequality. It is not, however, very expensive to ensure that a baby is born healthy, nor is it very difficult to target the expenditures at those very young children who have the greatest needs.

- Early education: Much of the literature on the effects of compensatory preschool finds that early education programs lead to significant improvements in educational attainment, behavior, and health status (although, interestingly, no persistent effects on IQ). Particularly noteworthy evidence has been obtained from the Perry Pre-School Study, a random assignment experiment, which found that the savings from $4.75 to $8.75 in future expenditure on special education, public assistance, and crime from every dollar spent on Perry Pre-school. Financial constraints, however, mean that children from poor families are half as likely to attend pre-school compared to children in more affluent families. Programs like Head Start are an attempt to help ensure that children from poor families will also be able to enjoy the benefits of pre-school.

- <u>Education</u>. One of the clearest results in the literature on education is that an additional year of schooling adds about 10 percent to future earnings. Furthermore, much of this increase reflects the enhanced productivity of the worker and is not simply a signaling device. Programs like Pell Grants that make it possible for more people from low-income families to get more education will clearly help reduce inequality while boosting productivity. For this reason the President has gotten Congress to agree to the largest increase to the maximum Pell Grant award in over two decades. The budget agreement also will provide resources to add several hundred thousand students to the program. Expert opinions on the link between spending on education and educational outcomes is more divided. Although some studies show that more spending on education (or smaller class sizes) enhances the future employment opportunities and earnings of students, the evidence is far from decisive. The lesson I take from this is that it matters a lot how the money is spent. I'm not sure that we know the best way to invest money in education, but some avenues seem promising. As I discussed earlier, computer skills are an increasingly important determinant of earnings. The Administration has placed a high priority on providing computers, including used government computers, to schools. In addition, helping to ensure that all students can access the Internet by the year 2000 will be potentially important in ensuring that society does not become segmented between those that can use this technology and those that cannot.

- Training. Studies suggest that the payoff from government training programs can be substantial, although their success is not nearly universal. For example, a study of a government sponsored Job Training Partnership Act for out-of-school youth in 1987-89 showed no increase in their earnings; the best results were for adults assigned to receive on-the-job training at the workplace. Another difficulty comes in targeting training programs to make sure that it increases skills at the margin, rather than just subsidizing training that would have taken place anyway. These concerns suggest that school-to-work strategies for youth and programs that combine vocational with conventional classroom education may have the highest payoffs. Also important are programs that ease the adjustment process for dislocated workers by helping them improve their skills and find new jobs.

It is important to be realistic about what programs in areas like 0 to 3, education, and training can accomplish. Many of these programs have had mixed success. Also, what works well for the individuals in a program will not necessarily have a noticeable impact on aggregate productivity or inequality. Finally, and most importantly, we cannot expect any of these programs to change the income distribution (or productivity) instantly. The purely economic benefits of Head Start, for example, take at least 15 years to ripen: the time it takes for a Head Start child to grow up and join the labor force.

Over the long run, however, properly designed programs that target high reward areas (like ages 0 to 3), that change incentives and opportunities at the margin, rather than just subsidizing the inframarginal person, and that promote opportunity instead of dependence, should not only improve the skills of the workforce but should also alter the distribution of rewards to skills. As the supply of college (or high school) graduates relative to high school graduate (or high school dropouts) increases, the earnings premium I discussed earlier should start to narrow again, reducing an important source of income inequality.

CONCLUSION

In conclusion, I want to reiterate my most important messages. First, economic inequality is much greater today than it was 20 years ago. This basic fact is the reason we are all here discussing this issue.

My second message is a caution against those who use the increase in inequality to argue that decades of policies have been futile and need to be completely overturned. As I have discussed at length, many policies -- Social Security, Medicare, EITC, and support for education to name a few -- have played and continue to play an important role in reducing inequality.

My third message is that the most important policies for reducing inequality are policies to enhance opportunity. In the short run this means sound macroeconomic policy; in the long run, programs for education, training, and work opportunity. In particular we need to emphasize the importance of program design, building on our successes and learning from our failures.

The trend towards rising inequality is indeed troubling. But long-term trends can be broken. I am hopeful--I might almost say confident--that we are on the road to addressing this challenge in a meaningful way.

Acknowledgments

I would like to thank Jason Furman, Phil Levine, and the staff of the Council of Economic Advisers for their substantial assistance in preparing these remarks.

Chart : Growth in Real Househ[illegible] Income by Quintile, 19[illegible]-1979

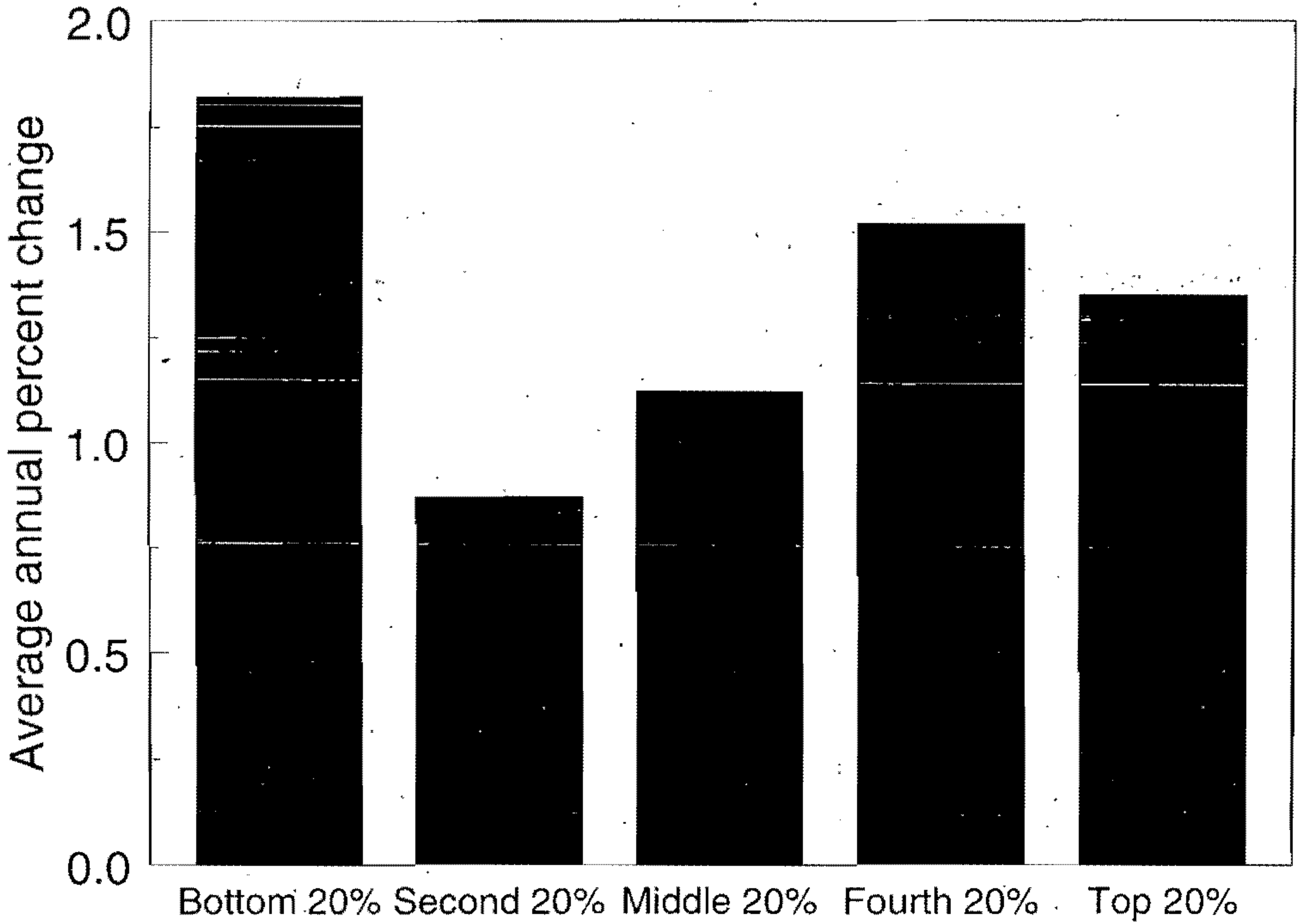


Chart : Growth in Real Househc Income by Quintile, 19 -1993

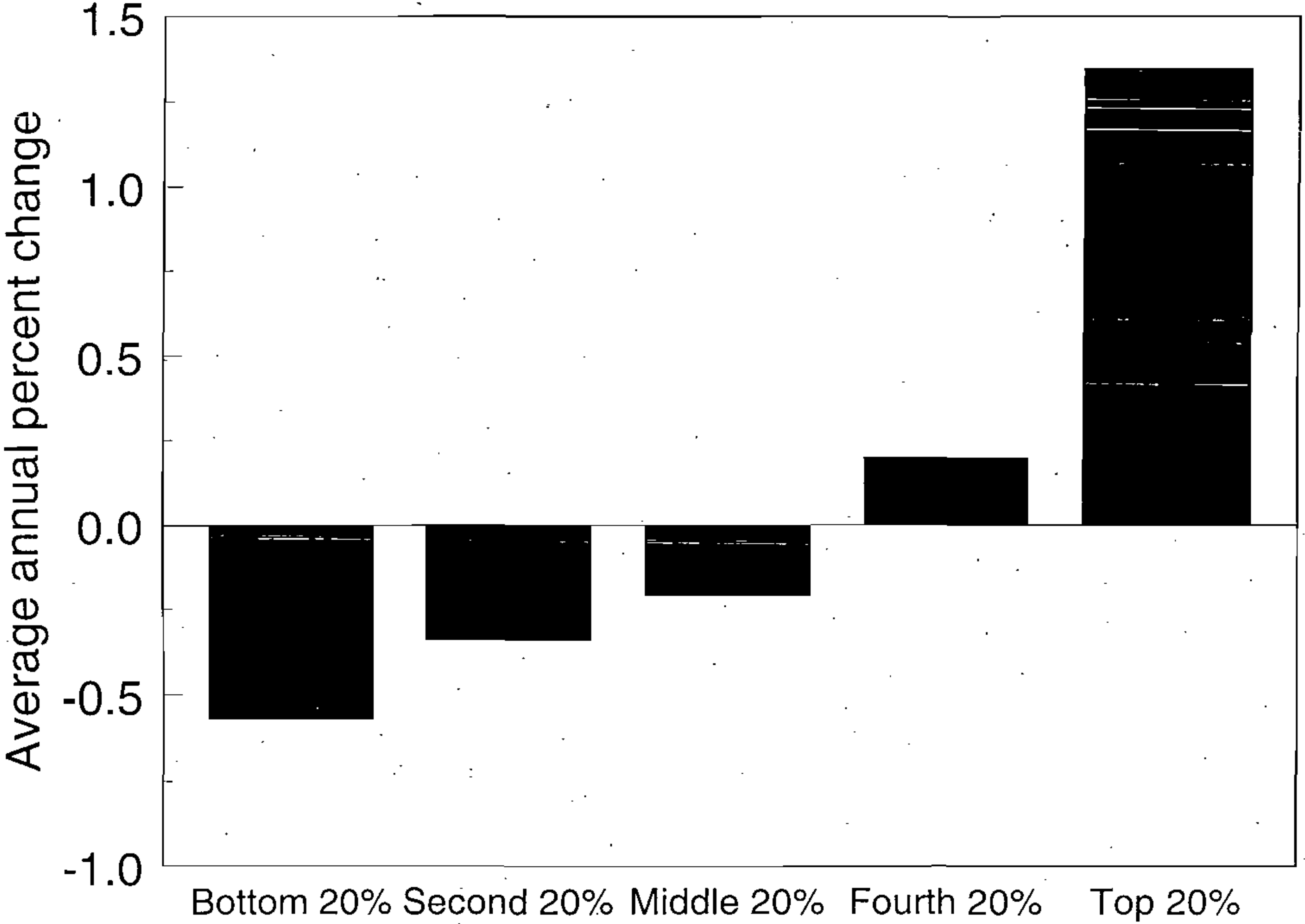


Chart : Gini Coefficient

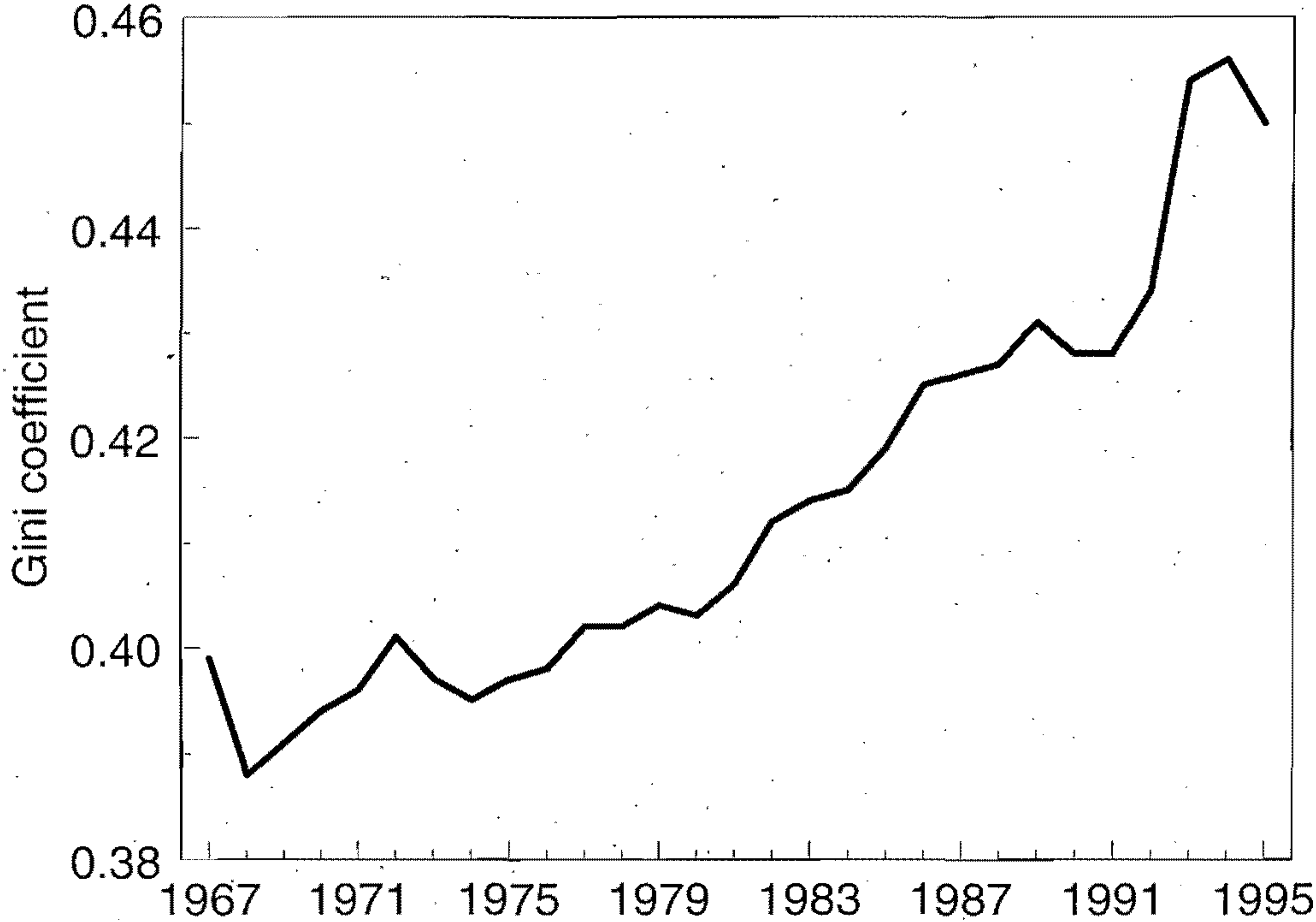
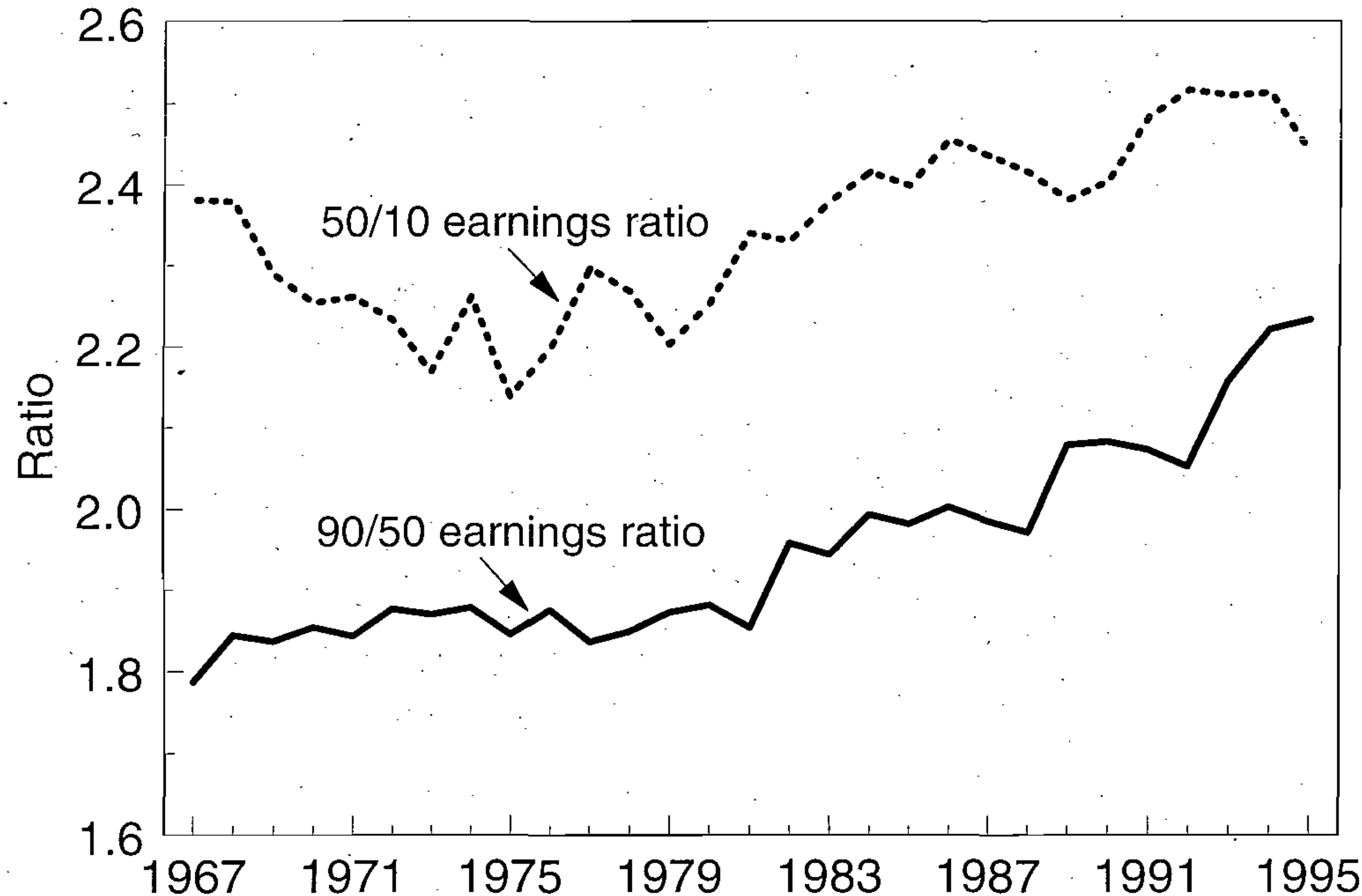
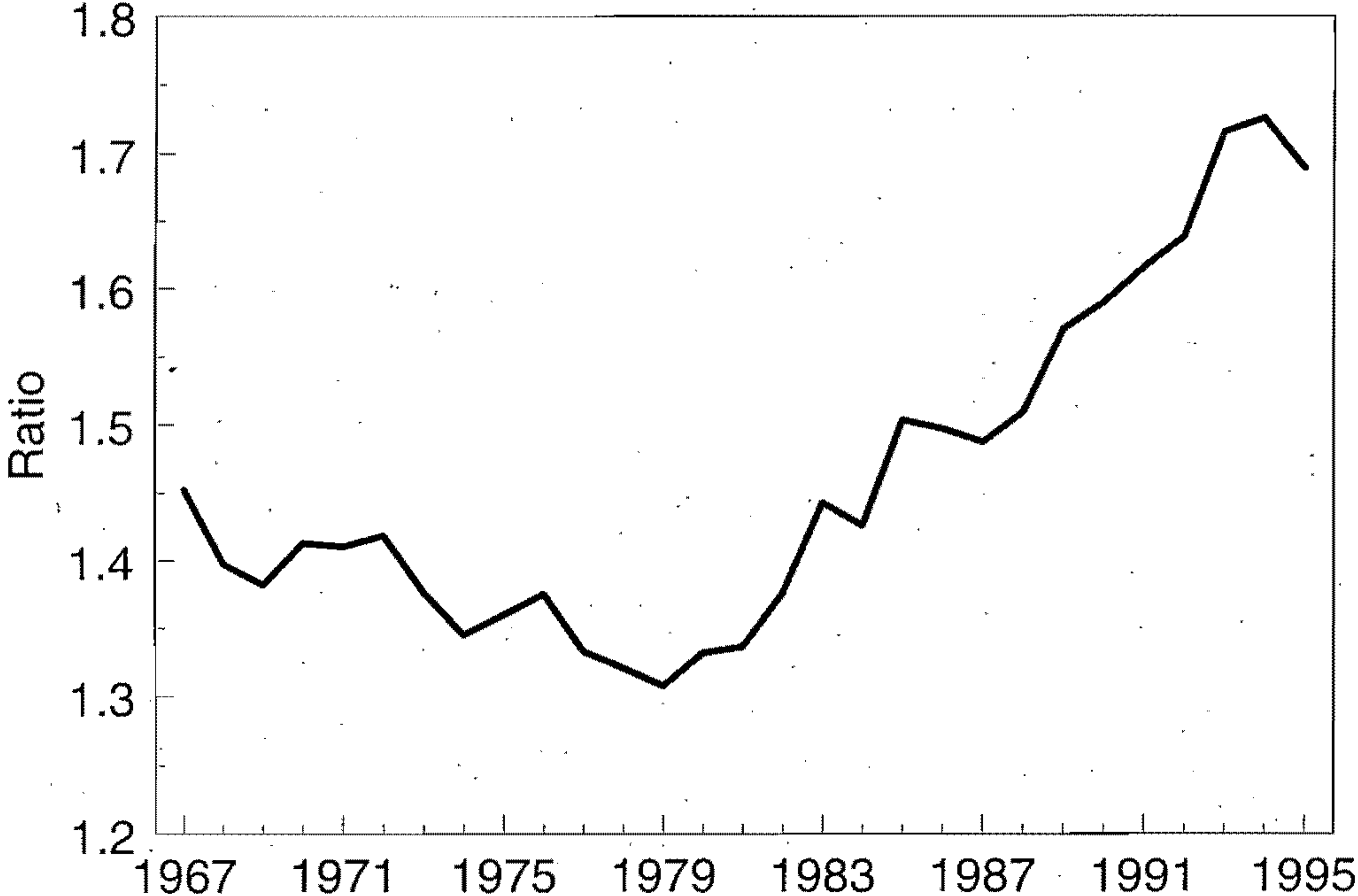


Chart : Earnings Ratios



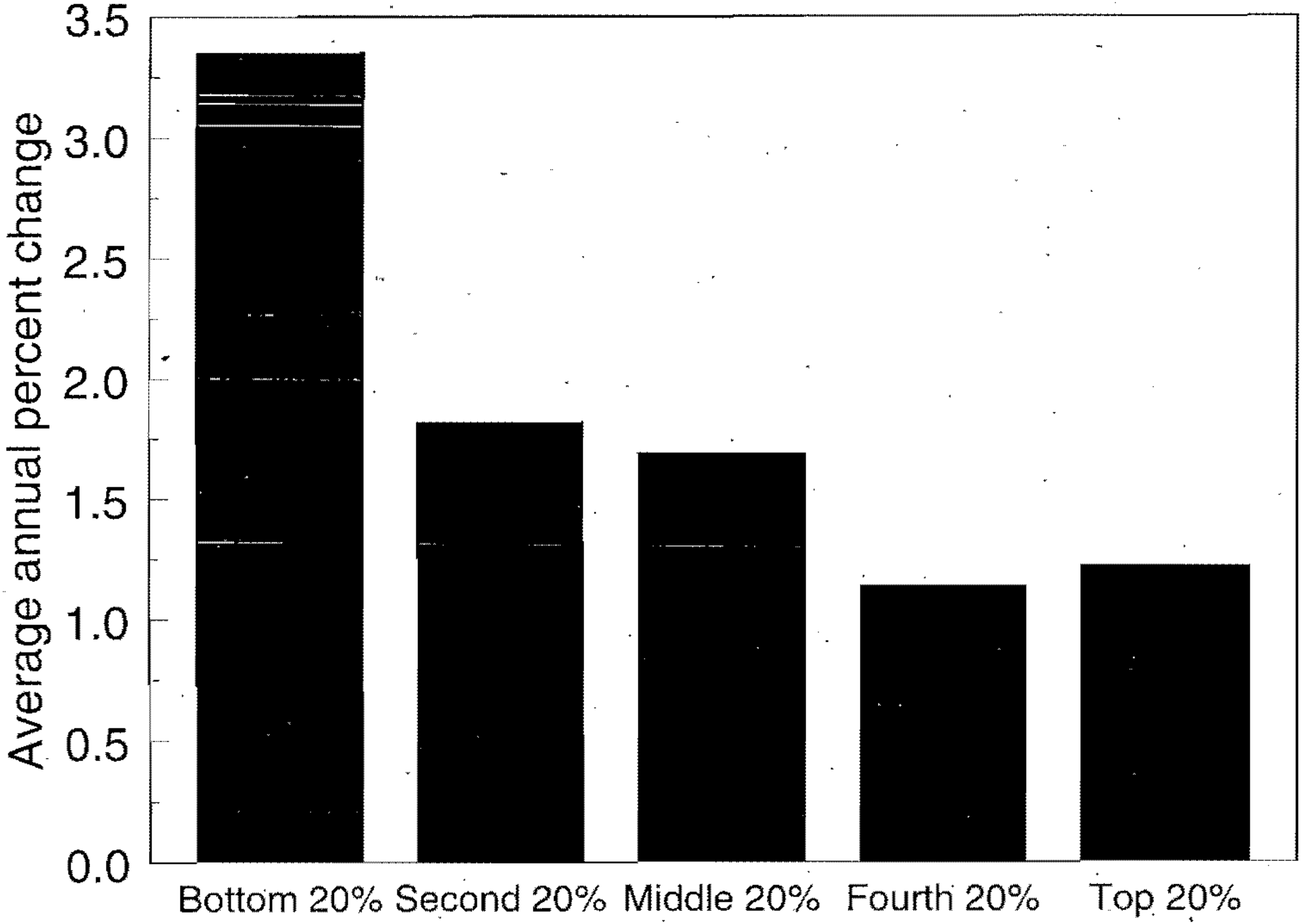
Note: For male full-time, year-round workers.

Chart : College/High-School Me an Earnings Ratio



Note: For male full-time, year-round workers.

Chart [illegible]: Growth in Real Household Income by Quintile, 19[illegible]-1995



THE ROLE OF GOVERNMENT IN ECONOMIC DEVELOPMENT

Joseph E. Stiglitz

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It has been almost three decades since I began working on economic development issues. During that time, there have been marked changes in both the world and the intellectual framework with which we approach development. Then we felt both hope and concern. We believed that the less developed countries could close the substantial gap separating them from the more developed countries, but we worried that so few countries had managed to bridge that gap. Standard textbooks mentioned the leaps the Soviet Union had made between the mid-1920s and the onset of Wold War II. That supposed success -- which may have been more apparent than real -- obviously influenced developing countries, as many around the world set up planning commissions to guide their economies. In many instances, the State went well beyond guidance, to actual production and ownership of enterprises.

What a change thirty years makes! As one example, Korea -- whose per capita income in 1960 was roughly the same as India's (at less than $500 in 1995 dollars) -- is now in the process of applying to the OECD. The success of Korea and other East Asian economies demonstrates the wisdom of a more market-based development strategy. In most instances, the governments of these economies abandoned the rigid planning model early on. But they also did not err by going to the other extreme. Their governments helped to guide and create markets, rather than completely supplanting or surrendering to them.

Meanwhile, those economies that stuck with the planning model experienced slow growth, stagnation, or worse; the collapse of the socialist economies was but the final nail in the planning coffin. By the 1980s, countries throughout the world were actively engaged in privatizing state enterprises. The dramatic failure of the grand socialist experiment had an unanticipated consequence: it lent support to extremists of the opposite ideological persuasion. According to these partisans, government should have almost no economic role.

But the rejection of one extreme is not the affirmation of the other. The real issue that both the success of East Asia and the failure of the socialist experiment raises is, *what is the appropriate role of government in economic development?* There is a third way -- or I should say, there are many third ways -- between the extremes of total government control of the economy and complete laissez faire. At different stages of development or in different situations, countries will and should choose different points within this spectrum. In my limited time, I cannot possibly touch on every aspect of the appropriate role of government. Instead, I want to draw selectively upon advances in economic theory, interpretations of the East Asia miracle, and my experiences within the U.S. government to highlight those aspects that have not received sufficient attention in recent discussions. My omission or brief treatment of certain topics (such as the role and design of industrial policies and the role of government in the financial sector) should be interpreted in this light: such topics have already been discussed widely elsewhere.

Before developing this framework, I want to make two preliminary remarks. The first relates to developments in economic theory. The perspective that I will argue for later in this talk places markets at the economy's center. Traditionally, the theoretical foundations for this market-oriented perspective rest on Adam Smith's invisible hand, and especially its modern rendition, the Fundamental Theorems of Welfare Economics. To be sure, economists have long recognized the need for selective interventions in the marketplace to remedy well-identified problems such as externalities.[1] But developments within the past fifteen years have emphasized that well-designed government actions can improve living standards whenever there are imperfections of information or competition or incomplete markets -- problems which arise in all economies, but especially in less developed ones. The use of the

[1] While some suggested that even those difficulties could be handled privately through Coasian bargaining, most economists believed that market interventions, in the form of Pigouvian taxes, were the appropriate remedy.

word "can" in this instance is crucial. Not every market "problem" calls for government action. In order to raise living standards, government actions must meet two criteria: they must address some serious imperfection in the marketplace, and they must be designed efficiently enough so that their benefits outweigh their costs.

My second prefatory comment is that arguments favoring an extremely circumscribed role for government have generally been shown to have only limited validity. Critics have asserted that government is unnecessary, ineffective, and to the extent that it actually affects anything, counterproductive. They argue that anything government can do, the private sector can do better; that anything the government does will be offset by actions of the private sector; and that rather than improving resource allocations, government interventions actually make matters worse, especially due to rent seeking. The first proposition is simply false, the second proposition is true only under highly restrictive conditions, and the third assumes perfectly competitive rent-seeking. The major thrust of these criticisms, however, is one which I have already noted and with which I fully agree: the fact that markets are not constrained Pareto-efficient does not imply that any arbitrary intervention will necessarily improve matters. One must assess carefully the full consequences of any proposed action.

Six illustrative roles of government

While theory no longer provides bright lines, it can continue to give us valuable guidance about the appropriate role for government. In this context, I believe the East Asian experience and the experiences of the currently developed countries are instructive. To be sure, there is the ever-present problem of the counterfactual: What would have happened if government had not taken the actions it did? Would these economies have grown even more quickly? While we may never know for sure, a wealth of evidence suggests the contrary. And I am convinced that while the United States also relied primarily on markets, its success was in part due to *selective* government actions. The performance of the rapidly growing countries of East Asia and the experience of the United States have at least six common themes.

The first is the role of government in promoting education. The East Asian countries emphasized the role of government in providing universal education, which was a necessary part of their rapid transformations from agrarian to rapidly industrializing economies. Universal education also created a more egalitarian society, facilitating the political stability that is a sine qua non for successful long-term economic development. In pursuing such egalitarian policies, the countries of

East Asia laid to rest trickle-down theories of development. Kuznets had argued that economic growth was associated with an increase in inequality, and Arthur Lewis had suggested that such inequality was necessary, because capital accumulation lay at the heart of growth. Since richer individuals were assumed to save more on the margin than poorer ones, higher levels of inequality would increase savings and hence growth. The East Asian countries showed that high levels of savings could be attained in an egalitarian setting and that human capital accumulation was every bit as important as -- if not more important than -- increases in physical capital.

The role of government in education is also clear in the United States. Even before the adoption of the Constitution, in the Ordinances of 1785 and 1787, the Federal government recognized its responsibility for the promotion of public education, by setting aside land in the newly formed states for that purpose. Later, in 1863, it helped establish the public university system.

The second role for government is in promoting technology. The Constitution of the United States, written in 1789, recognized the importance of science and technology by giving Congress the right to grant patents to "promote the progress of science." Even in the early part of the nineteenth century, support for research went well beyond the establishment of a system of intellectual property.

Just as the modern telecommunications system -- including the Internet -- was fostered by government, so too were earlier advances. For example, in 1842, the federal government financed the world's first telegraph line between Baltimore and Washington. Over the more than 150 years during which it has supported research, the U.S. government has had an impressive record of successes. In the nineteenth century, agriculture was the center of the economy, representing more than 35 percent of GDP in the 1870s. The federal government's support for research and its dissemination is largely given credit for the remarkable productivity growth in that sector. Similarly, East Asian governments played a central role in the promotion and transfer of technology.

The third theme is the government's role in the <u>financial sector</u>. Sometimes depicted as the "brain" of the economy, the financial sector's job is to deploy scarce capital resources in the most efficient way. As such, it is concerned with gathering, processing, and disseminating information --- precisely those areas in which market failures are often most marked. In 1863, in the midst of the Civil War, the United States recognized the imperative of creating a *national* financial system and passed a

National Banking Act, establishing the first supervisory banking agency. We now know that far more is needed for financial stability; yet even this beginning constituted a vast improvement over the financial instability that had characterized the economy earlier. In later years, the government created the Federal Reserve system as well as a series of financial intermediaries (to spur markets that had been thin or non-existent prior to the government action). Similarly, the East Asian governments took an active role in ensuring the safety and soundness of financial institutions, and in creating new institutions and markets to fill the gaps within the private sector.

Fourth, governments played a major role in <u>infrastructure investment</u>, including roads and communications systems. More broadly, and perhaps more importantly, government created *institutional infrastructures* within which competitive markets could thrive. Only recently, as the formerly socialist economies have striven to establish market economies, have we become fully aware of the importance of this institutional infrastructure -- which includes property rights, contract and bankruptcy laws, and policies to promote competition where it is viable and regulate markets where it is not. For instance, will the lives of the farmers in these countries be much improved if the state agricultural monopolies (to which they were forced to sell their produce, and from which they were forced to buy their inputs) are replaced by equally or more exploitive private monopolies?

The fifth theme is the role of government in preventing environmental degradation. While economists have discussed the need for government action to correct market failures at least since Edgeworth, it has become widely accepted only during the past quarter century. I wish to emphasize that good environmental policies should not be viewed as luxuries, to be enjoyed only by the well-off. We should not confuse increases in GDP with increases in standards of living; nor should we confuse increases in measured GDP today with increases in long-term wealth. Recent attempts at building "Green GDP" accounts recognize these points. It will take generations to correct the environmental disasters that plague many LDCs and transition economies.[2]

Sixth, the government has a role in creating and maintaining an appropriate safety net, including access to basic health services. In some cases, these activities can be justified in utilitarian terms: they reduce opposition to change, foster political stability, and increase the productivity of the labor force. But they may also be justified in terms of basic values. As I noted above, standards of living

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[2] In many cases, even the short-run costs of unsound environmental policies can be large (e.g., those associated with health costs).

embrace more than just those variables captured in GDP statistics. There is a fundamental sense in which improved health conditions represent an improvement in living standards, despite the fact that such an improvement is not necessarily reflected in GDP.

Virtually all societies have provided a social safety net, though not always through the government. In fact, for at least two reasons, governments today may have to assume a larger role in providing a safety net than either the United States or East Asian governments did at comparable stages of their development. First, the pressures of urbanization militate for a stronger government role. In 1975, just over one-third of the world's population lived in cities; the United Nations and the World Bank estimate that proportion will have doubled by 2025. Urbanization -- and the migration out of traditional communities with which it is associated -- is likely to result in less effective community-based social safety nets. Second, in the transition economies, large corporations traditionally provided much of the social safety net (such as pensions and health care). The transformation of these economies is being accompanied by the shedding of these social responsibilities by corporations facing new competitive pressures. The government is the only backstop.

In a sense, much of the role of government can be viewed as establishing infrastructure in its broadest sense -- the technological, educational, financial, environmental, and social infrastructure of an economy. Since markets cannot operate in a vacuum, this infrastructure is necessary if markets are to fulfill their central role in increasing wealth and living standards. And constructing the broad infrastructure is beyond the capacity or interest of any single firm. It must therefore be primarily the responsibility of government.

The special role of government in less developed economies

The six roles I have delineated above hold in both developed and developing economies. But I want to take note of the special problems facing the less developed economies and the economies in transition. Market failures in these economies are larger: more markets are missing, and those that exist may function less effectively.[3] Meanwhile, information problems loom larger in the transition

[3] For instance, recent literature has emphasized the importance of reputation mechanisms and implicit contracts in governing economic relations. The effectiveness of these mechanisms depends on the long-term nature of the relationship. In LDCs, rapid transition threatens the long-term viability of many such relationships; the weakening of social ties reduces the role of social sanctions as an enforcement mechanism; while high interest rates provide an encouragement for short run self-interested behavior at the expense of long run cooperative behavior.

process simply because of the rapid change in the economic environment. Development is associated with the acquisition of knowledge about, and implementation of, more advanced modes of production.

The problem is that while market failures may loom larger in less developed economies, the capacity of the government to correct these market failures often is weaker.[4] Assessing the appropriate role of government requires a recognition of both the need for, and the limitations of, government actions. Successful governments have helped create markets (such as bond and stock markets as well as long-term credit institutions). They have enforced laws and regulations that enhanced the stability of the financial sector, and enhanced competition in all sectors. In many cases, governments have acted as a surrogate entrepreneur, encouraging the establishment of firms to enter certain markets. Governments have given firms strong incentives, especially in export markets. (Some econometric evidence suggests that these government interventions actually worked. An analysis of the mild financial restraint evidenced in most of the East Asian countries suggests that it did lead to more rapid economic growth.)

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[4] Thus, we noted earlier the importance of establishing the appropriate institutional infrastructure for a market economy in the economies in transition. But it may take a strong government to establish the institutional infrastructure enabling a strong market's viability.

The conservative counter-reply

Most economists today accept the proposition that markets by themselves may not succeed in ensuring economic efficiency and may also fail to protect segments of society from abject poverty. While most economists also agree that *in principle* such shortcomings might provide a rationale for government action, some argue that *in practice* government interventions all too often have been counterproductive. Any balanced account of the role of government must acknowledge that this has often been the case, a topic I will touch upon below. But that in itself proves nothing: the question is, can *responsible*, democratic governments put into place policies that raise living standards? Based on the experiences of both East Asia and the United States, I believe the answer is a resounding yes.

Some critics of the role of government argue for a different perspective on the East Asia experience. They contend that all -- or almost all -- of the growth of the economies of East Asia can be accounted for by factor accumulation. Thus, they argue, there is no miracle. Instead, there is simply the inexorable workings out of standard fundamentals: increased inputs lead to increased outputs. Total factor productivity growth has been negligible.

There are a number of technical problems associated with the studies purporting to find these results. For example, does anyone who has studied wage setting in Singapore really believe that wages are set in a competitive process, so that the real wage equals the marginal product of labor, as most of the studies assume? But even if we take at face value the findings of low total factor productivity growth, these studies do not really address the question of whether government policies made a difference. They neither ask nor answer questions such as the following:

- Why were savings rates so high? Elsewhere, such savings rates had been attained only under the compulsion of strong government force, as in the Communist countries. While econometric studies suggest that these savings rates may partly be explained by traditional economic factors, *government actions also played a constructive role in mobilizing savings in East Asia.*

- Why were the East Asian economies able to invest *efficiently* at such a rapid pace? Other countries have invested heavily, but ended up with high incremental capital-output ratios rather than rapid growth.

- Why were they able to reduce the technological gap between themselves and the most advanced countries so quickly? The East Asian countries demonstrated an enormous capacity to absorb both capital and technology. The rapidity with which they closed that gap entailed more than just "buying technology." Governments played a major role in human capital investment, in allowing foreign investment into the country (with some exceptions), and in creating an economic atmosphere conducive to foreign investment.

- And how did the East Asian countries ensure that the benefits of their rapid growth were spread widely among the population? As I have already noted, the increases in inequality that earlier experiences had suggested inevitably accompany development simply did not occur in East Asia. To the contrary, there are reasons to believe that greater egalitarianism -- a result of deliberative government policies -- actually *contributed* to the remarkable growth in these countries.

The limitations of government

I have argued above that those who want only an extremely circumscribed role for the government -- providing only for items such as the national defense, for example -- go too far. But I want to stress once again that government is not infallible. Even in the economies of the East Asian miracle, governments made mistakes. The Japanese government, for example, at one point apparently attempted to prevent Honda from entering the auto industry. The point is that government is not a panacea; it cannot fix every problem. In sum, government definitely has a place, but it must know its place.

Improving government performance and the changing role of government

The pragmatic framework for assessing the role of government that I have set forth in the first part of this talk entails a balancing of the strengths and limitations of markets and government, and asking how they can complement each other most effectively. It does not begin by drawing two columns on a page, with one column labeled "activities to be carried on by government" and the other "activities to be carried on by the private sector." This careful balancing puts greater emphasis on <u>how</u> the government does what it does and <u>how</u> it interacts with the private sector. To that effect, I want to outline a few general principles, motivated both by theoretical analyses and historical experiences.

The setting

In assessing the proper role of government, we must take into account two fundamental points. The first one is the importance of incentives. The second is the dynamic nature of government's role; as the economy changes, so too must the government.

The role of incentives

The government is a large organization, differing from large market organizations in that it is not subject to the pressures of market competition. But in democracies, political competition exercises some discipline: incompetence gets punished just as performance gets rewarded. To be sure, political competition is a far cry from the textbook ideal of perfect competition. But so too is market competition of the form typically observed. It is sometimes alleged that bureaucrats lack incentives; but incentives in large corporations can also be muted. For example, one recent study found that in the typical large firm, aggregate pay of all top managers increased by only $3.25 for each $1000 increase in the market value of the firm. It is also alleged that bureaucrats are not responsive to the wishes of voters. But both theory and evidence suggest that managers of many large corporations may not always be very responsive to the wishes of the voters (shareholders) to whom they are in principle accountable.

In short, the distinctions between the public and private sector are often overblown. But we must once again be careful not to go to the other extreme: incentives do play a somewhat more important role in the private than the public sector. *Provided adequate competition policies are put into place,* market competition is more effective in providing incentives than ersatz public competition. The question is whether, and how, the public sector can put into place an effective framework and set of incentives.

The changing role of government

We must also recognize that the role of government is not static. Changes in the economic environment fundamentally alter what the government can and should do. In a world with limited international trade, for example, it might have made sense for countries to worry about material balances. Accordingly, there might have been some rationale for the kinds of planning exercises that dominated development thinking in earlier decades.

But as international trade has expanded and the costs of transportation have fallen, countries can now specialize on that part of the production process in which they have a comparative advantage; they are not limited to domestic markets on either the demand or supply side. Consider automobile production. Assembly is only one part of the car's cost -- representing only about a fourth of value added at the factory. Different parts can be constructed in different countries and then shipped to the assembly point. Modern telecommunications ensures that parts orders can be transmitted quickly from the assembly plant to the parts plant, wherever it is located.

In the past ten years, this pattern has spread from large multi-nationals to far smaller companies. Again, credit goes to improved transportation and telecommunications: a small or medium-sized firm in the United States or Europe can develop relationships with suppliers in East or South Asia, sending them precise product specifications. While the long run implications are far from clear, these developments have been a boon for less developed economies. The "globalization" of entrepreneurship has slackened the constraint on growth imposed by one of the scarcest of factors in LDCs.

Globalization is just one example of a change in the economic structure that necessitates a change in government policies. Later, we shall discuss other examples, including how changes in technology have enhanced the scope for competition in areas that formerly were natural monopolies (telecommunications and electricity.)

Recognizing the importance of incentives and the continually changing role of government, we can now consider various imperatives for improving government performance:

increasing consumer orientation, monitoring and rewarding performance, extending the scope for competition, privatizating and corporatizating, and improving regulatory policies.

Increasing consumer orientation

One of the problems arising from lack of competition is lack of choice: consumers do not get to choose which bureau issues their driving license or a passport. When consumers have a choice, some will choose to go to airlines with shorter queues, even if they have to pay a slightly higher price; the market reflects the diversity of consumer preferences. One way to address the problem of choice within the public sector is to create more competition (see below); short of that, government can create a culture of customer orientation. While vocabulary (such as thinking of users of government services as customers) may help, performance measures may be even more effective in drawing <u>organizational</u> attention to relevant variables, and perhaps in motivating <u>individual</u> behavior.

For instance, one can, with modern technology, easily monitor the length of time that it takes a telephone to be answered. Standard survey techniques can evaluate customer satisfaction with the telephone interaction. Indeed, at the individual level, motivational and monitoring problems facing, say, the Social Security Administration are little different from those facing a private insurance company -- and in the United States, as we have worked hard in the last three years in improving customer orientation, we have shown that government can in fact succeed: ratings put our Social Security Administration's services at a level highly competitive with the best in the private sector.

Monitoring and rewarding performance

Private firms have simple, bottom line performance measures -- profits and market value. While government as a whole has no comparable summary statistic for performance, performance at particular activities (typing letters, issuing airline tickets, processing drivers' licenses) can be identified and measured. Nonetheless, it is important that output and not process or input measures be used: too often, rewards are based on how well the worker complied with the standard operating procedures.

Yardstick competition. In many cases, there are sufficient similarities between activities performed in the public and private sector, that private sector performance can provide a yardstick for comparison. For instance, while every firm has slightly different travel needs, it is possible to obtain a range of estimates of the administrative costs associated with travel. These costs can then be used to see how government agencies compare, and to judge performance relative to those norms as a basis of rewards.

A caveat. Many of the activities conducted within the public sector are different from those in the private sector. Public sector activities are disproportionately administrative in nature, making measurement of individual performance particularly difficult. We do not know how to measure the quality of many administrative decisions made collectively, let alone the contribution of any single individual. In many other activities, there is no single metric of performance. Consider education for instance. Rewarding only performance in terms of basic skills (which can be more easily measured than other skills) will divert resources away from developing higher order and cognitive skills. However, it may be possible to design the production process to mitigate these effects, e.g. by assigning different teachers different tasks. Whether this is desirable requires evaluating the magnitude of the incentive distortions in comparison with economies of scope. If there are weak economies of scope (say between teaching basic skills and higher order cognitive skills) then this organizational design is desirable.

Extending the scope for competition

One way to provide more effective incentives, including enhanced consumer orientation, is to extend the scope for competition. Creating effective competition among vendors, for example, is an essential step in ensuring that the government procures at the lowest possible cost. But the task of competitive procurement is more difficult than often realized. It used to be thought that competitive bidding was the simplest way to ensure that government does not pay too much for a good or service. Competitive bidding, however, typically requires the government to have precise specifications of the item being purchased -- and describing a simple T-shirt might take thirty small print pages. Since most firms do not normally produce to those precise specifications, they may find it unattractive to bid even if their products have similar performance characteristics. Thus, the number of bidders often is relatively small. And a central result of the auction literature is that the equilibrium price is sensitive to the number of bidders. As a result of the reduced competition, government may have to pay higher prices than the public at large.

In a sense, the problem arises here because of the impossibility of specifying *performance* -- the issue with which we have been concerned throughout this section. The difficulty is in developing and clearly articulating performance measures (for a T-shirt that would involve comfort, durability, absorbency, etc.). The reason that government uses competitive bidding is that it wants to make sure that taxpayers are not overpaying. Relatedly, cumbersome procurement policies have developed in many countries because politicians do not want to be vulnerable to the criticism that they have wasted taxpayers' money. (These cumbersome procurement policies often overlay micro-management of contractor production, and ironically have contributed to *increasing* average costs.) In those cases where there is a competitive marketplace, the discipline of competition *in the marketplace* may suffice. In the United States, procurement reforms enacted under this Administration will save U.S. taxpayers $12.3 billion over the next five years.

Privatizing and corporatizing

Even when competition is not viable, it may be desirable to incorporate many features of a private firm. This objective goes beyond introducing performance pay, extending to broader personnel issues, procurement, and budgeting. But when competition is not viable, there remains a real danger of abuse of monopoly power. The three key questions are

- Is there a dedicated source of revenue, related to the benefits conferred?

- Is there a governance structure that can assure efficiency and a regulatory structure that can protect against abuses of monopoly power?

- Can there be an effective separation of production issues from other public policy issues, including those related to externalities, safety, etc.?

Privatization represents only one point along a spectrum of organizational forms; this spectrum includes a variety of corporatization structures *within* the public sector. The *Fundamental Theorem on Privatization* established that the conditions under which privatization could fully implement the public objectives of equity and efficiency were extremely restrictive -- and were quite similar to the conditions under which competitive markets attain Pareto-efficient outcomes. Because of differences in risk adjustment and time discounting, the state may receive less -- possibly far less -- than the expected present discounted value of the profits of the enterprise. Moreover, the state may not be able -- even with a complicated set of Pigouvian taxes -- to induce the privatized industry to act in the way that it would like, especially when there are complicated social objectives.

The theorem's main thrust is that privatization has to be justified on a case-by-case basis -- incentive improvements must be found to increase economic efficiency sufficiently to outweigh privatization's disadvantages. In many cases (as in telecommunications) that case clearly has been established.

When it is decided that privatization is desirable, it is important that it be done in the right way and with appropriate protections -- including protections against abuse of any resulting monopoly power. Typically, appropriately designed competitive auctions will be the most effective way of ensuring that the public obtains full value for publicly owned resources. The carefully structured spectrum auctions in the United States have illustrated how to raise public revenues at the same time as promoting competitive markets and innovations.

Corporatization and privatization -- as well as the other reforms discussed earlier -- help to focus attention on performance, on outputs rather than inputs and process. This focus is necessary if the efficiency of the public sector is to be enhanced. And in several areas where privatization may be inappropriate, such as the granting of patents, government functions can still be organized to focus on performance. We in the U.S. Government call them *performance based organizations* (PBO's), and have put into place organization and individual incentives to enhance the focus on performance.

Regulatory policy

A focus on performance is also critical to efforts that ensure regulations obtain their objectives at minimum costs. In many countries, the environmental regulations of the past two decades have made enormous differences in air and water quality. They have worked. But in some cases, the objectives could have been obtained at lower costs. Rather than focusing on performance criteria, design standards were imposed. In some cases, this was because at the time, there were no effective ways for monitoring performance. But appropriately designed regulations could have provided incentives for the development of the monitoring technology.

Nowhere is the changing role of government, and the increasing reliance on market-based regulatory policies, more evident than in the case of the telecommunications and electricity industries. We used to think of these industries as natural monopolies, where governments faced a choice between nationalization and regulation. Most chose the former. But as the inefficiencies of state-owned enterprises became clear, more and more privatized their telecommunications system, creating a monopoly often subject only to weak regulation.

Few governments took the next step. They did not ask: How can we ensure that there will be competition? They did not ask this question because economists told them that competition was not viable: these industries were thought to be natural monopolies. But as we have looked more closely at these industries, we have realized that competition is indeed viable in many, if not most, of their segments. We are therefore left with a subtle question: How do we ensure that monopolies in those segments where competition is not viable do not destroy competition (e.g. through discriminatory access or pricing) in other segments?

In the case of telecommunications within the United States, it became clear that regulation alone could not effectively prevent discrimination, so structural separation of the "last mile" (a natural monopoly) and other parts of the telecommunications system was required. With the appropriate institutional infrastructure, one could make competition viable in large segments of this vast market, allowing government regulators to focus on a much narrower set of issues.

The same process is now happening within electricity, another industry traditionally seen as a natural monopoly. We now recognize that this industry has at least three major components: generation, transmission, and marketing. Already, changes in technology have made possible a competitive market in generation. Complex problems have to be solved to make the network viable, but it appears that these are being addressed effectively. In the United States, a competitive market in electricity generation is rapidly emerging. Telecommunications and electricity represent two areas for which governments in most countries used to assume at least some responsibility but that today can largely be provided efficiently by private entities.

CONCLUSIONS

It has become almost a cliche to refer to the vast changes in our world and how we must adapt to those changes. Yet the fact remains that there have been changes, and that the societies that adapt better to those changes will do better, in terms of raising living standards, than those that do not. Government can help societies embrace change.

In a way, both the constants and the changes in development practice and theory are remarkable. So too is the similarity of arenas of activity between countries that developed successfully in the nineteenth century and the East Asian countries that developed largely in the post-war era. (One difference is that the earlier development experience lacked the benefit of insights from modern economics!) Among the constants are putting competitive markets at the center of an economy, while still encouraging governments to assist, use, and supplement those markets; providing public investments in education and technology; and constructing appropriate institutional infrastructures, including those that support a dynamic and competitive telecommunications and financial sectors. Among the other responsibilities that governments today should and do take seriously are providing a basic safety net and protecting the environment. Among the changes is the recognition that government can make use of many of the mechanisms that have helped make markets work so effectively, and that the scope for competition is broader than had previously been thought.

Making government perform better is as important within less developed countries as it is here in the United States. Good environmental, education, and health policies are not luxuries to be postponed to a later date. And making government more customer-oriented, performance-based, and competitive is also essential. Indeed, the scarcity of resources and the tightness of fiscal constraints facing developing countries today make it all the more imperative that resources be spent efficiently.

Too often, discussions of what the government should do present false dichotomies. Good environmental and educational policies can actually enhance economic growth. Yet is also true that only if the less developed economies grow more rapidly will they be able to provide a decent standard of living to their citizens. Development and improved living standards have many dimensions, but in the end, they all must rest on increased production of goods and services. It is right that we redress an imbalance that saw this increased production as an end in itself. But having refocused our attention on the right set of objectives, we should not lose sight of the means by which those objectives must be attained.

The theories and historical experience to which I have alluded in this talk may guide us in shaping the role of government. Leadership can help articulate visions of that role. But in the end, it is the desires -- real and perceived -- of the people whom government is supposed to serve that will determine both the scope of government and its ability to be a positive and creative force in our societies.

In closing, I'd like to relate a brief story. After I was appointed as a member of the Council of Economic Advisers, my good friend John Taylor (who preceded me on the Council in the Bush Administration) suggested in an interview with the New York Times that I would soon be disabused of my notions concerning the positive role of government. While I have learned quite a lot from my experiences, I must admit that so far I have not lost confidence in government. Instead, I am more committed than ever to helping make government a more effective tool in promoting economic growth and raising living standards.

AN ECONOMIC AGENDA
FOR THE 21ST CENTURY
Yeshiva University
February 26, 1996
Dr. Joseph E. Stiglitz

Yeshiva University was founded on the premise that learning and education can -- and should -- be combined with traditional values. The University is guided by a vision that the heritage of contemporary civilization -- the liberal arts and sciences -- is compatible with the ancient traditions of Jewish law and life. The lives and minds of your students are enriched through an understanding and examination of the moral and ethical principles that shape historical events and decisions.

For the past three years, I believe that this Administration's economic agenda has also been guided and shaped by an understanding of this nation's fundamental values. Economics often seems to involve cold statistics--and often tries to pass itself off as a hard science. But, in reality, we are talking about the lives and well-being of real people and their families.

For instance, we want the economy to grow faster -- not just so we can boast that our growth rate is 3 percent -- but because by growing faster, we can raise living standards for all Americans. And, so we can address in a meaningful way some of the challenging problems that America faces. While America may be the richest country in the world, we know that the costs of fully addressing problems of prolonged poverty and the problems of our inner cities, require enormous resources. Higher economic growth gives us more resources to address these problems.

In my talk this evening, I want to focus on the primary economic challenges facing America. I will then talk about why the short-term, politically-driven palliatives being discussed today are not the answer for addressing these challenges. And, finally, I will focus on the Clinton Administration's positive agenda for addressing these economic challenges. This "Economic Agenda for the 21st Century" has 3 parts: growing the economy in a way that enhances economic opportunity; embracing change by facilitating transitions; and, finally, doing no harm to the most vulnerable members of our society.

THE ECONOMIC CHALLENGES

Let me begin with the challenges.

First, over the last 20 years we have seen slow growth of wages and incomes. The only way for wages to increase is for workers to increase the amount they produce per hour. Before 1973, output per worker rose 2.9% per year; from 1973 to the present, productivity growth has averaged only 1.1%. [CHART] As a result, compensation has grown at about one-third the rate it used to. Moreover, the rising cost of health care and other fringe benefits has meant that take-home wages have grown even more slowly. Many Americans simply do not feel that they are making any headway.

A different way of looking at this problem is that in advanced industrialized countries there has been a dramatic increase in the demand for skilled labor and a decrease in the demand for unskilled labor. To be sure, recent political debates have focused on the consequence of this change: in the United States, in the increased disparity in wages between skilled and unskilled workers; in Europe, where governments have not allowed unskilled wages to fall so much, in increasing unemployment among the unskilled. I have deliberately couched the challenge this way to emphasize that there are underlying economic forces at play, and that they are worldwide.

But, not only have wages and incomes grown more slowly over the past 20 years, the distribution of income gains has become markedly unequal. During the 1950s and 60s, all Americans -- rich and poor -- saw their incomes rise in roughly the same proportions.

Over the past two decades, the numbers have changed. Since 1979, the bottom 60% of families have seen their real incomes actually fall, not rise. The only families seeing their incomes rise were in the upper 40%. [CHART] Let me be clear: the problem is not that some Americans are getting rich. The problem is that many American families are getting nowhere.

And, these increased disparities are tearing at our social fabric. For example, on any given day in 1992 <u>almost one-quarter</u> of all males between 18 and 34 who had not received a conventional high school diploma were either in prison, on probation, or on parole. That is compared to <u>only 4%</u> of those with a high-school diploma. [CHART] To an economist, this result, while highly disturbing, is not surprising: lacking economic opportunity induces individuals to turn elsewhere. This is stating a harsh reality--not condoning this type of behavior.

I want to emphasize that these are long-run economic trends. They are challenges that have been built over two decades. They will not be corrected in a week or a year. After decades of neglect, it will take vision and long-term commitments to reverse the trend. And, it will take political courage to undertake policies, the main benefits of which will be felt only in years to come.

<u>The Wrong Way to Address these Challenges: Protectionism and "Trickle Down Economics</u>

No, the answer to these long-term economic challenges is not short-term, politically driven solutions that attempt to exploit the uncertainty and insecurity felt by many Americans. These simple palliatives will not work -- and, in fact may well exacerbate the problem. The worst of these rely on jingoism, blaming foreigners, and trying to create barriers. Others resort to failed policies of trickle down economics.

I want to now explain why those simple palliatives will not work, and contrast them with this Administration's positive, pro-growth economic agenda for the 21st Century.

Recently, we have heard a loud and angry call for a return to protectionist policies. Some advocate erecting economic barriers around the United States as they pursue isolationist foreign policies. I believe that abandoning America's role of world leadership is morally wrong--but tonight, I want to argue that reverting to protectionist policies is also a recipe for economic suicide.

This Administration has made great progress opening up markets abroad. Exports of goods have expanded, in real terms, by more than 25 percent in just three years. [CHART] We have been able to expand our production of those goods where we have a comparative advantage -- and where our workers are more productive. On average, workers in these sectors earn 13 percent higher wages than workers in the economy as a whole. The challenge of foreign competition has spurred innovation and efficiency throughout the economy. America can, and has, met the competitive challenge. For the last two years, America was rated, for instance, the most competitive economy in the world by the World Economic Forum. American mini- steel mills are among the most efficient producers of steel in the world. Some of the automobile plants in the United States have attained productivities rivaling those anywhere else--allowing the United States to once again become the largest producer of automobiles in the world.

Some have argued that international trade -- and competition from abroad -- has forced down wages. Most analysts, however, believe that foreign trade is only one of several factors that have dampened wages. The most important factor -- which is also affecting wages in other countries around the world -- is the change in technology. Today's world requires those with computer and other advanced skills.

Other factors having a dampening effect on wages include the decline in unionization -- from 30 percent of the work force 25 years ago to about 15 percent now -- the increased level of competition in our domestic market place, and the decline in the real value of the minimum wage -- to nearly a forty-year low.

Indeed, there is a theoretical argument that might lead one to expect opening trade might have some effect in increasing the demand for the relatively abundant factor (skilled labor), relative to that of the relatively scarce factor--for the professional economists in the audience, this is the well known Stopler Samuelson effect. But those who have looked closely at the role of international trade in inducing declining wages point out that the required changes in relative goods prices that would be associated with such movements in relative factor prices simply have not be observed.

Unfortunately, much of the protectionist rhetoric is based on a misguided view of how a well-operating economy works. When an economy is on track, it creates enough new jobs not only to find employment for new entrants into the labor force, but also for those who lose their jobs as a result of corporate restructuring and changing demands for American goods. This is what we have done over the past three years, with more than 8 million new jobs being created net. The gross number of new jobs is even larger. This is a dynamic economy--with more than 2 million new businesses seizing new opportunities in the last three years.

I know that critics say, yes, but these are not good jobs: that charge is simply false. On average, the new jobs reflect the restructuring that is going on in the economy. In the nineteenth century, the United States was an agricultural economy. It restructured--becoming an industrial giant in the early twentieth century. We are now restructuring once again, into a service economy. Too often, this draws up images of flipping hamburgers. But the service sector includes the dynamic financial markets, the health care sector, computer programmers, and other high technology parts of the economy. Indeed, if we look at the jobs from the perspective of skills required, they are disproportionately high paying, professional and managerial sectors within the service sector. [CHART]

The conclusion is that even prohibiting all foreign trade would do little if anything to address the underlying challenges. Indeed, pursuing protectionist policies would have strongly adverse effects, not only on the poor, but on all Americans. Closing off American markets to foreigners in the Smoot-Hawley Act of 1930 is generally believed to have been one of the main contributors to the country's slide into the Great Depression. Erecting protectionist barriers would be met by retaliation by our trading partners; our exports would decline with our imports. There would be massive lay-offs and unemployment, particularly in our highly productive export sectors.

It is difficult for me to tell whether those who advocate protectionist policies suffer from misguided political opportunism or from naive economic analysis. It makes no difference: protectionism is a retrograde policy which should be given no place in an economic agenda for America.

There is another simple palliative which has also been widely discussed: this year's version of supply side economics, the flat tax. To some of us, this seems like Voodoo Two or Deja Voodoo. These are policies that were tried--and failed. Marginal tax rates were lowered in the early 1980s. What we got was not the burst of growth that was widely vaunted, but rather the largest peacetime deficits in the history of the Republic, with the national debt quadrupling in 12 years. A close look at the economic data shows not even a blip in productivity. The policies simply did not work.

The flat tax has been so badly trounced by everyone that I hardly need to add my voice to the chorus. But there are two aspects, related to tonight's theme, that I do want to emphasize: First, unless one wishes to repeal the laws of arithmetic, lowering taxes at the top of the income distribution means that, to raise the same revenue, taxes have to be raised on the most vulnerable members of our society at the bottom of the income distribution -- the very people whose incomes have declined or stagnated over the past quarter century. This is unfair, and makes no economic sense.

Second, the flat tax reflects a view of the economy that I find troubling. It sounds to me that the are saying that the best way that we have to address the problems of stagnating wages is to give tax breaks to upper income individuals, particularly those whose primary source of income is from inherited capital. The data simply do not provide support for this kind of trickle-down economics.

Fifty years ago, distinguished economists such as Nobel Prize winner Simon Kuznets suggested that increasing inequality was an inevitable part of rapid growth. Another Nobel Prize winner, Arthur Lewis, emphasized that inequality might even promote economic growth, since savings rates among the rich were greater than among the poor. Fortunately, the countries of East Asia did not follow the logical implications of these hypotheses: Those countries that have grown most rapidly over the past quarter century--the countries of the East Asia miracle--deliberately pursued policies which reduced income inequality. They emphasized universal education, including education of women. These countries demonstrated that reducing inequality does not necessarily run counter to economic growth.

The Clinton Administration's Agenda for the 21st Century

Let me now turn to the 3 key elements of this Administration's positive agenda for expanding opportunity and enhancing economic security for all Americans. There is no magic bullet, but a set of programs to address the multiple facets of what is an extremely complicated problem. The 3 key elements are:

* Growing the economy in a manner that enhances opportunity for all Americans;
* Embracing change, by facilitating transitions and
* Finally, "doing no harm."

First -- growing the economy in a way that enhances opportunity for all Americans. Everyone wants the economy to grow faster. But wishing it so will not make it happen. Exhortation will not make it happen. Only sound economic policies will make it happen.

For this reason, the Administration has enacted a four-pronged growth agenda. It includes:

- o Reducing the deficit;
- o Investing in people and technology;
- o Expanding markets; and
- o Making government more efficient.

Let me talk briefly about this agenda. **First, REDUCING THE DEFICIT.** Both President Clinton and Congress agree: the deficit must be zeroed-out. The question is no longer whether we should eliminate the deficit but how we eliminate it.

Why? The reason is clear: deficits can stunt long-term economic growth. Borrowing against our nation's savings to finance consumption -- rather than investing in things like education and technology and infrastructure which will add to our future productivity -- will limit economic growth down the road.

In the previous three years, we have made great strides in reducing our budget deficit. [CHART] Indeed, the Clinton Administration has for the first time since President Truman succeeded in reducing the deficit three years in a row.

For the first time since the late 1970s, the debt/GDP ratio -- which is the <u>real</u> measure of the burden we hand on to future generations -- began to stabilize. [CHART]

Because of this progress in reducing the deficit, we are now in a position to eliminate the deficit by the year 2002.

And, most important, the Administration's 1993 deficit reduction effort created an economic climate in which businesses could invest and create jobs and compete: almost 8 million jobs have been created since the Administration took office; unemployment is down; inflation is under control; and investment is strong.

That brings me to the second part of our growth agenda: <u>investments that raise living standards and promote long-term growth</u>. The private sector clearly is responsible for most of our nation's investments. But, in certain key areas, government efforts are important. One is education. The other is technology and R&D.

Let me start with education. Investments in education are more important today than ever before. Education has become a fundamental fault-line running through the workforce. Demand for high-skilled workers is soaring, while demand for less-skilled workers is shrinking. In 1979, a full-time male worker over age 25 with at least a bachelor's degree earned 49 percent more per year than a worker with only a high school degree. By 1993, that difference had grown to 89 percent. [CHART]

Education is also an important determinant of economic growth. Between 1963 and 1992, increases in education added as much as 0.3 percentage points per year to our nation's economic growth -- meaning that education contributed about 20 percent to the growth in incomes over that 30-year period.

The Federal government can not -- and should not -- be responsible and involved in every classroom in our nation. But, government investments in education can make a difference.

For instance: Head Start and other compensatory pre-school programs have substantial economic payoffs. Head Start and other programs give a substantial boost to academic achievement: Head Start kids are less likely to be held back in school, less likely to be classified as special-education students, and more likely to graduate from high school. As a result, the program yields benefits not only for the pre-schoolers but also for our nation's taxpayers.

And, the government can help students from lower-income familes get access to higher education by guarenteeing student loans. This is especially important now. There is a growing disparity between college enrollment rates for those who are most well-off and those who are struggling to make ends meet. In recent years, the differences in enrollment rates between children from lower-income and upper-income families actually increased. [CHART]

The other important government investment is in R&D and technology. Investments in R&D may account for half or more of the growth in output per person. These investments yield high returns -- both to those that perform the R&D and to society as a whole. High social returns come from "spillovers" -- that is, benefits that accrue as other researchers use new findings.

But the fact is: because of these spillovers, firms will underinvest in R&D. That is why the federal government has to step in.

Federal support of R&D is neither new, nor is it purely a Clinton Administration initiative. The Federal government has a long record of successful R&D support, from its support in 1842 of Samuel Morse's original telegraph line from Washington to Baltimore to the development in more recent years of the Internet, the Global Positioning Satellite (GPS) system, and support of basic research leading to the discovery of DNA, which is central to our dynamic biotech industry.

To put it simply: certain government investments -- in things like education and technology -- are important for long-term economic growth and higher living standards.

Unfortunately, during the balanced budget debate this past year, some in Congress suggested that critical investments, such as funding for education and training and R&D, be put on the chopping block along with everything else. This is troubling and extremely short-sighted. Failing to make these necessary investments now will have serious long-term damaging consequences to the health and strength of our nation's economy.

Deficit reduction is not an end in itself -- it is a means to an end: which is stronger long-term economic growth and higher living standards for all Americans. Reducing the deficit in the wrong way -- by eliminating important investments -- may actually be counterproductive. Deficit reduction done the wrong way might actually lead to a slowdown in economic growth and increases in inequality.

So, I have talked about 2 important parts of the Clinton Administration's growth agenda: deficit reduction and investments that promote growth. The third part of this agenda is opening foreign markets to U.S. exports.

Since President Clinton's first days in office, he has aggressively sought to open markets abroad. This Administration fought for and won enactment of NAFTA. We broke 7 years of global gridlock and won passage of the Uruguay Round of GATT. We forged a new trade relationship with Japan -- opening markets for U.S. exports of autos and auto parts.

In part because of these market opening efforts, U.S. merchandise exports since this Administration took office have grown 33%. Let me repeat that: in just over 3 years, American exports have grown 33%. This extraordinary growth in exports approaches that experienced by the most successful East Asian countries -- such as Taiwan or Korea.

And, finally, the fourth prong of our growth agenda is making the portion of the economy over which we have control -- that is, the Federal Government -- more efficient and performance oriented. The Clinton Administration understands that there is an important -- but defined -- role for government. Government must be a partner in growth -- not a drag or a roadblock.

This Administration's "Reinventing Government" effort, headed by Vice President Gore, has focused on making government agencies more efficient and more performance and customer oriented, by developing performance measures and ensuring that those measures are used for evaluation. This effort has also revised, reformed, streamlined and -- where necessary -- eliminated thousands of pages of regulations.

We have cut over 16,000 pages of federal regulations. The Environmental Protection Agency alone will cut regulations by 25%. The Department of Agriculture has reduced the number of its agencies from 43 to 29 and is in the process of closing or consolidating 1,200 field offices. America's farmers this year will fill out 3 million pages fewer of government forms than in years past.

And, as a percentage of civilian nonfarm employment, the Federal workforce is the smallest it has been since 1933 -- before the New Deal. At the same time our economy is so much larger and there are so many more services that we have come to expect government to provide. As a result, we have had to make government more efficient and more performance oriented.

We recognize -- and have acted on the recognition -- that our economy will never achieve its full potential if our entrepreneurs and our businesses are dragged down by unnecessary regulation and inefficient and bureaucratic government.

<u>Now, let me turn to the second key element of the Clinton Administration's economic agenda:</u> <u>Embracing change by facilitating transitions.</u>

America has a dynamic, ever-changing economy. Our continued prosperity and well-being depend on our embracing -- not retreating from -- the constant succession of new opportunities and challenges in an ever-changing world. In an effort to become more competitive globally, American firms have restructured and become more efficient. They have taken a hard look at what they do, how they do it, and what they must do differently. The result: in many sectors American firms are the most competitive in the world. For instance, America's world-class computer makers continue to lead the industry at a breakneck pace of technical innovation. The explosive growth of the Internet and the increasing popularity of the World Wide Web illustrate the capacity for invention, adaptation and creativity by American entrepreneurs.

When firms and their workers embrace change as many of our most competitive industries have done, the economy as a whole benefits in the form of higher real incomes, lower prices for goods, a wider variety of products, and enhanced opportunities.

But, while embracing change raises growth and living standards in the aggregate, not everyone is immediately made better off. In a rapidly changing economy, some will find themselves without the skills required for the new jobs being created. When workers with outdated skills lose their jobs, they face the threat of prolonged unemployment or a new job at lower wages. And, all too often the loss of a job means the loss of health insurance or pension benefits. As a result, many Americans are concerned about their economic future.

This Administration is firmly committed to addressing these economic challenges and enhancing economic security for all Americans. We can do this by ensuring American families will still be able to buy health insurance if they lose a job or if someone in their family is sick; by ensuring the portability of pensions and health insurance; by encouraging more firms to offer their workers pensions; and by providing training vouchers so that unemployed workers can get the skills they need in our changing economy.

That brings me to the <u>third, and final element of the Clinton Administration's economic agenda for the 21st Century</u>: <u>doing no harm</u>. We must not exacerbate the difficulties of those working families who are struggling the hardest to make it in this new economy.

In 1993, the Administration expanded the Earned Income Tax Credit (EITC) for 15 million more low-income working families. The EITC is designed to ensure that a family with a full-time wage earner should at least have a take-home pay to bring them out of poverty. This expanded EITC is now worth about $1,800 a year for a family of four living on $20,000. Some in Congress have suggested that this important effort to reduce taxes on working families be reversed. This is wrong and the Administration has opposed it.

Finally, this Administration has proposed an increase in the minimum wage from $4.25 an hour to $5.15 an hour. Within a year, the minimum wage will fall to nearly a 40-year low in purchasing power. This is especially troubling since the average minimum wage worker brings home half of his or her family's weekly earnings.

Some question whether raising the minimum wage will hurt employment. I might agree if we were talking about tripling the minimum wage. But, that is not the case. We are simply trying to restore its value to the 1983 level. And the econometric evidence shows little negative employment effects for a minimum wage increase of the size proposed.

By raising the minimum wage we support the notion that work pays -- and we help ensure a better standard of living for millions of working families.

Conclusion

The first part of this economic agenda for the 21st Century -- growing the economy -- is part of a long term strategy to enhance economic opportunity, the dividends of which will only be realized years into the future. For instance, a child receiving the opportunity to take part in Project Head Start will not enter the labor force for 14 or more years. These are, as I have emphasized, long-term investments -- and it is often long-term investments which pay the highest returns.

But while we have embarked on a long-term strategy, we cannot ignore those who are confronting the problems of today. That is why we have pursued at the same time a set of policies which address the transitions American workers are experiencing in our changing economy. These are policies that are designed to reduce uncertainty and enhance economic security. And, finally, while we cannot immediately redress what are, after all, long-term economic forces, we should be careful not to exacerbate their consequences. We should not add insult to injury. If we cannot in the short run solve these important problems, at least we should do no harm.

Yes, some look for easy short-term solutions to difficult, long-term economic problems. It would be easy and perhaps tempting for us to focus our attention on strategies which yield returns in the short-run. But such a strategy would be short-sighted. It would not fair to our children and it would not be right for our country.

Now is not the time for short-term thinking. We need to create opportunity, embrace change, and help ease uncertainties in times of transition. These are the kind of tried and true principles on which to construct an economic agenda for the twenty-first century. An agenda that builds on and fosters fundamental American values.

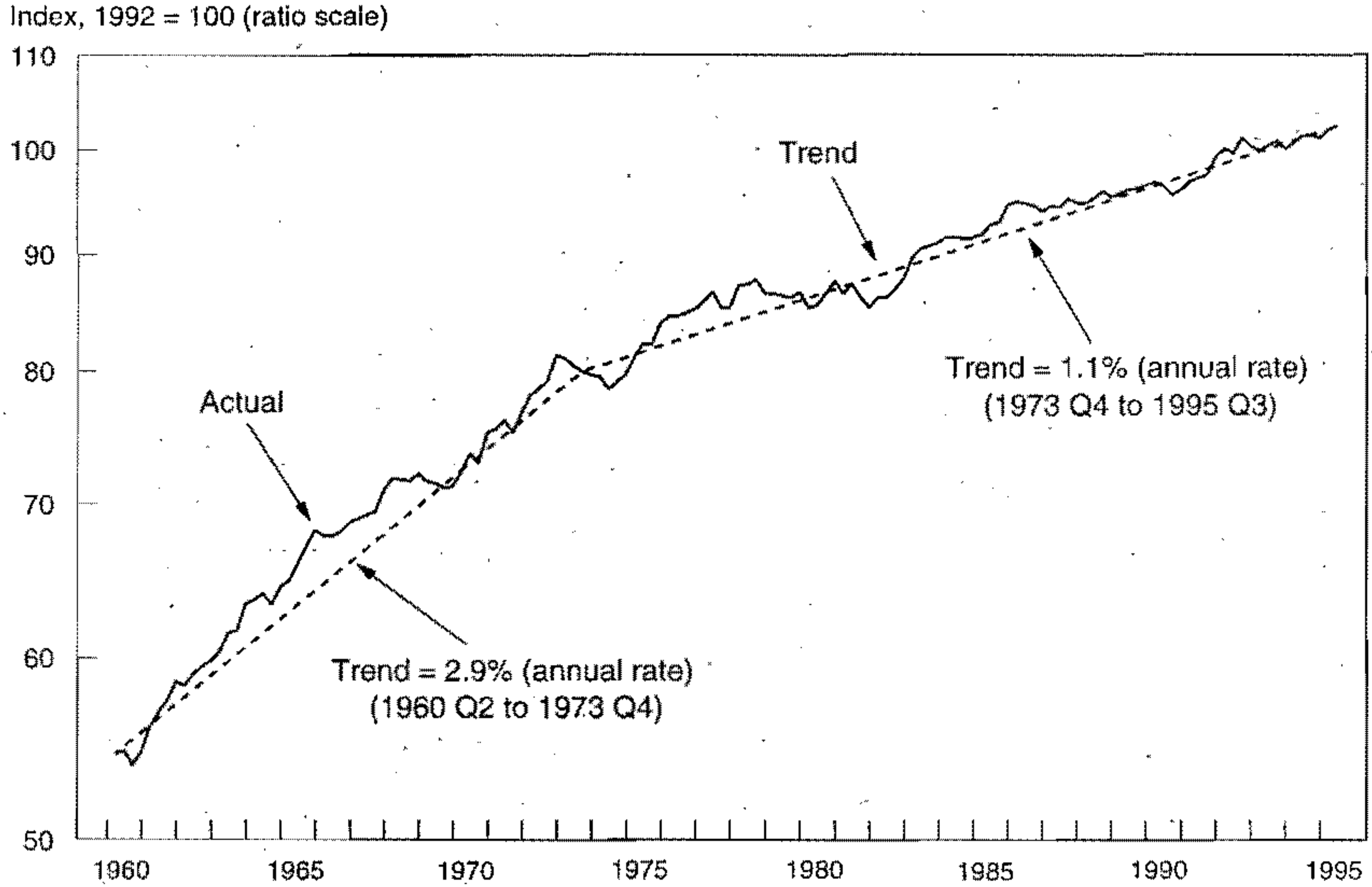
This Administration has a positive, constructive economic agenda that holds open the promise of the 21st Century. It is an agenda that will ensure not only that our economy grows faster, but that the fruits of that growth are shared among all Americans; not only that economists tell us that our aggregate economic statistics are strong, but that Americans truly see their living standards improve and they are living richer and fuller lives.

Two Important Economic Challenges

* *Stagnating Wages*
* *Increasing Inequality*

Actual and Trend Labor Productivity

Smoothed for cyclical fluctuations, labor productivity has grown at a steady 1.1 percent average annual rate since 1973.

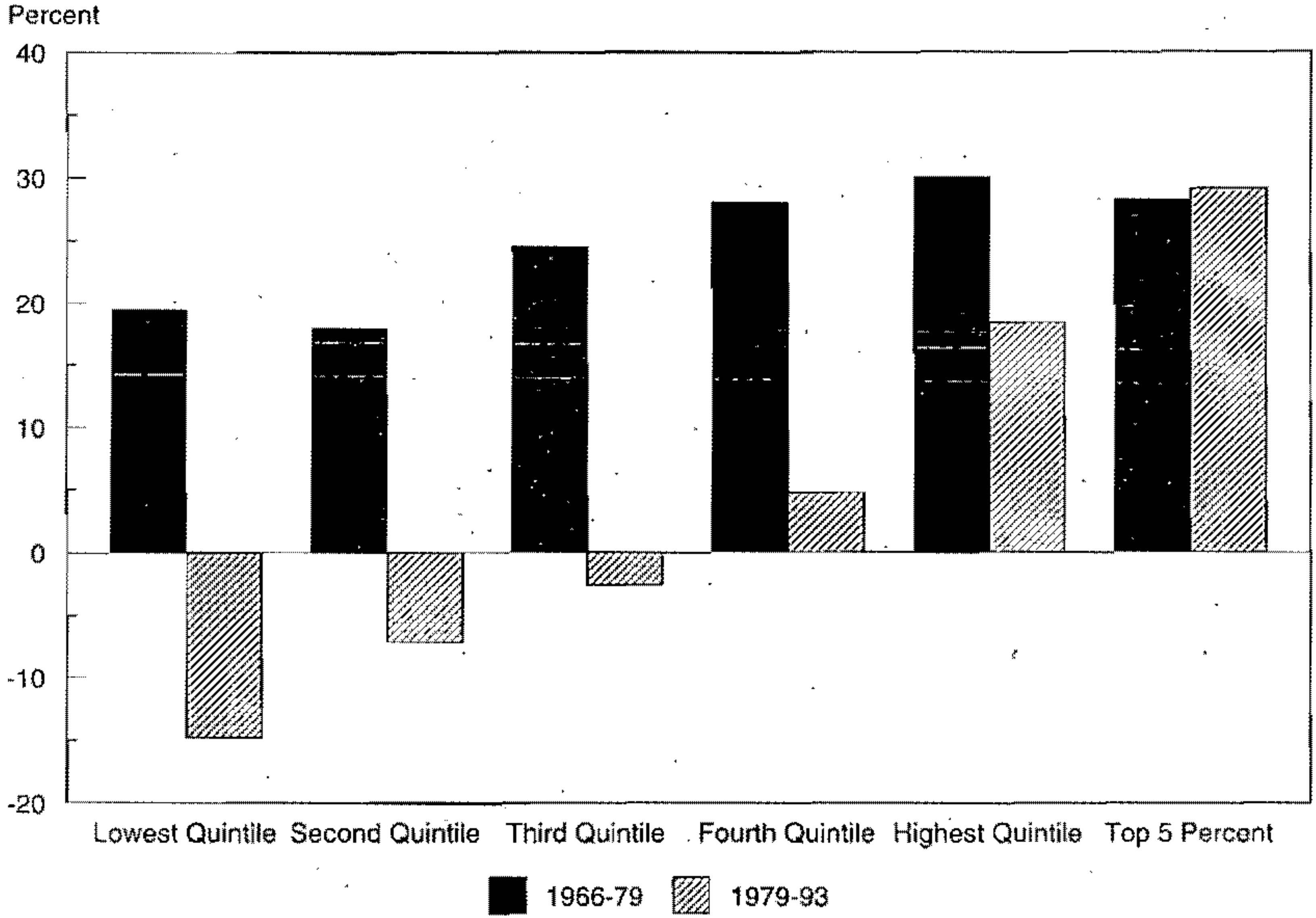


Note: Data are for the nonfarm business sector.

Source: Provisional estimates calculated by the Council of Economic Advisers from data provided by the Departments of Commerce and Labor.

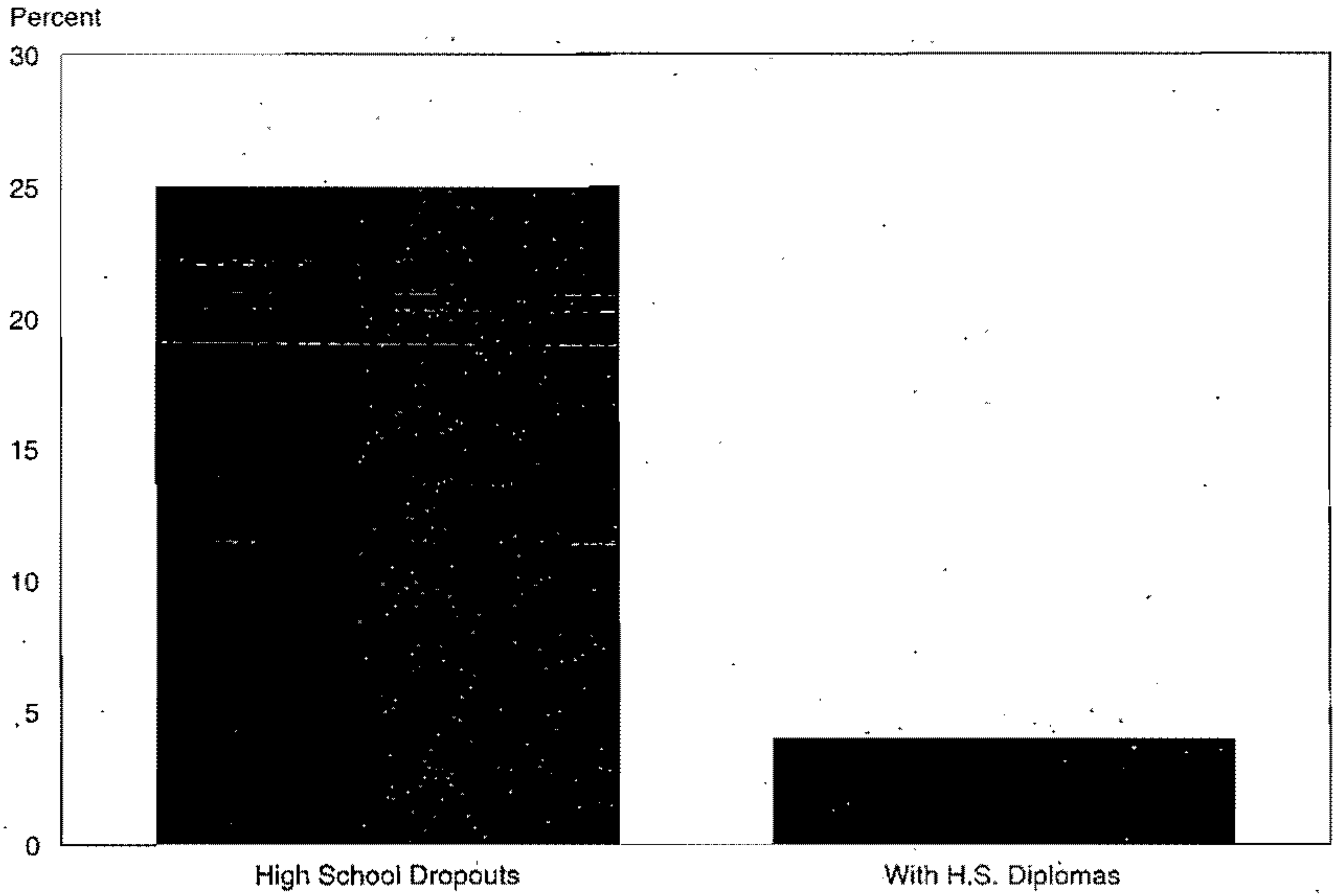
Changes in Average Real Family Income by Quintile

Real incomes have fallen or stagnated for most American families since 1979.



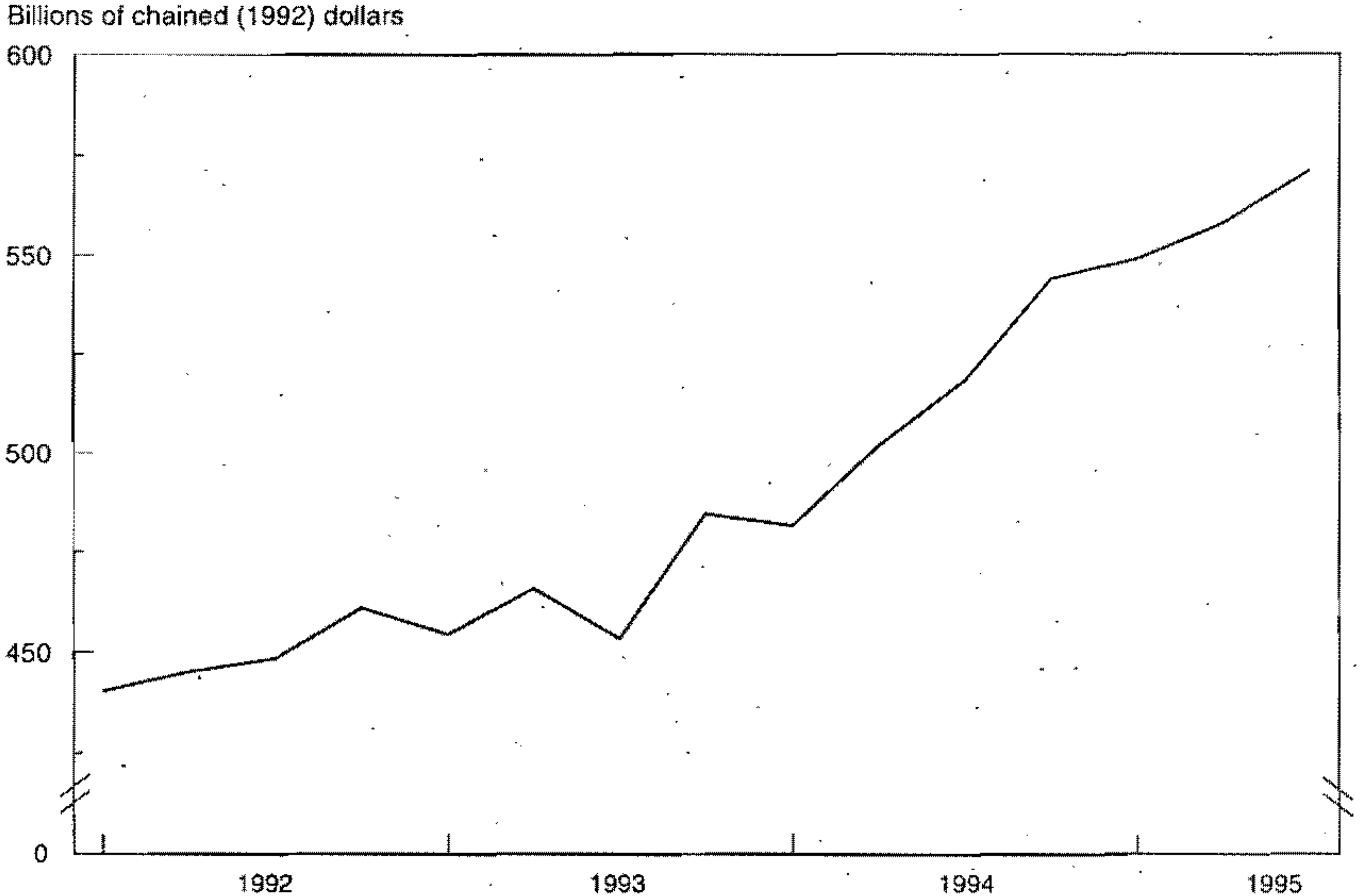
Note: Family income is deflated by the CPI-U-X1.
Source: Department of Commerce.

Percent of Men Aged 18-34 in Prison, Probation, or on Parole in 1992.



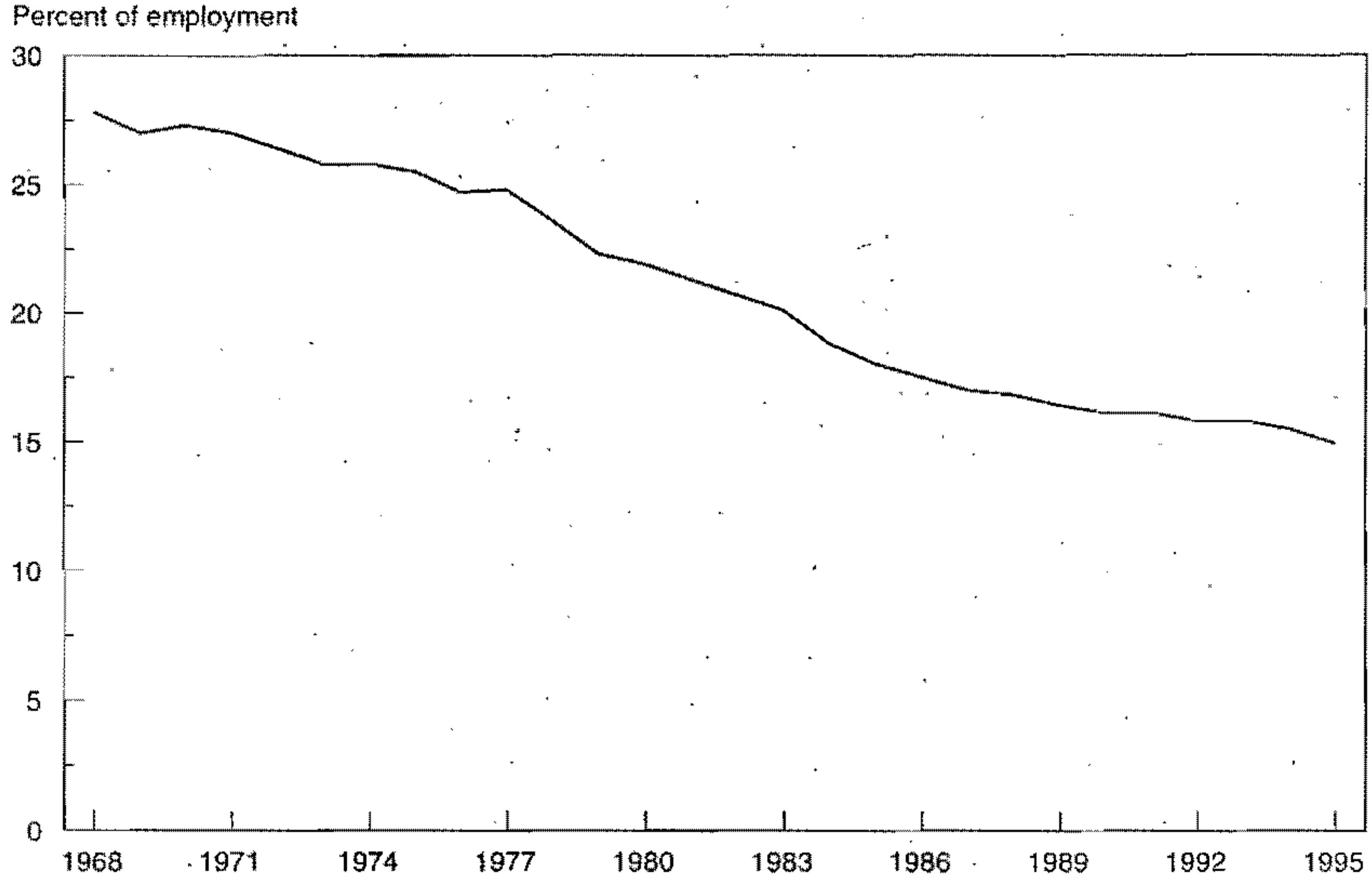
The Wrong Way to Address these Challenges: Protectionism and "Trickle Down" Economics

Merchandise Exports
Goods exports have grown by 26 percent in real terms since the Administration took office.



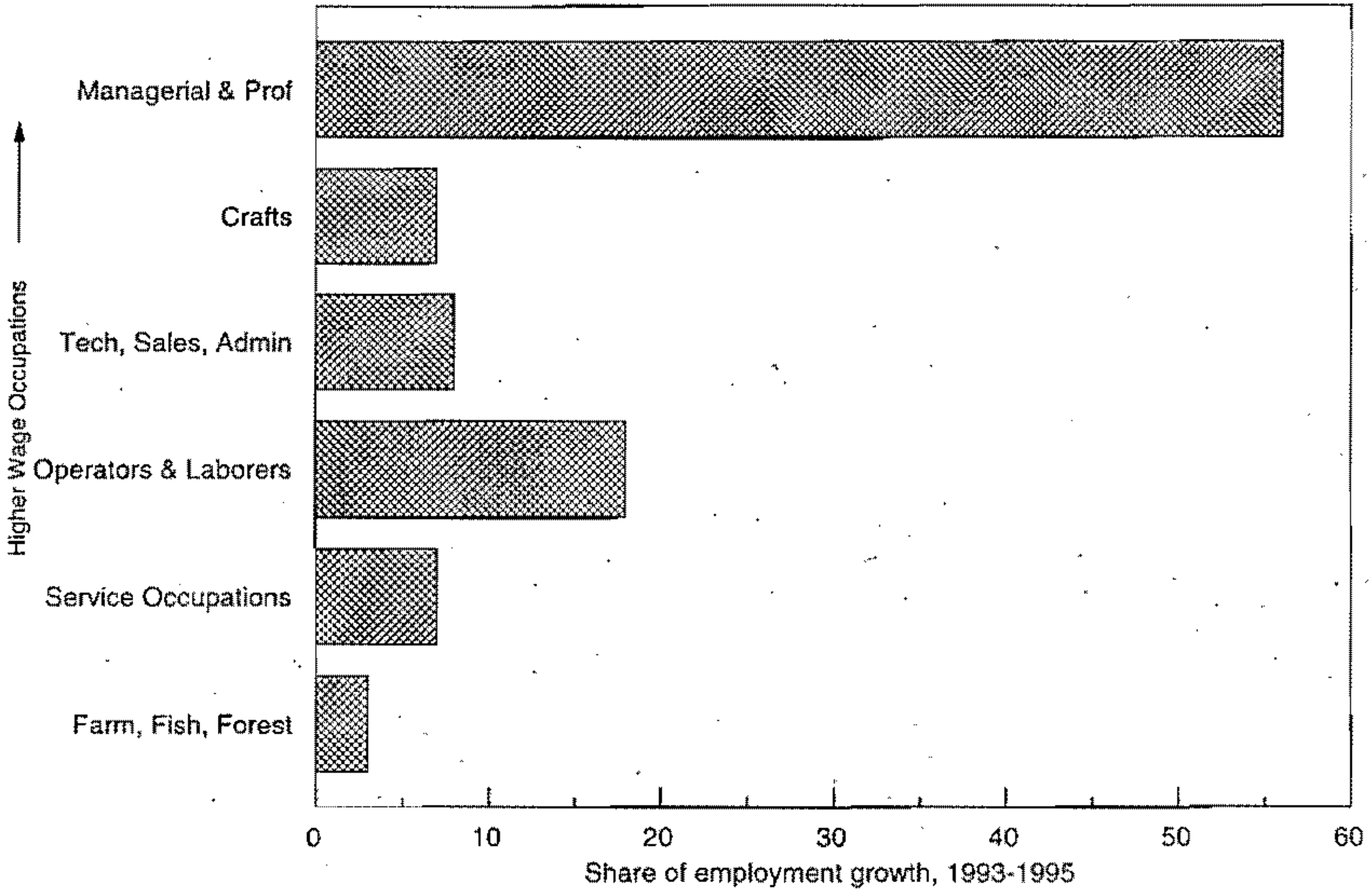
Note: Data are at annual rates.
Source: Department of Commerce.

Union Membership



Note: The Union membership series between 1980 and 1983 is interpolated.
Source: Department of Labor.

Job Growth by Occupation, 1993-1995



Source: Department of Labor.

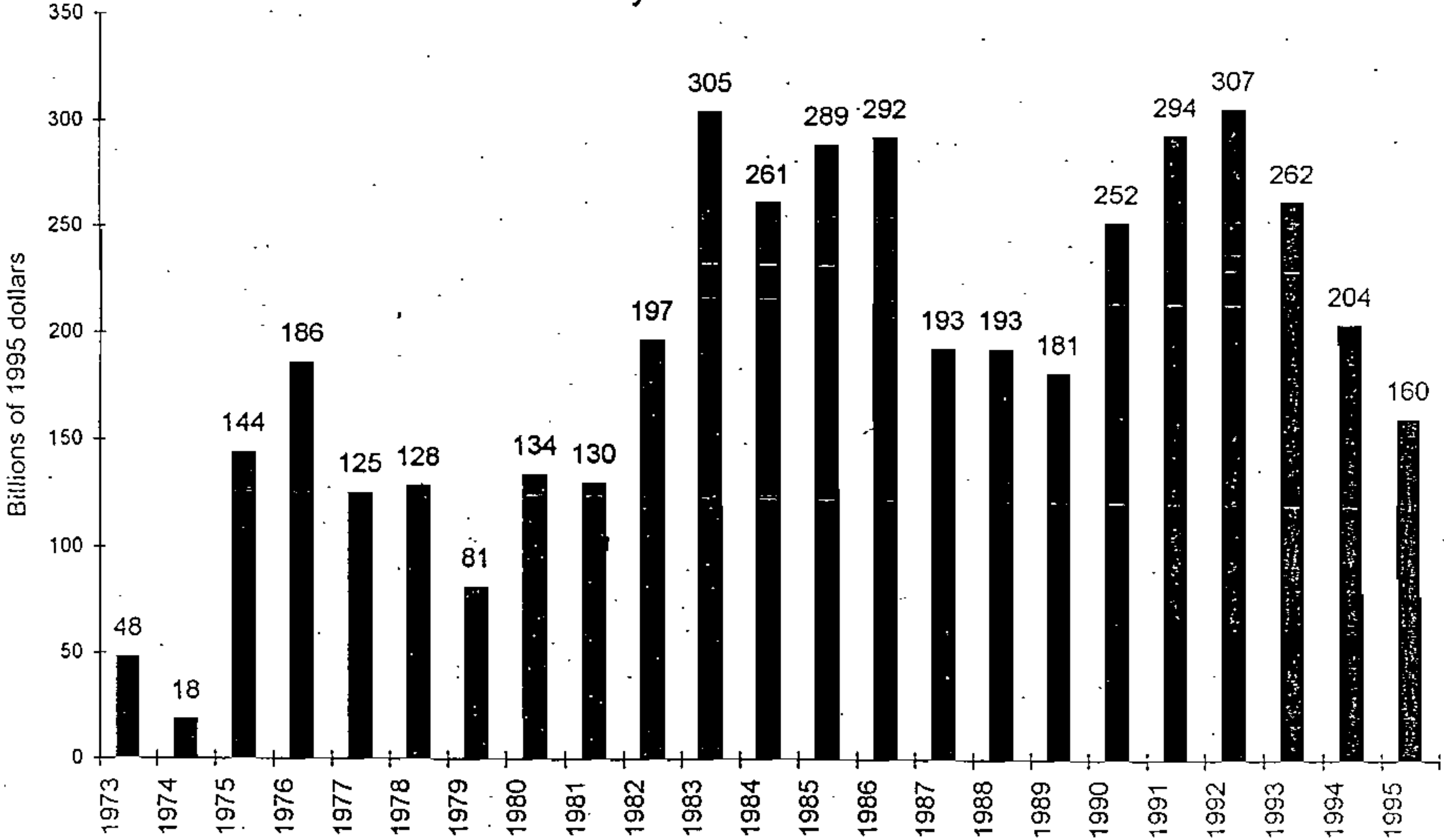
The Clinton Administration's Economic Agenda for the 21st Century

* *Growing the Economy in a Way that Enhances Opportunity*
    - *Deficit Reduction*
    - *Investing in Education and Technology*
    - *Opening Markets*
    - *Making Government More Efficient*

* *Embracing Change by Facilitating Transitions*

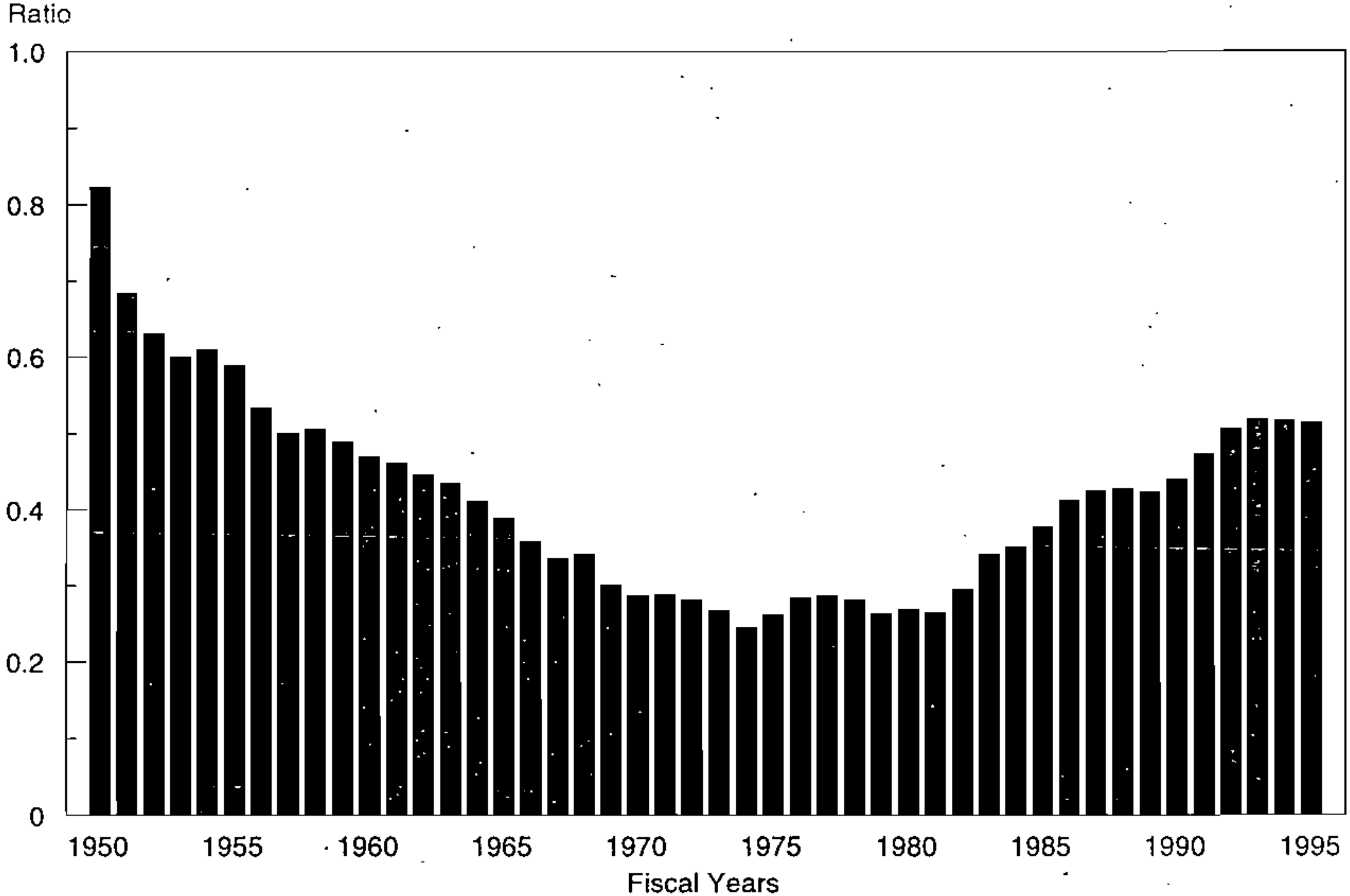
* *Doing No Harm*

Real dollar value of the budget deficit
Fiscal years 1973-1995



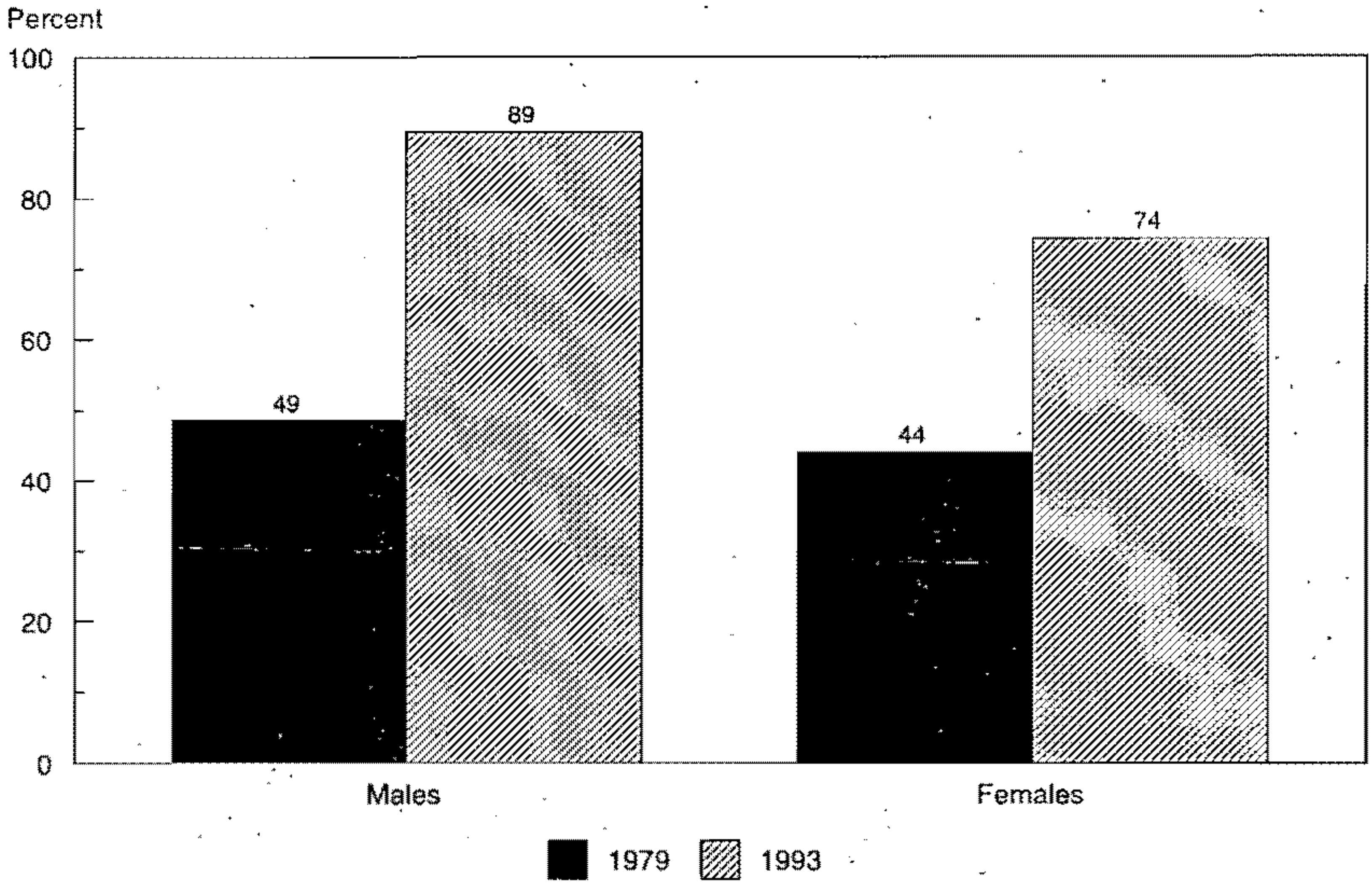
Federal Debt-to-GDP Ratio

After falling throughout the early postwar era, the Federal debt as a percent of GDP rose in the 1980s and has now leveled off.

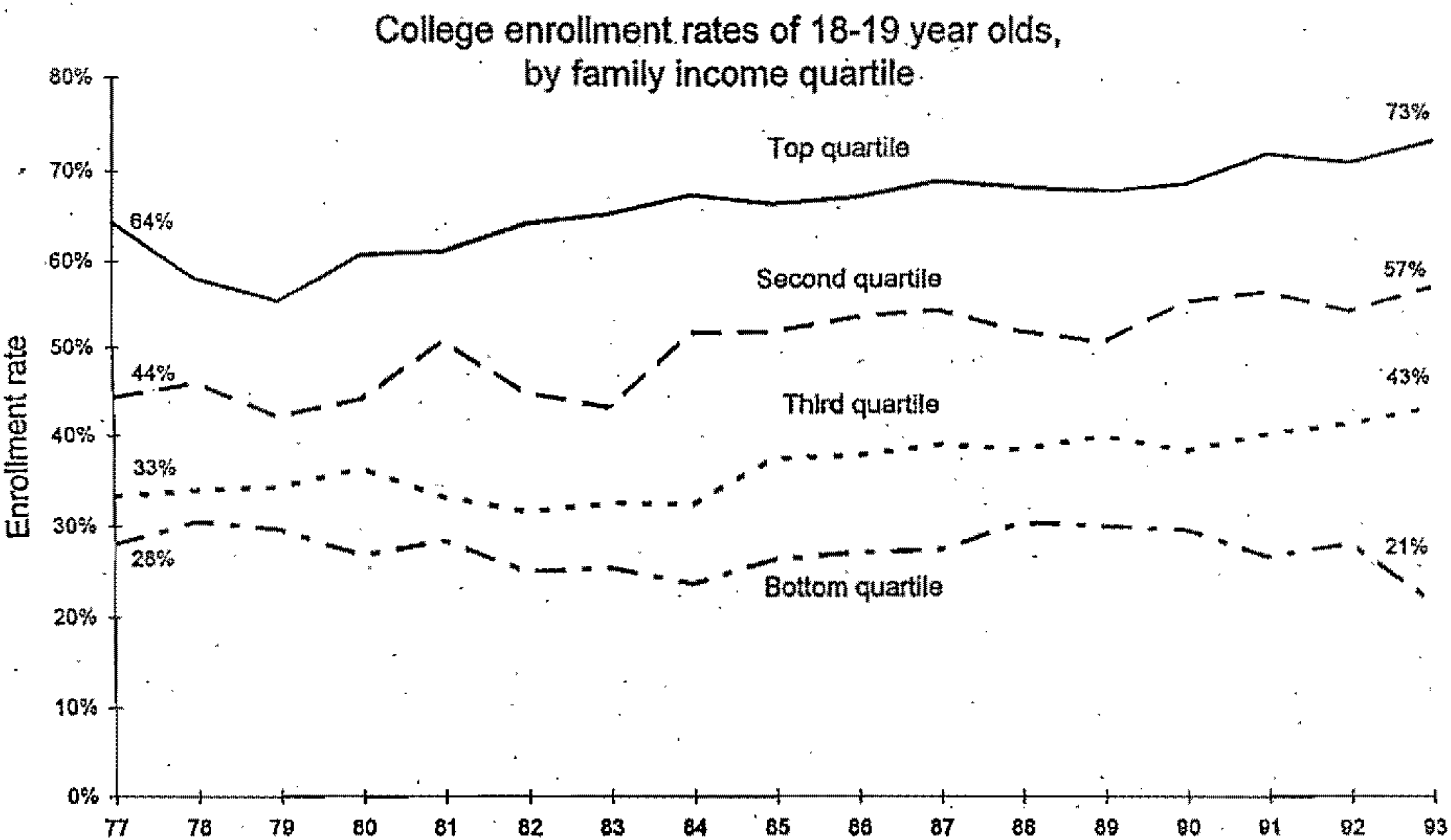


Note: The GDP measure used is pre-January 1996 benchmark revision.
Source: Office of Management and Budget.

Percent Difference in Annual Earnings for College and High School Graduates
Differences in mean earnings by educational attainment have widened.



Note: Data are for year-round, full-time workers, age 25 and over.
Source: Department of Labor.



Source: Current Population Survey, October Supplement, 1977-1993.

Remarks by Joseph E. Stiglitz

Chairman, Council of Economic Advisers

at the Brookings Institution

February 15, 1996

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Tax Reform

I am pleased to have the opportunity to speak to you tonight about the Administration's approach to the question of tax reform. Clearly, tax reform will be one of the major issues being discussed over the next few months, and I commend the Brookings Institution for organizing this important conference.

In looking for polls about American attitudes toward taxes and the IRS, my staff found some interesting data--I am not sure if they are good or bad. According to an October 1995 Gallup poll, the IRS is hated, but only slightly more than the Federal government as a whole. Actually, the poll found that 60 percent of the population believes that the Federal government has too much power, and 63 percent of the population believes this of the IRS.

I also had my staff do a little econometric work, and they found that the lag structure on attitudes toward government is roughly 2 1/2 years, so of course, these views primarily reflect attitudes toward previous Administrations. But, the current tax system is an easy target to attack--it is perceived as intrusive and complex, and it is downright scary for a lot of Americans. Many Americans believe that the tax system is too complex, and that the system unfairly benefits the rich.

While it is easy to take potshots at the current system, we don't believe that there are any easy answers. Many of the attributes of our current tax system stem from natural outcomes of the political process, from measures designed to ensure compliance, and even from measures designed to ensure equity. For example, a tax system that bases tax liability on family structure necessitates some rules to determine who is part of the family and who is not. This is but one illustration of how some complexities naturally enter almost any tax system. Whatever the cause of these complexities, the demand for tax reform is real.

There are several aspects to this dissatisfaction with the tax system, each requiring a different remedy. First, there is a perception problem. Because so many people receive large packages of tax forms and instructions from the Federal government, with more forms than they could ever use, they view the tax system as overwhelming.

Perhaps more important, they believe that it is unfair: If the IRS is sending all these forms, there must be people who know how to use them to lower their tax bill.

This perceived problem of complexity and unfairness is important--after all, the more taxpayers view the tax system as simple and fair, the higher is voluntary compliance, the lower are compliance costs, and equally as important, the lower is antagonism toward government.

In reality, however, the tax system is not that complex for most people, in part due to the Administration's efforts. In 1994, 17 million households--or roughly 16 percent of filers-- used the form EZ. The 1040-EZ consists of only 12 lines, and could in principle be placed on a postcard--the current acid-test of simplicity. An additional 18 percent used the 1040A, a somewhat longer, but still relatively simple tax form.

Furthermore, under this Administration's reinvention of government initiatives, more and more filers are able to file their entire return over the phone or electronically, even from their home pc.

But, for individuals with self-employment income or significant capital income, and for most large companies, our tax system is very complex, and this true complexity is another source of dissatisfaction with the current income tax system. As you all know, much of this complexity comes from the fact that we tax different types of income differently, rather than from the fact that we have different rates. Thus, the fact that capital gains are taxed on realization but interest paid on debt is deductible annually means that we need complicated provisions to prevent tax arbitrage. Similarly, the taxation of US companies with foreign subsidiaries, or US subsidiaries of foreign companies, requires complicated transfer pricing rules.

The Administration recognizes that the current tax system has some real problems, and we are open to ideas about how to fix them. We have laid out a number of criteria by which we feel tax reform proposals should be judged.

The first criterion is fairness. Of course, having a fair tax system means different things to different people. But, in this age of increasing dispersion of income, with the rich getting richer and the middle class barely keeping up, major redistribution of taxes away from the rich and toward the poor and middle class is unconscionable, unless you believe in trickle-down economics and implausibly large incentive effects.

The second criterion is simplicity. If one of the main problems with the current tax code is that it is too complex, then any tax reform ought to focus on simplicity. But, it is important that the simplicity of a proposed tax reform be evaluated realistically. Evaluating the simplicity of a proposed tax reform requires considering both the regulations that would be required in order to ensure adequate compliance, as well as the potential complexities introduced by the nature of proposals wending their way through the political process.

The third criterion is efficiency. The issue of efficiency is a contentious one. Some argue that a consumption tax would enhance efficiency by reducing the tax on savings--but, it should be recognized, our tax system cannot be described as a pure income tax system; it really is a hybrid income-consumption tax. The availability of pensions, IRAs and the favorable tax treatment of capital gains mean that much of capital income is untaxed. For most Americans, most of their savings is already untaxed. Thus, moving toward a pure consumption tax, while reducing the tax on saving, would necessarily be regressive.

Finally, in any consideration of a fundamental tax reform, the issue of the transition looms large. While lump sum taxes have wonderful efficiency effects and may seem great in theory, in practice, they often seem unfair.

A business owner who buys office equipment expecting to be able to depreciate it for tax purposes, or a recent homebuyer depending on the deductibility of mortgage interest, would find repeal of these provisions quite unfair. It seems very likely that the political process would alleviate such losses. Thus, transition relief would undoubtedly be provided. And such relief is likely to be complex, as well as eroding some of the efficiency gains.

The complexity of the transition does not mean that no major tax reforms should be enacted, but it does mean that the promised benefits of such a reform must be sufficiently large to bear the costs of the transition.

So, how do some of the tax proposals currently being discussed stack up against these criteria? Well, to the extent that the tax proposals being discussed broaden the tax base and lower tax rates, they clearly have some advantages. Such base broadeners can enhance efficiency by eliminating or reducing tax subsidies to certain types of consumption, and by reducing marginal taxes on labor and capital income. But, eliminating some of these subsidies also involves some philosophical issues. In particular, what attributes should be taken into account when determining ability to pay tax? Is number of children sufficient? What would happen to horizontal equity under a tax that did not allow for deductions for state income and property taxes? Should a taxpayer in good health be taxed the same as a taxpayer who spends 50 percent of his or her income on medical expenses? These may seem like relatively unimportant concerns, but to the affected taxpayers, they are central. Of course, the advantages of addressing these issues must be weighed against the costs of doing so.

Let's talk about simplicity. While a flat tax might, in principle, be simpler, it would not avoid all the complications of current tax law. Depending on the provisions, it is possible that some things could even get more complicated. For instance, no one is talking about a truly flat tax--most proposals provide an exemption for low income workers--so who pays the tax could still matter. If firms were simply denied the deduction for employee fringe benefits, for example, then firms with many low-income employees would pay too high a tax on fringes, and fringe benefits would actually be discouraged and low income people could actually lose their health insurance. This would put a new and different wedge between health insurance and wages, while replacing the current one. If, instead, the value of the fringe benefits were imputed to employees as part of their taxable income, then rules would be required on how to do such imputations. For example, would workers of different ages be assigned different insurance values, or would they all be lumped together in a single group and assigned the average value?

Another potential source of complication would be the rules required to ensure compliance. Under a flat tax, the incentives to convert ordinary income into capital income would be substantial. A few years ago, I showed how in a perfect capital market, preferential tax treatment of capital gains allows people to engage in schemes that can eliminate income tax liabilities. While I have not given much thought to the types of transactions one could undertake to evade a flat tax, the fact that capital income would be untaxed, that low-income workers would face a zero rate of tax, and the possibility of engaging in transactions with foreign companies operating under different tax systems leads me to believe that such possibilities exist. Of course, not all tax avoidance schemes would be discovered at once. But, over time, more and more avoidance schemes could be uncovered, followed by either reductions in revenues or statutory changes aimed at preventing these tax avoidance games. These changes would reintroduce inefficiencies, not to mention complexities.

Of course, potential efficiency gains could make this type of tax reform worthwhile. Evaluating the efficiency of fundamental tax reforms is quite difficult--at best, we are able to use highly stylized models, requiring us to plug in very uncertain parameter estimates.
Using such techniques, some analysts do find substantial efficiency effects from going from a pure income tax to a pure consumption tax. But, apart from the fact that these simulations rely on highly uncertain estimates of key elasticities--in particular, the savings elasticity--as well as crude models of saving behavior, these simulations are often highly stylistic.

The simulations used to evaluate the efficiency gains of tax reforms often rely on an unrealistic description of our current tax system and of the tax reforms that are likely to emerge out of the political process. First of all, we don't have a pure income tax now. So some of the benefits of consumption taxation, to the extent there are any, are already being enjoyed. Second, the probability of moving to a pure consumption tax -- with no transition relief, no special interest provisions, and no tax avoidance, is close to nil. For instance, even the Kemp Commission backed away from an aggressive position on deductibility of mortgage interest and charitable contributions, and the Commission recommended that unspecified transition relief be provided for existing assets. As the purity of the consumption tax is reduced, so are the possible efficiency effects.

Finally, let me discuss what is perhaps the most important problem with some of the tax proposals currently being discussed--fairness. It is clear that going from a system with a progressive rate structure to one with a single rate well below today's top marginal rate will lower taxes on the high end of the income spectrum, and raise them for those in the middle and at the bottom. If, on top of this change in the rate structure, we also exempt capital income from tax, the Federal tax system will become even less progressive.
And, this effect would be exacerbated if the earned income tax credit is repealed. Of course, the lack of transition relief might also hurt wealthier people who benefit from the elimination of taxes on new saving.

One way to assess the fairness of a tax system, however, is to examine its impact on middle income families. According to Treasury estimates of the Armey-Shelby flat tax proposal, families with income of $200,000 or lower would, on average, pay more tax than under the current system, and those with income of $200,000 or more would, on average, receive a tax cut.

For example, the total tax burden for a hypothetical married couple with $50,000 of wages, two children, and employer-provided health insurance would increase by $1,604.

By this measure, the Armey-Shelby tax is unfair.

Unless a tax reform can improve efficiency and simplicity without raising taxes on middle income and lower-income families, the case for a wholesale change in the tax system is be hard to make.

I should perhaps make a few comments about what economic theory has to say about this whole matter. It would be nice if economic theory had simple and clear prescriptions, but we should be honest with ourselves, and with the public, that it does not. Economic theory has provided a framework within which we can address the question, what is the optimal structure of taxes? It has even allowed us to ask questions about pareto optimal tax structures, that is tax structures which have the property that no group can be made better off without making other groups worse off. Is it a general characteristic of pareto optimal tax structures, that taking into account impacts on different generations, and accordingly, on economic growth, that the return to capital is not taxed? The answer is, only under highly restrictive conditions.

Both practical and theoretical concerns about the tax reforms currently under discussion shouldn't excuse us from thinking long and hard about how to change the tax system in ways--small and large--that could actually make it better according to these criteria.

One example is this Administration's proposal to greatly simplify the rules for setting up employee pensions. In the 20 years since Congress enacted ERISA, the pension laws and regulations have become extremely complicated. And, while many of the rules and regulations were enacted for good cause, the cumulative result was to raise compliance and administrative costs to a level where many employers--especially small businesses--could not afford to offer retirement plans to their workers. Our 1997 budget includes a new, simple retirement savings plan (called the NEST - for National Employee Savings Trust) that allows firms with fewer than 100 workers to set up an IRA-type pension plan. As long as the employer follows some simple matching requirements and some minimum contribution levels, no testing for nondiscrimination is required.

In the long run, other types of proposals are worth thinking about. For example, Congressman Gibbons has touted the idea of a hybrid tax system which would combine a VAT with an income tax on high-income taxpayers. Similarly, a simple collection system has been in place in the UK, where employers withhold taxes, and the vast majority of taxpayers never file forms. However, today's New York Times had an article stating that the UK was largely abandoning its form-free tax system, and moving toward the US system. The article was not clear about what sparked this decision, but it is telling nonetheless--in this day and age, with the tremendous array of financial instruments and methods of compensation, no significant and fair tax system is likely to be very simple.

But that does not mean we should give up. Small tax reforms that can make life easier for people, without entailing any large revenue losses, should be adopted. Tax reforms that significantly reduce complexity, without doing major damage to revenue or to social goals, should be adopted. Various definitions, for example, need not be as complicated as they are, even if in some cases, a simpler definition would only provide rough justice. And larger proposals that broaden the base and lower the rates, while maintaining the fairness of the system, are likely to be worthwhile. The challenge is going to be to come up with an equitable, simple, non-intrusive tax structure that we all can live with. While none of the current proposals seems to accomplish this goal, I look forward to the coming year, in which tax reform proposals will certainly be the subject of some very stimulating discussions.