CHAPTER 1

Growth and Opportunity: Creating a New Economic Order

THE AMERICAN ECONOMY TODAY is the healthiest it has been in three decades. But just as important as the economy's current performance is the foundation being laid for its future health and strength. Like its predecessors, this *Economic Report of the President,* the last of this President's first Administration, summarizes the present state of the economy and the accomplishments of the past 4 years. But it also sets forth the economic legacy this Administration hopes to leave. That legacy includes a vibrant and evolving set of public institutions, investments that will provide the basis for continued growth, and an economic philosophy of government and markets that will help to guide these institutions and investments. Together these will constitute a bequest to future generations, contributing to rising living standards, expanded opportunities, and a greater sense of community.

The real measure of the success of any Administration's economic policies is not just today's economic statistics, but also the strength of the Nation's economy in 10 or 20 years' time. Today's economic policies will be judged favorably if, as a result, growth is stronger, the environment cleaner, and the number of children growing up in poverty fewer. History will pronounce these efforts a success if, a generation from now, opportunity has been expanded in our cities, tomorrow's senior citizens are at least as economically secure as today's, and all our citizens have the education they need not just to cope with but to profit from the challenges of a changing world. If we can look back upon a record of such accomplishments, we will know that the last years of the 20th century laid a solid foundation for the 21st.

No Administration starts with a clean slate: each must work with the assets and the liabilities it has inherited, and each Administration that follows will to some degree reshape and revise what this one has built. We are constrained and enabled not just by our physical and our fiscal inheritance, but also by our intellectual inheritance—by prevailing modes of thought and by the ways in which we and our contemporaries view and approach the world. Consequently, it is hard enough in the present to formulate the

policies that will guide us toward a more prosperous future, harder still to assess today their impact decades hence.

For more than two decades America has faced several serious problems: productivity growth has been slower than in the past, income inequality has increased, and poverty has persisted. In addition, serious challenges loom for the future, such as the aging of the baby boom, which threatens to create severe fiscal strains in the next century. In the last 4 years the Administration has taken important steps to respond to these challenges. Only if we maintain and extend these initiatives will we leave a strong legacy for the future.

This chapter begins by describing what will perhaps be viewed as this Administration's most enduring contribution, the formulation and implementation of an economic philosophy for the 21st century. The economic record, which reflects the policies articulated by this philosophy—policies that have mitigated or reversed many of the undesirable economic trends of the 1980s and early 1990s—is the second subject of this chapter. But the task of preparing for the future is far from complete. The third section of this chapter therefore focuses on the Administration's agenda for promoting the three complementary goals of growth, opportunity, and responsibility.

AN ECONOMIC PHILOSOPHY

At the center of the U.S. economy is the market: vibrant competition among profit-maximizing firms has enhanced economic efficiency and generated innovation, giving the United States one of the highest standards of living in the world. Within this market-based economy, government plays a limited, yet critical, role. It is essential to understand the proper role of government if the economy's strong performance is to continue and to improve.

In the past, two opposing visions of the American economy have vied for dominance. To put it starkly, one is a Panglossian view of an America of vigorous, self-sufficient individualism, the other of a world in which government is primarily responsible for our well-being. The first view is one of Horatio Algers making their way on their own, of self-reliant entrepreneurs creating wealth from which everyone eventually benefits. In this vision the main job of government is to keep out of the way, to do no harm. This economic worldview has its roots in the writings of Adam Smith, was refined into the classical liberalism of the 19th century, and has persisted into contemporary times in the rhetoric of the Reagan Presidency and its supporters.

The second vision is one that distrusts markets. At its extreme, this is a vision of an America full of monopolistic firms despoiling

the environment and exploiting the masses of workers to earn huge profits for a handful of managers and shareholders. It sees pervasive market failures producing dire consequences, such as farmers and workers precluded from earning a decent living, and large parts of society—particularly in the inner cities and impoverished rural areas—simply left behind. The hero of this vision is government, endowed with both the omniscience and the omnipotence to cure these ills through active intervention in the market. The New Deal crystallized these currents into a new kind of liberalism, in some ways antithetical to the old.

THE NEW VISION

Over the past 4 years, this Administration has promoted a third vision, one that synthesizes and transcends these two polar worldviews. This vision puts individuals at its center, but it emphasizes that individuals live within and draw strength from communities. It recognizes that many have been left behind by the changing economy and may need government assistance, but that the role for government is limited: it can and should promote opportunity, not dependence.

This new vision includes a renewed conception of government—one in which government recognizes both the market's efficiencies *and* its imperfections. The government can sometimes make markets work better, but it is seldom in a position to replace them. Government has its strengths and its limitations. We need to understand those limitations and, where possible, work to improve government's performance. The government cannot ignore the role of market forces in its own programs: it needs to take advantage of the power of incentives to accomplish its objectives.

Critics of government often pose a false dilemma: which can do the job better, the government or the market? Yet the question is seldom whether government should replace the market, but rather whether government can usefully complement the market. On this question a consensus holds that, in many particular circumstances, the answer is clearly yes. In the trough of the Great Depression, for example, one out of four workers was without a job—clearly the market was not performing well. It was that harrowing experience that led to enactment of the Employment Act of 1946 (the same legislation that established the Council of Economic Advisers), which assigned to the Federal Government the responsibility to "promote maximum employment, production, and purchasing power."

Over the years, economists have identified the various circumstances in which markets fail to produce desirable outcomes, and in which selective government intervention can complement markets. Competition may be imperfect, market participants may

lack needed information, or markets may be missing. Would-be innovators and entrepreneurs may fail to capture enough of the benefits of their activity to justify their effort, or the users of resources, such as clean air and water, may escape the full costs of their use, degrading the resources for all. Although such problems may occur throughout the economy, it is important for the government to focus on those that are particularly severe. Like any successful enterprise, it must identify a core mission and pursue it.

GOVERNMENT'S CORE ECONOMIC MISSION

Government's presence in the economy has become so pervasive that we can easily lose sight of its core mission. A few simple principles can serve as a guide to rediscovering that core mission.

The criterion for government involvement in any activity should not be how essential that activity is to the economy, or how many jobs it generates, or how much it contributes to the trade balance. In the overwhelming number of cases, the government cannot hope to surpass private firms at generating output, jobs, and exports. The proper question in circumstances where a choice between government and the market arises is whether any reason exists *not* to rely on markets. Is there—in the language of economists—a market failure?

The government should focus its attention on those areas in which markets will not perform adequately on their own, in which individual responsibility is insufficient to produce desirable results, and in which collective action through government is the most effective remedy. Americans are better off in a society in which individuals are encouraged to exercise as much responsibility as possible. But both economic theory and historical evidence indicate that, left to themselves, individuals and firms will produce too little of some goods like basic scientific research, and too much of others, such as pollution and toxic wastes. We also know that, without government assistance, many children from disadvantaged backgrounds may not be able to realize their full potential. Government social insurance programs have enabled individuals to make provision for risks that almost all individuals face and that, at the time the programs were launched, markets did not—and still largely do not—address effectively. Among them are programs that provide some insurance against unemployment, retirement benefits secured against the risk of inflation, and medical care for the aged.

It is essential to remember, whenever evaluating an existing government program or contemplating a new one, that the government cannot direct resources to someone without taking resources away from someone else. In a full-employment economy such as the Nation enjoys today and hopes to maintain, misguided subsidies pull resources away from more productive sectors and divert them to-

ward less productive ones. Some individuals gain, but society as a whole suffers a net loss.

To prepare the economy, and the government, for the 21st century, we need to rethink and revitalize our policies to respond to the new challenges. We also need to strip away outmoded programs that respond primarily to problems of the past.

AN INTERNATIONAL VISION

In international just as in domestic economic policy, two fundamentally different visions have long dominated the debate. At one extreme, countries interact atomistically in an undifferentiated world of free trade abroad and free markets at home. In this view, international economic relations are just a matter of opening markets. The other perspective harks back to 18th-century mercantilism, often supplemented with metaphors from the Cold War. It replaces ideological competition with economic competition, and sees the gains on one side of the border coming at the expense of losses on the other. The trade deficit, in this view, replaces the missile gap as the measure of our national inadequacy.

Here, too, this Administration has sought to carve a new path. It recognizes the benefits of free trade, but also the existence of international public goods, not just in the trade arena but in other dimensions of international affairs as well. This new vision does not split the difference between these two views; rather, it recognizes that the vision of trade as war is profoundly wrong. Trade is not a zero-sum game. It does not merely create a winner for every loser: *all* countries can gain. As America's trading partners grow, they buy more U.S. goods and services. As the U.S. economy grows, we buy more of theirs, so that trade can play a catalytic role in a virtuous cycle of ever-higher levels of growth and living standards. The opposite is also true: attempts by many countries in the 1930s to escape from the Great Depression by pursuing beggar-thy-neighbor policies only made everyone worse off.

Defenders of free trade can do it a disservice by promoting it as a way to create more jobs or to reduce bilateral trade deficits. Jobs, the unemployment rate, and the overall balance of payments are ultimately a consequence of macroeconomic policies, not of trade barriers. The real objective of free trade is to raise living standards by ensuring that more Americans are working in areas where the United States is comparatively more productive than its trading partners. In a full-employment economy, trade has more impact on the *distribution* of jobs than on the *quantity* of jobs.

The new philosophy recognizes that unfettered global markets are not, by themselves, sufficient. Markets function best within an institutional environment that makes rules to promote free competition while facilitating the cooperation necessary for a stable

world economy. What is required is general understanding of the issues and difficulties in international trade and mutual commitments, of the kind embodied in the General Agreement on Tariffs and Trade and the World Trade Organization (WTO), not to allow the pleadings of special interests to interfere with the gains that all enjoy from free international trade.

The new philosophy also recognizes that just as domestic public goods will be underprovided by free markets at home, so a decentralized trading system is insufficient to supply public goods that benefit people around the globe. An important example of an international public good is economic cooperation, including that essential to maintaining free trade. Basic research and a clean environment are other examples of international public goods in which cooperation can provide benefits to the United States, while also helping other countries. In making these international public goods available, we need to combine competition in the international marketplace with cooperation in establishing the rules of the game.

THE ECONOMIC RECORD

In 1992, against a backdrop of an uncertain and jobless recovery and rising budget deficits, the then-Governor of Arkansas, campaigning for President, set two basic goals for economic performance in his first term: to establish an economic environment in which more than 8 million jobs would be created, and to cut the Federal budget deficit in half. Both these goals have been surpassed.

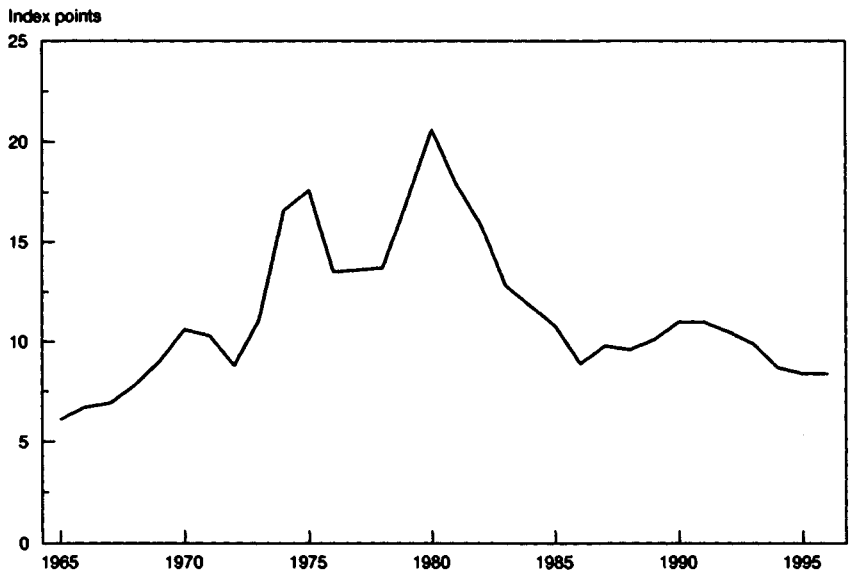
THE ACHIEVEMENTS

In 1992 the national unemployment rate averaged 7.5 percent. Almost 10 million people were looking for work. Over the last 4 years the unemployment rate has come down to 5.4 percent. Not only has the economy created more than 11 million new jobs, over 3 million more than promised, but the new jobs are mostly good jobs: two-thirds of recent employment growth has been in industry/occupation groups paying wages above the median.

Meanwhile underlying inflationary pressures have subsided. In 1992, inflation as measured by the core consumer price index (the core CPI excludes the volatile food and energy components) was 3.7 percent. In 1996 core inflation was only 2.7 percent. The combination of low unemployment and stable inflation has given the United States the lowest "misery index" since the 1960s (Chart 1–1). Some of the key factors contributing to the economy's increased ability to maintain both stable prices and low unemployment are analyzed in Chapter 2. Among the important ingredients are increasing competition and greater openness to the rest of the world economy.

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 initiative to reinvent government has slowed the growth of the public sector. Private sector demand, by contrast, has grown at a 3.2 percent annual rate since the beginning of this Administration, up from 2.4 percent over the previous 12 years. It is particularly heartening to note that investment and exports have led the expansion. Investment is booming: real spending on producers' durable equipment has grown a stunning 11 percent per year since 1993. 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. The second-strongest component of growth has been exports, which have increased by 7 percent per year since this Administration took office.

Chart 1-1 **The "Misery Index"**
The combination of a low unemployment rate and stable inflation has produced the lowest "misery index" since the 1960s.



Note: The "misery index" is the sum of the unemployment rate and CPI inflation.
Source: Council of Economic Advisers based on Department of Labor data.

Just as important as today's conjuncture of growth, unemployment, and inflation is the question of whether the economy can continue to grow, with low unemployment and stable inflation. In terms of sustainability and sound fundamentals, this expansion is

one of the strongest in recent memory. In contrast, much of the growth of the 1980s and early 1990s was fueled by large deficits and a quadrupling of the national debt. This path of growth fueled by government spending could not have continued indefinitely. No less important, over that period changes in the tax system created perverse incentives that led to overbuilding of commercial real estate and high vacancy rates. Although investment rates were high, much of this investment did not enhance the long-run productive potential of the economy. Another factor that bodes well for this expansion to continue is the health of the financial system, which has finally recovered from the debacle of the late 1980s, caused in part by lax regulatory oversight.

Not only has the economy grown rapidly and sustainably, but the fruits of that growth have begun to be shared more equitably. 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. Median real household income rose 2.7 percent in 1995—and more if, as some believe, the CPI has been overstating actual inflation. Chapter 5 provides more details on trends in household income and the factors that may account for the recent decrease in inequality, which appears to be larger than the normal cyclical improvement.

THE REASONS

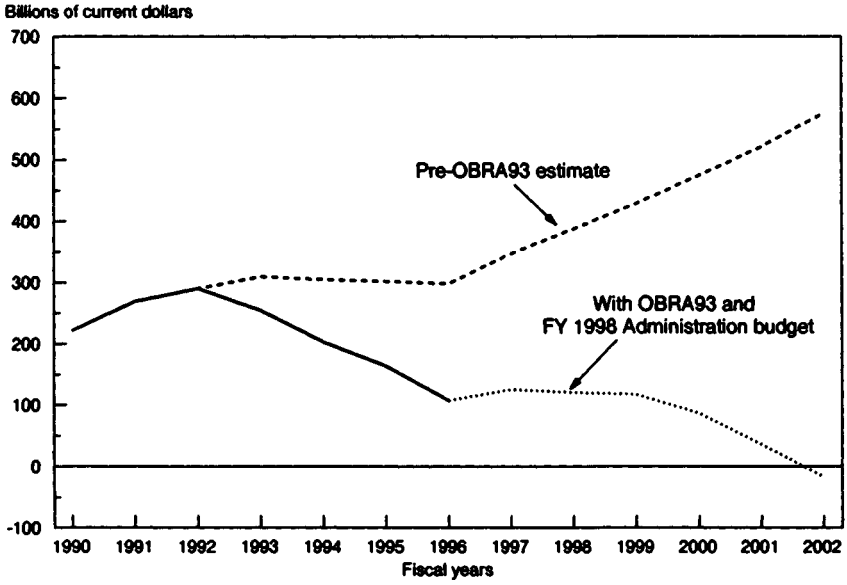
Since 1993 this Administration has developed a comprehensive agenda that has contributed to the Nation's current economic health and strength. The key elements of this agenda are reducing the deficit, opening markets at home and abroad, and restoring prudence to macroeconomic management.

Reducing the Deficit

The Administration's most important economic policy accomplishment has been a substantial reduction in the Federal budget deficit. Since the 1992 fiscal year the deficit has been cut, not just in half as the President promised, but by 63 percent—from $290 billion in 1992 to $107 billion in fiscal 1996 (Chart 1–2). As a share of gross domestic product (GDP), the deficit has fallen over the same period from 4.7 percent to 1.4 percent—its lowest level in more than 20 years. In 1992 the U.S. general-government deficit (the combined deficit for all levels of government) was larger in relation to the economy than the deficits of Japan or Germany were

to theirs; today it is a smaller fraction of GDP than in any other major industrialized economy.

Chart 1-2 **Federal Budget Deficit**
Since fiscal year 1992, the Federal budget deficit has been cut by 63 percent.



Source: Office of Management and Budget.

The dramatic decline in the deficit over the past 4 years is the result of many factors. By far the most important are the fiscal policy changes adopted in the Omnibus Budget Reconciliation Act of 1993 (OBRA93) and the stronger economic performance to which it contributed. Under the policies in place when this Administration took office, the 1996 deficit was projected to rise to $298 billion, even though the projection assumed 5 years of robust expansion.

Lower spending and increased revenues resulting from OBRA93 and subsequent legislation were responsible for more than $100 billion of deficit reduction in the fiscal year that ended in September 1996. The remaining budget savings are due to a combination of higher-than-expected tax revenues and lower-than-expected spending, which resulted from the stronger economy and a variety of technical factors unrelated to legislative changes. Many of these economic and technical factors are also the product, although less directly, of the Administration's policies—including the policy of deficit reduction itself. Even though the Administration felt confident that its policies would significantly improve the economy, it continued to use conservative forecasts for budgetary purposes:

growth in every year of this Administration has turned out to exceed these budgetary forecasts.

It is difficult to say with confidence what would have happened had the Administration not put deficit reduction at the top of its economic agenda and pushed through OBRA93. A controlled experiment on the entire macroeconomy is obviously impossible, but a simple analysis can provide some insights. We can say, first of all, that if deficits had continued at the levels projected in 1992, the Federal debt today would be half a trillion dollars higher than the $3.7 trillion currently held by the public. With so much more accumulated debt, and with higher deficits continuing, interest rates would certainly be higher than they are today. The more restrained fiscal policy helped create conditions that enabled the Federal Reserve to maintain a more expansionary stance—that is, lower short-term interest rates—than it might have otherwise. It is hard to imagine that the rapid expansion of investment in producers' durable equipment that has supported this expansion could have happened in an environment of higher interest rates.

The effect of deficit reduction on business confidence has been less tangible, but no less important. Business confidence was weak in 1992: business leaders felt genuine concern about the mounting deficits and the political system's evident inability to address the underlying issues. Such anxieties are bad for investment. After 12 years of budgetary excess, however, this government has finally showed that it can bring its own finances under control. But confidence is something that has to be continually renewed. That is why this Administration is committed to continuing to reduce the deficit to zero.

In short, had the Administration not put deficit reduction at the top of its economic agenda, the Nation's debt would surely be much larger, and its economic future bleaker, than they are today. And it is unlikely that the economy would have experienced as healthy an expansion as it has.

Opening Markets at Home

Another 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. In reforming electricity and telecommunications regulation, the Administration's belief was that the proper regulatory structure would enhance competition, which would lead to valuable new services and lower prices. Recent financial reforms have provided greater incentives for competition and innovation, in ways that have reduced the overall cost of regulation to both the government and the banking sector itself while preserving and enhancing the safety and soundness of the Nation's banks. 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. Tradable permits for sulfur dioxide emissions are a prime example. The full import of these and other regulatory changes will not be felt for years to come.

Opening Markets Abroad

The third element of the Administration's economic policy has been an aggressive effort to increase exports through the opening of markets abroad. Two major trade agreements—the North American Free Trade Agreement (NAFTA) and the Uruguay Round accord of the General Agreement on Tariffs and Trade, which established the World Trade Organization—were enacted during the President's first term. 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. The United States will certainly gain, both as a major exporter of information technology and as an importer, as American industries take advantage of new foreign technologies that will lower their costs and increase their productivity. In addition, the value of NAFTA to U.S. exports was proved during Mexico's 1995 financial crisis. Despite Mexico's sharp economic contraction, NAFTA ensured that Mexico kept its markets open to U.S. products, in sharp contrast to the restrictive policies that had followed Mexico's 1982 financial crisis. As a result, U.S. exports were maintained, and by 1996 they had risen to new records. Mexico also benefited because NAFTA prevented any potential recourse to insular and protectionist policies; partly as a result, by the second half of 1995 the Mexican economy had started to recover.

Two other major regional groupings—our Pacific Rim trading partners in the Asia-Pacific Economic Cooperation forum and our Western Hemisphere neighbors engaged in talks toward a Free Trade Area of the Americas—have made commitments toward free trade among their members by 2020 and 2005, respectively. More than 200 other trade agreements have been completed since the beginning of this Administration.

As already noted, U.S. exports have boomed, especially in those areas where trade agreements have been reached. Increased trade allows the United States—and its trading partners—to exploit comparative advantage. These gains from trade are reflected in the fact that wages in jobs supported by goods exports are 13 to 16 percent higher than the national average. Some critics suggest that the growth in exports was simply a matter of exchange rates tilting in favor of the United States. Over the last 4 years, however, the trade-weighted exchange rate of the dollar (a standard measure of exchange rates with all of the United States' principal trading partners) changed by only about 2 percent.

Restoring Confidence in Economic Policymaking

Americans now have more confidence in their government's handling of the economy. Polls show that more Americans rated the conduct of economic policy favorably in November 1996 than at any time in the previous decade. This vote of confidence was the result of a number of factors. First, the government was putting into practice an economic philosophy that not only seemed to be working, but was in accord with the country's basic values. That economic philosophy, as enunciated above, understands both that neither the market nor the government can correct all the shortcomings in American society. Government has a place, but government has to know its place. The initiatives outlined above—from getting the deficit under control to securing the long-overdue passage of a new telecommunications bill—were proof that this philosophy could work.

Not only was the substance of economic policy viewed as a success; so was the process of policy development. The establishment of a National Economic Council (NEC) to oversee that process ensured that the economy would get the same attention within the White House that foreign affairs had gotten since the National Security Council was established nearly 50 years earlier. The NEC has effectively coordinated the inputs of the many Federal agencies, to ensure that the President receives the best options and advice, without setting agency against agency in wasteful internal turf battles. Also, the public differences between the Federal Reserve and the executive branch that had sometimes characterized earlier Administrations were replaced with a respect for the central bank's independence.

THE ECONOMIC AGENDA

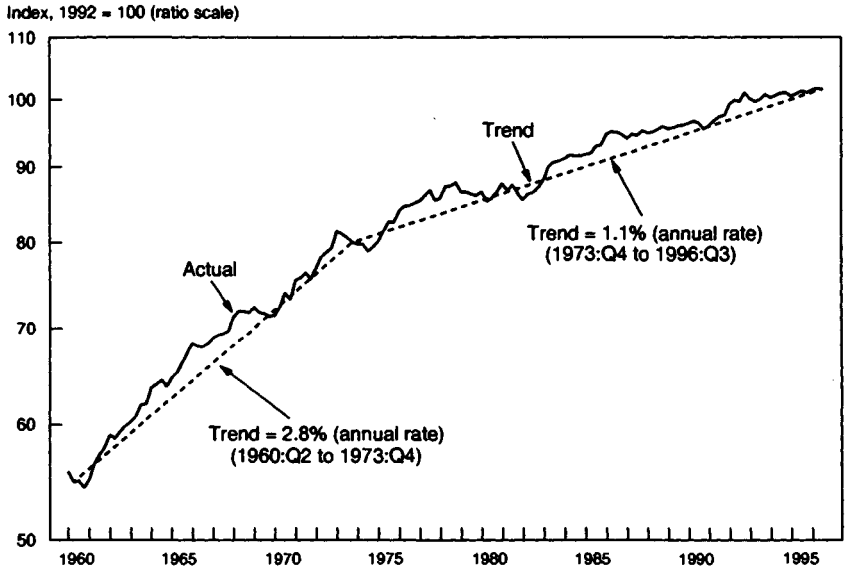
The United States still faces major economic challenges. American technology, the economy, and society are all changing rapidly. Instead of ignoring or lamenting these changes, the Nation must embrace them, transforming problems into opportunities. We can do this only if we set a coherent economic agenda. This Administration has already accomplished much with the policies of the last 4 years. In the next 4 years the Administration will continue to build on those policies, holding fast to its new vision of the government's role in the economy as the basis for an agenda to promote growth, opportunity, and responsibility.

GROWTH

Productivity growth has been slow since the early 1970s. Since 1973, annual rises in productivity in nonfarm businesses have averaged 1.1 percent, a drastic decline from the 2.8 percent annual

average that the Nation enjoyed between 1960 and 1973 (Chart 1–3). Biases in the methods used to calculate these numbers may exaggerate the slowdown (a question taken up in Chapter 2), but something has undoubtedly happened to slow the pace at which output per hour increases (Box 1–1). Slower productivity growth has the direct consequence of retarding increases in the Nation's standard of living. It also places obstacles in the way of solving some of the Nation's other challenges. Americans may be less supportive of freer trade when trade liberalization has been associated, however spuriously, with slower growth. It will be harder to balance the budget over the long term, especially while supporting a growing aged population, when productivity growth is slow. And workers are more reluctant to share their resources with those who are worse off when they feel that their own wages are stagnant.

Chart 1-3 **Actual and Trend Labor Productivity**
Labor productivity has grown at a 1.1 percent average annual rate since 1973.



Note: Data are for the nonfarm business sector.
Source: Department of Labor.

The sources of economic growth can be grouped under three headings: increases in physical capital, improvements in human capital, and increases in the overall efficiency of the economy—the amount of output per unit of input. The Administration's economic agenda is based on strengthening each of these three pillars of economic growth.

Box 1-1.—Explaining the Productivity Slowdown

The framework that economists use to decompose growth into contributions of physical capital, human capital, and their efficiency can be used to understand the causes of the productivity slowdown. This slowdown, which began around 1973, was similar in its timing and magnitude in all the advanced industrial economies. Consequently, it cannot be explained by purely domestic factors.

Slower growth of inputs—physical capital and human capital—is not a major cause of the slowdown. The capital-labor ratio has grown a bit more slowly since 1973, but only enough to account for 0.2 percentage point of the approximately 2-percentage-point decrease in productivity growth. And the rate of increase of human capital—the education and experience of workers—has actually increased since the 1950s and 1960s. Human capital growth now accounts for not only a larger *share* of productivity growth (27 percent from 1973 to 1994, compared with 3 percent from 1960 to 1973), but a larger absolute amount as well (0.3 percentage point versus 0.1 percentage point). Policies to increase investment, education, and training, however important for other reasons, do not address the underlying causes of the slowdown.

From an accounting perspective, almost the entire slowdown is attributable to a decrease in multifactor productivity growth, that is, the efficiency with which capital and labor are used. Although the causes are murky, some insight comes from the explanation of the productivity *speedup* of the 1950s and 1960s. Some of that era's abnormally rapid productivity growth resulted from the private sector's use for civilian purposes of the burst of innovation—largely government funded—inspired by the war effort in the 1940s. Some important examples are the digital computer, other advances in electronics, and the development of nuclear energy. Thus, although we may not fully understand the causes of the slowdown, policies aimed at increased support for science and technology are obviously strong candidates to be part of the solution.

Increasing Physical Capital

The first pillar of economic growth is increases in physical capital, which enable workers to produce more goods and services. Because it reduces the government's borrowing, deficit reduction will remain the key to how much of national saving is available for private investment in physical capital. The Nation has made great

progress in bringing down the deficit in the last 4 years, but this ground will be lost unless we address the strains that some of the major entitlement programs will place on the budget over the long term. As the population ages, expenditures on Social Security are expected to grow from an estimated 4.7 percent of GDP in 1996 to around 6.4 percent in 2030, then stabilize. A much more serious challenge is posed by Medicare and Medicaid. If nothing is done to reform these programs, their outlays are projected to grow from an estimated 3.9 percent of GDP in 1996 to 13.0 percent in 2050. Their projected growth is due not just to the aging of the population, as in the case of Social Security, but also to the expectation that the volume and intensity of medical services consumed will continue their rapid rise. Chapter 3 analyzes the factors underlying these projections and some of their implications for the future of these programs.

Assuming Federal tax revenues remain at their historically constant level of around 18 percent of GDP, the projected increase in entitlements, especially Medicare and Medicaid, will have one of two effects: either it will balloon the budget deficit, or it will all but crowd out other vital government expenditures, including those necessary to sustain long-term economic growth, such as education and research and development. The deficit reduction of the last 4 years, however, has put the Nation in a position to address these long-term issues in a manner that preserves the important achievements of Medicare, Medicaid, and Social Security.

When the government runs a smaller deficit, it absorbs less private saving and frees up resources for private sector investment. But *public* investments in infrastructure, such as roads, schools, and airports, are also important. It is false economy to release funds for investment in one area by cutting back in another where the need and the return are just as great. Entrepreneurs will be reluctant to build new factories, homes, and offices if the highways and bridges that link them are inadequate for the new traffic they generate.

To be sure, government must take pains to see that every dollar it invests, like every other government dollar, is well spent. We have to think hard about how to put into place incentives that make such outcomes more likely. And we have to think carefully about which public investments should be the responsibility of the Federal Government and which the responsibility of States and localities. But fear of misdirected investment should not lead to underinvestment, because too little investment is costly to future growth. In short, we should not create an infrastructure deficit while attempting to improve the budget deficit.

Improving Human Capital

The second pillar of economic growth is improvements in what economists call human capital: the knowledge, experience, and skills of the workforce. As the economy has changed, the demands imposed on the brainpower of the American workforce have increased enormously. As Chapter 5 reveals, the returns to education, as measured by the difference in incomes between college and high school graduates, have risen sharply in the last 20 years. Much of this difference probably reflects the increasing importance of computer skills in the workplace.

Many American schools do a superb job of human capital formation, but some are failing at the task. Standardized test scores reflect only part of the learning that goes on in schools, yet the fact that American children perform less well on standard science and mathematics tests than many of their foreign counterparts is a continuing source of concern. There is no easy answer.

Recognizing the challenge that these changes pose, the President has set ambitious goals for the Nation's education system: every 8-year-old should be able to read, every 12-year-old should be able to log onto the Internet, every 18-year-old should be able to go to college, and every classroom and library in America should be linked to the Internet.

An array of policies, current and proposed, are directed toward achieving these goals. The America Reads initiative, working through the National Service program, will call on thousands of people to mobilize an army of a million volunteer tutors, dedicated to ensuring that every child in America can read by the age of 8. A good education in the early years of a child's life is necessary, but hardly sufficient to endow that child with the skills that our technological society demands. Therefore, in addition to early-education programs, we need to promote technology in the classroom and encourage young people to take more years of college.

Although the returns to additional years of education are substantial—between 5 percent and 15 percent—without government involvement many students would find it difficult to borrow for college. Not only do they lack a credit history, but they cannot borrow against expected future earnings—human capital cannot be pledged as collateral. The result is a classic market failure: markets by themselves do not provide all the education for which the benefits exceed the costs, even when the benefits are measured only in narrow economic terms. Since the G.I. Bill was passed in the 1940s, the Federal Government has had an acknowledged role in making higher education more affordable. Policies already implemented by this Administration are bringing us much closer to the day when every American who wants to will be able to attend at least 2 years of college. Under the new direct student loan pro-

gram, for example, individuals can borrow money for college directly from the Federal Government and tailor their repayments to suit their own financial circumstances. Seeking to build on the success of this program, the President has also proposed tuition tax credits, to support those seeking higher education, and penalty-free withdrawals from individual retirement accounts, to encourage them to save for it themselves.

Meanwhile the Technology and Literacy Challenge initiative is bringing advanced computer technology into every classroom in the Nation. It is making significant progress toward ensuring that all American students are computer literate, equipped with the skills they will need in the 21st century. Under this initiative, 20 percent of all the schools in California have already been wired to the Internet—a good example of government and the private sector complementing each other. The Federal Government served as entrepreneur for this initiative, but much of the work was done by 50,000 volunteers, with many of the Nation's leading high-technology firms donating equipment. The initiative also stresses the development of educational software and the training of teachers to harness the potential of these new technologies.

Other steps are important in preparing the Nation's educational system for the 21st century. Recent reports have documented the extent to which America's public schools have become dilapidated. Schools with leaky and collapsing roofs have had to be closed. Because students need a more conducive environment in which to learn, the President has proposed $5 billion in Federal funding to support a program, administered by the States, that would spend $20 billion for school construction and renovation. Additional efforts are focused on enhancing resources for those communities facing the hardest problems (e.g., those with disproportionate numbers of disadvantaged children), improving standards through the Goals 2000 program, and promoting new approaches through the charter school movement.

Education does not end with college. That is why this Administration has consistently emphasized lifelong learning and employability security, to boost economic growth and reduce the adjustment costs associated with a vibrant economy. Unfortunately, the legacy of past efforts in this sphere has left workers facing a complicated maze of dozens of government-assisted training programs, each with its own rules, regulations, and restrictions. The President has proposed replacing this complex system with a single choice-based system for adults. This system should use a market-oriented approach, relying on training vouchers or grants to empower people directly to seek the training that will help them the most.

Research and Development

The third pillar of growth is greater economic efficiency—learning to produce more output with fewer inputs. Additions to the Nation's technological arsenal through research and development are an important contributor to efficiency: private industry invests over $100 billion in research and development each year. This is a huge sum, but it may not be enough: history and economic theory suggest that, left to their own devices, private firms will not invest sufficiently in improving technology, because they themselves do not realize the full benefit therefrom. Even though the patent system encourages invention by guaranteeing that inventors retain property rights to their innovations, many very useful ideas developed in more basic scientific research cannot (and should not) be patented.

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 first Baltimore-to-Washington telegraph line, to its latest major development, the Internet. In agriculture, government-funded research provided the basis for enormous improvements in productivity that today allow less than 3 percent of the workforce to feed the entire Nation, and have made the United States one of the world's leading agricultural exporters.

Detractors of government support for research have often distorted the issue. Some have posed a false dichotomy between basic research, for which public support is almost universal, and technology, which they say should remain the province of the private sector. Yet many areas of technology have huge spillover benefits and therefore would be underprovided without government support. Critics have also accused government of trying to "pick winners"—of seeking to supplant the market at one of the things it does best. But government support of technology is not aimed at outguessing the market. Rather, it is focused on setting up partnerships and other structures to identify, together with the private sector, those areas in which large benefits to society are not likely to be produced by the market alone.

In the spirit of the Administration's new vision for the economy, the Federal Government has placed public-private partnerships at the center of its research and development policy. The Advanced Technology Program (ATP), 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 development. The record shows that the success rate of this and similar programs is indeed formidable.

Increasing Competition

Improving the efficiency of the economy is not just a matter of improving technology. How the economy is organized plays just as important a role in creating incentives for firms to use their capital and labor as efficiently as possible. If the market economy is to deliver on its promise of growth and prosperity, markets have to be competitive, because it is competition that drives firms to be efficient and innovative. Firms, however, often find it easier to increase profits by reducing competition than by improving efficiency in response to competition. Monopolies and oligopolies not only can charge inefficiently high prices and restrict output, but may also have a diminished drive to innovate.

The traditional way to increase competition is to prevent the growth of monopoly power in the first place. This Administration has restored vigor to the enforcement of the antitrust laws, blocking anticompetitive mergers and, where warranted, prosecuting alleged violators. But competition is not viable in some industries, namely, those called natural monopolies. Antitrust enforcement may be of little help in these areas; instead government regulation can help to ensure that monopoly power is not abused.

The extent and the form of competition are constantly changing. Joseph Schumpeter, one of the 20th century's great economists, described capitalism as a process of creative destruction. New industries constantly come into existence as old industries are destroyed. The late 19th and early 20th centuries saw the transformation of the economy from a mostly agricultural to a mostly industrial one. Today services and information are assuming the lead position, while at the same time demand for U.S. goods is increasingly coming from abroad. Sometimes analysts focus on manufacturing as if it still represented the core of the economy. Manufacturing is important—it is the Nation's largest investor in research and development and its leading exporter—but manufacturing employment today represents only 15 percent of total employment, and service industries also produce many of our important exports, for example in telecommunications, financial services, and other intellectual property.

Today, new technologies have expanded the scope for competition in many sectors that have historically been highly regulated, such as telecommunications and electric power. Traditional regulatory structures, however, with their rigid categories of regulation versus deregulation, and competition versus monopoly, have become increasingly unhelpful in guiding policy in these areas. These new technologies do not call for wholesale deregulation because not all parts of these industries are adequately competitive. Instead they

call for appropriate changes in regulatory structure to meet the new challenges. Such changes must recognize the existence of hybrid areas of the economy, some parts of which are more suited to competition, while others are more vulnerable to domination by a few. Market power in one part of a regulated industry cannot be allowed to maneuver itself into a stranglehold over other parts, or else economic efficiency may be severely compromised. The Administration's regulatory reforms in the telecommunications and electric power industries have attempted to achieve competitive balance.

Even as these changes have intensified competition in some parts of the economy, it remains limited in others. In particular, where goods and services are locally provided, and where transportation costs are high, consumers in some areas may have too little choice, even if providers in the country as a whole are numerous. In parts of the country, for example, a single hospital may be the only one serving a large rural area. In the health care sector, new guidelines for antitrust enforcement were recently issued in response to concerns such as these, and the Administration has resisted attempts to scale back antitrust enforcement in this area. The benefits of competition can be seen in our university system, where competition remains keen—and perhaps partly accounts for the dominant position American universities hold in the world of higher education.

Expanding Trade

The third source of increasing efficiency in the economy is more-open markets abroad. Like the freeing up of domestic markets, opening of foreign markets shifts resources into relatively more productive areas. 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.

The global economy, like the domestic economy, is evolving, and its change brings with it new challenges. A clean environment, a safe workplace, and competitive markets are important to us internationally just as they are at home. Trade liberalization can complement these goals in many ways. Anticompetitive practices abroad, for example, frequently cohabit with restrictions on trade and may forestall entry of American firms into foreign markets. Liberalizing trade in agriculture can lead to a more environmentally sound international allocation of farming activity. The side agreements to NAFTA, on which the Administration conditioned its approval of the agreement, demonstrate that safeguarding a shared environment, promoting better working conditions, and liberalizing trade are not mutually exclusive goods to be traded

off against each other. Pursuing these goals in the multilateral framework of the WTO will be increasingly important. At the same time, it is important that countries not allow domestic regulation to become a pretext for nontariff trade barriers whose real purpose is to restrict competition.

Some of the fastest-growing economies are the emerging markets of the developing world, many of them in East and Southeast Asia. To grasp fully the opportunities that these new markets offer, the United States needs to strengthen economic relations with these countries. Chapter 7 sets forth some of the principles on which these new relations will have to be built.

Improving Public Sector Efficiency

The fourth and final way to increase the overall efficiency of the economy is by improving 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 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 early 1930s (Chart 1–4).

OPPORTUNITY AND INDIVIDUAL RESPONSIBILITY

America cannot reach its full economic potential if any of its assets—including its human resources—do not live up to theirs. Just as the productivity slowdown since 1973 poses a challenge for growth, so the persistence of income inequality and the entrenchment of poverty of the past two decades make it more difficult to ensure that all Americans have the opportunity to make the most of their lives.

Americans of all incomes participated in the economic growth of the 1950s and 1960s. But in the two decades that followed, not only was overall growth slower, but these shrunken gains were reaped disproportionately by those at the top of the income distribution. As already noted, some evidence suggests that this trend may have begun to reverse itself in the past few years. Chapter 5 discusses trends in inequality and shows that an important contributing factor is the increasing wage gap between educated and uneducated workers.

Another major problem is the persistence in some areas of pockets of poverty. The nationwide poverty rate has hovered between 10 and 15 percent for the past 30 years, but the burdens of poverty

Chart 1-4 **Federal Government Employment**
The Federal workforce as a percentage of total employment was smaller in 1996 than at any time since the early 1930s.

Note: Excludes Postal Service.
Source: Department of Labor.

have been spread very unevenly throughout American society. The poverty rate for blacks fell to its lowest level in 1995, yet over 40 percent of black children still grow up in poor homes. Poverty seems particularly entrenched—with poverty rates in some cases exceeding 50 percent—in the inner cities and in certain remote rural areas. The gap between rich and poor has a variety of origins. Changes in technology inevitably confer advantages on some parts of the country more than others, and citizens and governments in some places have more effectively seized upon the opportunities offered. Vestiges of discrimination, directed at the large share of minority members in many communities, may also have played a role in the geographic entrenchment of poverty.

Government programs have had much success in reducing inequality and poverty. Government cash transfers lifted over 21 million people out of poverty in 1995, lowering the poverty rate from 21.9 percent to 13.8 percent. If the effect of all taxes, the earned income tax credit (EITC), and the valuation of noncash transfers were included, the poverty rate would be still lower, at 10.3 percent. All told, 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.

We must never allow the Nation's social safety net to become tattered, but it is also imperative to design policies in ways that will

fully integrate our lagging communities into the American economy. The Administration's approach is based on four principles: providing people with opportunities to find work, making sure they have the right incentives to avail themselves of those opportunities, strengthening communities, and easing the transition between jobs for dislocated workers. Education, discussed above in the context of economic growth, also plays an important role in enhancing opportunities.

Work Opportunity

One of the most important contributions that any Administration can make to the Nation's economy is to ensure that every American seeking work can find it. The decline in the unemployment rate from over 7 percent in 1992 to below 5½ percent in 1996 was a major step forward not only for growth, but also for opportunity. But moving welfare recipients into jobs takes more than just creating 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.

Jobs, skills, and infrastructure are all important, but discrimination and its legacy can still place obstacles in the way of some Americans. Some employers continue to deny employment or advancement on the basis of race or sex. This is illegal as well as economically irrational, and the Administration is committed to the vigorous enforcement of equal opportunity laws. But this may not be enough; affirmative action programs, based not on quotas but on principles of advancing opportunity, are also called for.

Incentives

Few individuals consciously choose a life of dependency, whether on public welfare or private charity. True, the environment into which a child is born, and the opportunities he or she is afforded, strongly influence whether that child matures into a productive member of society or becomes dependent on the state. But most economists believe that incentives also play a role in determining that outcome. When a worker earns little more from a minimum wage job than what he or she could get by going on welfare and accepting food stamps and free public housing, the incentive to work is not strong. In the past, the availability of welfare made the effective wage for many low-wage workers (i.e., the addition to income from an extra hour of work) not the advertised $4 or $5 an hour, but half of that or less.

Over the past 4 years this Administration has increased the returns to work relative to welfare in several ways. The expansion of the EITC and the recently legislated increases in the minimum

wage have together increased the return to work for low-wage workers, to the point where a full-time, year-round minimum wage worker with two children will receive more income than ever before, even after adjusting for inflation. And the reforms of the welfare system, including the imposition of work requirements and time limits on benefits, may provide further incentives.

Incentives are not only important for individuals, but need to be designed with businesses in mind as well. The President has taken the first step in reforming welfare. As important as the public sector's role in creating opportunity is, however, the private sector must also participate if welfare reform is to result in better lives for those who have depended on support in the past. This Administration challenges the private sector to work with government to help welfare recipients move into the mainstream of work and opportunity. The welfare-to-work tax credit proposed by the President last summer is one example of how the government can help create the incentive for businesses to hire long-term welfare recipients.

Community

Many of the themes of this Administration's economic strategy are drawn together in policies that work not just with and for individuals, but with and for the communities in which they live. Part of any sensible economic strategy for reducing poverty involves concentrating on those areas where, as already noted, poverty is most entrenched. The Federal Government, however, cannot and should not be solely responsible for revitalizing these communities; rather, the most effective strategy is to provide local communities with the resources and tools they need to realize their full potential.

The Empowerment Zone/Enterprise Community initiative incorporates an entirely new approach to community revitalization. Rather than imposing restrictive Federal mandates on America's distressed central cities and rural areas, this effort begins from the premise that local residents know best how to solve their communities' problems. To be considered for an Empowerment Zone or Enterprise Community designation, communities have to meet eligibility criteria, be nominated by their State or local government, and submit a strategic plan that describes the community's vision for its future. This competition for designation provides an incentive for community leaders to develop innovative strategies to address their problems. The designated communities are then provided with access to a combination of flexible grants, tax incentives, and special assistance in removing bureaucratic red tape.

The Administration plans to expand the Empowerment Zone/Enterprise Community initiative. The Community Empowerment Act, which was introduced in the 104th Congress, embodies the Administration's proposal for a second round of zones and communities. This act would designate an additional 20 zones and 80 commu-

nities to receive, over 3 years, $1 billion in tax incentives and $1 billion in discretionary funds. The Administration will work with the 105th Congress in securing passage of this extension.

Dislocated Workers

It is a subject of some debate whether the pace of change today is such that individuals are more likely than in the past to lose their jobs. Chapter 4 discusses both the evidence concerning changes in the incidence of job dislocation and its economic consequences. But even if the risk of job loss is no greater than in the recent past, dislocation is still hard on workers and their families. The market does not provide insurance against job loss, which is understandably a source of anxiety for workers. Economists generally endorse the virtues of Schumpeter's creative destruction. But for individual workers and their families the costs of a changing economy are far more apparent than the broader benefits to society from an economy that is better able to adapt to changing technology and markets.

In a variety of ways, government can help individuals make the transition between jobs, and in the process help make the economy more supple, able to respond quickly to changes in markets and technology. Unemployment insurance has long been the most important system of support for dislocated workers. This Administration considers it one of its special responsibilities to help those in transition between jobs. One of the harshest ironies of an economy in which employers provide most health insurance is the fact workers typically lose their health benefits when they lose their jobs—precisely the time when they can least afford to purchase health insurance on their own. 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 new jobs through job retraining programs and "one-stop shopping" career centers to cushion and facilitate the transition for those hurt by economic change. Finally, the Administration has worked 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.

CONCLUSION

The American economy is dynamic. This Administration's economic philosophy recognizes that American workers and enter-

prises, interacting through markets, are the source of that dynamism. The strength of this economy is its ability to adapt to change; at the same time, its dynamism sets further change in motion, ultimately enriching the lives and raising the living standards of all Americans.

Government has a limited but essential role in maintaining this dynamism. It creates an economic climate in which individuals and firms can flourish. It promotes competition. It seeks to ensure that all individuals have an opportunity to make the most of their talents. It protects our environment, our health, and our safety. This government's focus embodies elements both of continuity and of change. Many of its basic economic duties—such as enforcing property rights, maintaining a stable currency, and granting patents—are enduring, and the government's role in them is well established. As important as these areas are, this *Report* focuses on those other areas where the government's role is being, and needs to be, redefined.

Government must both adapt to and foster change. The past 4 years have demonstrated that the Federal Government is up to this challenge. And the private sector has more than amply demonstrated that it, too, can fulfill its part in this ever-evolving partnership.

The process is never-ending. Most of the challenges the Nation faces have deep roots in the past. Just as the productivity slowdown and the increase in inequality have no single, simple cause, neither do they have any single, simple solution. No magic policy wand can transport us back to the income distribution or the productivity growth America enjoyed in the 1960s. It takes time to respond effectively to, and even more time to reverse, trends that have been two decades in the making. To take just one example among myriad: the purely economic benefits of Head Start take 15 years or more to ripen—the time it takes for a Head Start child to grow up and join the labor force.

Our assessment of the success of government programs must therefore go beyond their impact on this year's or next year's GDP. Success will be measured by the kinds of lives that all Americans will live in the future. That success will be enhanced by the legacies we leave: not only investments in people, in the tools of production, and in technology that will increase our productivity, but also a philosophy of markets and of government that will guide us in the difficult choices we must make as we reach out toward the 21st century and beyond.