CHAPTER 1

Economic Policy for the 21st Century

The American economy has performed exceptionally well over the past 3 years. The combined rate of unemployment and inflation fell to its lowest level since 1968. Productivity in the manufacturing sector has increased by an average of 4 percent per year. Investment has soared, laying the basis for increased productivity in the future, while exports have boomed: equipment investment and merchandise exports both have climbed more than 25 percent since the beginning of 1993. Yet despite these encouraging developments, many Americans remain concerned about the state of their own economic affairs. Their dissatisfaction reminds us of the many challenges that remain.

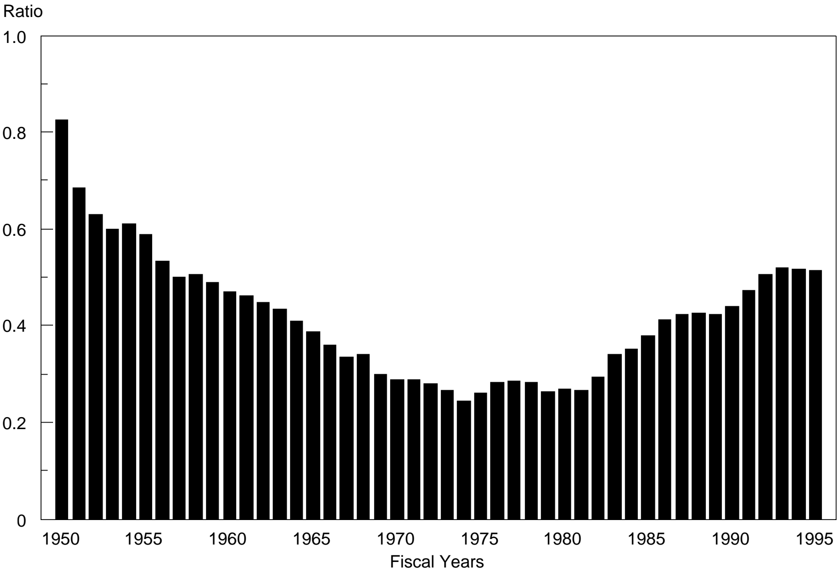
In 1992, more than 9 million Americans were unemployed, and the unemployment rate was above 7 percent. In parts of the country, such as California, nearly one-tenth of the labor force was without a job. By late 1995, however, the unemployment rate had dropped to 5.6 percent, and the economy was poised to reach the target the Administration had set for it: 8 million new jobs in 4 years.

Before the Administration could move ahead with its own positive economic agenda (which this *Report* describes), it had to address some of the economic problems it had inherited. The economy suffered from multiple infirmities—a weakened banking system, increasing poverty, and lackluster overall performance—but the most visible problem was the soaring budget deficit. The first step required to set the economy on the right course was to reduce the Federal budget deficit. By cutting the Federal Government's borrowing needs, deficit reduction has contributed to lower interest rates for businesses and consumers, thereby spurring investment and growth.

The Omnibus Budget Reconciliation Act of 1993 (OBRA93), which embodied the President's deficit reduction plan, put the country solidly on the road to fiscal responsibility. For over three decades the country had been gradually reducing the burden of the debt that had financed victory in World War II: the ratio of debt to gross domestic product (GDP) fell from 82 percent in 1950 to 27 percent in 1980. Within 12 years much of this progress was lost,

and the debt to GDP ratio soared to 50 percent by 1992 (Chart 1–1). Following passage of OBRA93, the debt to GDP ratio has stabilized.

Chart 1-1 **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.

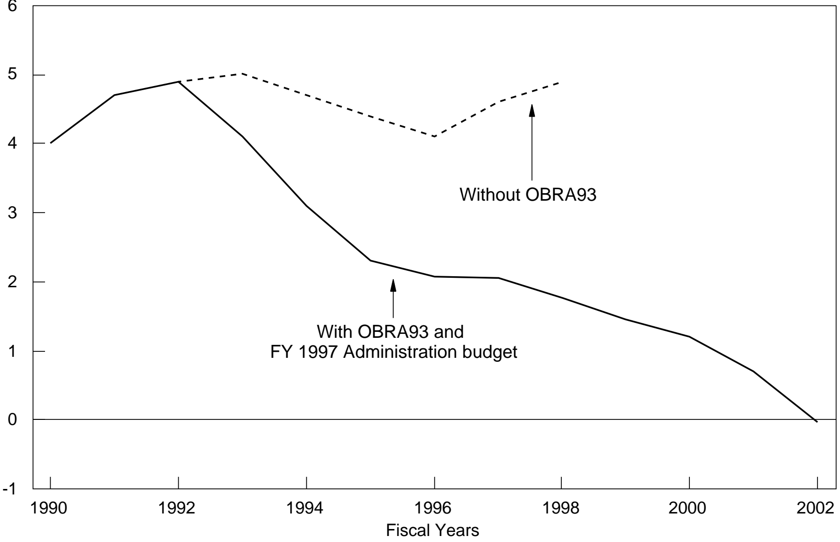


Note: The GDP measure used is pre-January 1996 benchmark revision.
Source: Office of Management and Budget.

Since OBRA93, the deficit has been cut nearly in half, from $290 billion in fiscal 1992 to $164 billion in fiscal 1995. The drop is even more dramatic when compared with the deficits that would have occurred without OBRA93 (Chart 1–2). The deficit has been reduced in dollar terms for 3 consecutive years for the first time since the Truman Administration. The decline in the deficit as a percentage of national output has been particularly striking: at 2.3 percent of GDP, the fiscal 1995 deficit is the lowest since fiscal 1979 and less than half the fiscal 1992 level of 4.9 percent. The Federal Government is now running a primary budget surplus: in other words, were it not for the interest payments on the inherited debt, there would be no deficit. And the general government deficit is now a smaller percentage of GDP than in any of the other major industrial economies (Chart 1–3).

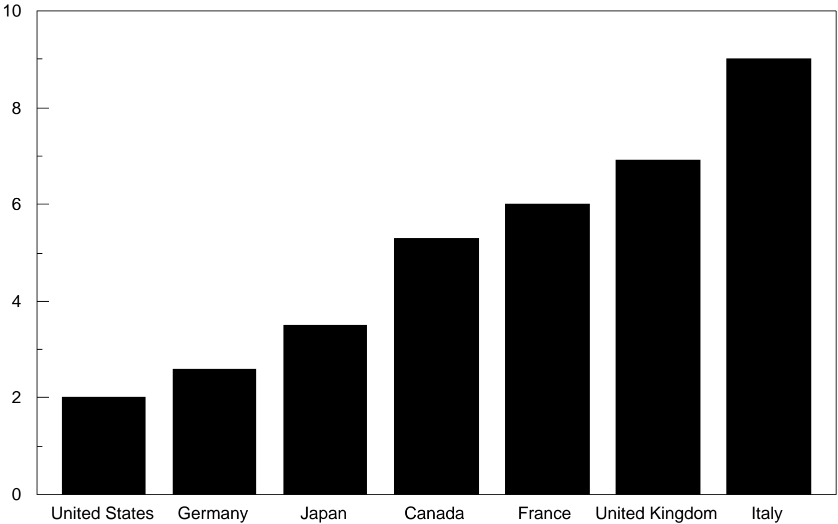
This restoration of fiscal responsibility, achieved without sacrificing crucial investments in our Nation's human, physical, and natural resources, provided the background for the current bipartisan resolve to eliminate the deficit within 7 years. A later section of this chapter discusses the right way and the wrong way to elimi-

Chart 1-2 **Federal Budget Deficit**
Budget deficits would have remained large relative to the size of the economy without deficit reduction initiatives. Instead, deficits have fallen sharply.



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

Chart 1-3 **General Government Deficits of the Group of Seven Countries in 1994**
The United States has the lowest general government deficit-to-GDP ratio of any major industrialized country.



Note: General government includes Federal, State and local.
Source: Organization for Economic Cooperation and Development.

nate the deficit, and Chapter 2 of this *Report* examines budgetary issues in more detail.

ECONOMIC CHALLENGES

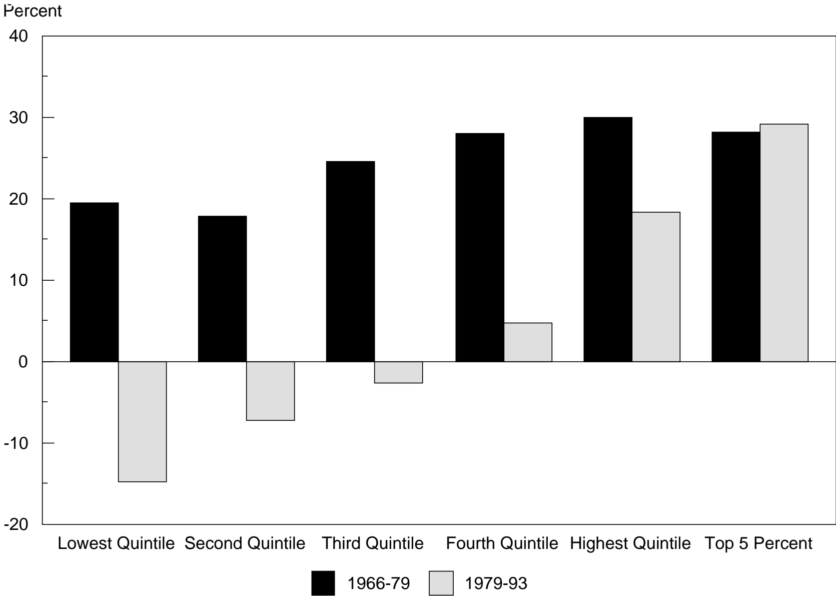
The economy's recent performance notwithstanding, pressing challenges remain. In the short run, as discussed in Chapter 2, the principal economic challenge is to maintain full employment with low inflation. In the long run, the two paramount challenges are to increase productivity growth and to ensure that all Americans share in the benefits of a stronger economy. Since 1973, productivity growth has been relatively sluggish: its pace in the economy as a whole is significantly slower than it was during the two and a half decades immediately following World War II. Output per hour grew by an average of 2.9 percent per year between 1960 and 1973, but has grown by only 1.1 percent per year since then. The cumulative impact of this productivity shortfall, compounded over decades, is dramatic: output per hour would be over 40 percent higher today if the pre–1973 rate of productivity growth had been maintained. Slower productivity growth since 1973 has resulted in stagnating real wages. Because of the difficulties in measurement, the extent of the weakness in wages may be overstated, but concern over slow wage growth is genuine and cannot be ignored.

Some evidence suggests that the tide may now be turning. In 1994 real median family income rose for the first time since 1989. But a 20-year trend cannot be corrected in one year. Indeed, even with the 1994 improvement, real median family income was just 2.5 percent above its 1973 level. More needs to be done. The Administration's economic policies are intended to boost growth and living standards well into the 21st century.

The negative effects of slower productivity growth have been sharpened for low-income Americans by a marked increase in income inequality. Between 1966 and 1979 Americans all across the income distribution enjoyed the benefits of economy-wide growth in real incomes: families in the poorest fifth of the population saw their real incomes grow by 20 percent, while families in the top fifth experienced real income growth of 28 percent. But since 1979 family incomes have grown apart. Between 1979 and 1993 real family incomes in the bottom fifth *fell* by 15 percent, while the incomes of the top fifth rose by 18 percent (Chart 1–4).

It is too soon to tell for sure, but we may be beginning to succeed in sharing the benefits of growth and reducing poverty. The poverty rate, for example, fell in 1994 for the first time in 5 years. But we must do more to reduce inequality and poverty: despite an improvement in 1994, over one-fifth of American children still live in poverty.

Chart 1-4 **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.

PRINCIPLES FOR RAISING LIVING STANDARDS

The Administration's economic policies address the twin problems of slow productivity growth and rising income inequality. Three principles guide the Administration's efforts to solve these long-run problems: *embracing change, creating opportunity,* and *promoting personal responsibility.* These principles reflect core American values, and as such they provide the basis for a national consensus for addressing our economic challenges.

Putting this consensus into practice requires a variety of partnerships—between workers and firms, between the public and the private sector, between individuals and their communities, and between the Federal Government and State and local governments. Competition is the driving force of a market economy, but companies compete more effectively when workers and managers cooperate. The public and private sectors can cooperate in solving environmental problems and in meeting skill shortages. And the Federal Government can work with the States to meet the need for infrastructure investment and a social safety net.

Much of the current debate over the economy and the budget stems from different conceptions of the roles that markets, governments, and individuals should play in improving our society. Private enterprise lies at the very heart of our modern economy. Indi-

viduals and corporations provide the initiative and innovation that have enabled the market economy to bring unrivaled prosperity to our Nation, and the underlying dynamism of markets is fundamental to continued improvements in living standards.

Yet unfettered markets occasionally fail to yield desirable outcomes or to meet important national objectives. For example, in a completely unregulated marketplace, firms may produce too much of some "goods," such as pollution, and too little of others, such as basic research and development. This failure to produce the "right" amounts of certain goods and services is due to the presence of *externalities*. Externalities arise when the actions of one firm or individual produce costs or benefits for others without that firm or individual being charged for the costs or compensated for the benefits. In such cases the government has a special role. The government has an obligation to perform that role as efficiently as possible, minimizing the burden on the economy and the intrusions in the lives of its citizens. Not every market "problem" calls for government action. In order to raise living standards, government actions therefore must meet two criteria: they must address some serious imperfection in the private marketplace, and they must be designed so that their benefits outweigh their costs.

A variety of government programs have proved extremely successful in raising living standards. We take for granted many of the government services—such as retirement and disability benefits (Social Security), health insurance for the aged (Medicare), and unemployment insurance—that the market had failed to provide (Box 1–1). Before Medicare was enacted in the 1960s, for example, many elderly Americans lacked health insurance, whereas today almost all have it.

Medicare is a good example of a government program that filled a gap in the range of services provided by the private sector. But government programs can and do go awry. Indeed, government is sometimes part of the problem, not part of the solution. For example, the construction of high-density public housing projects may have contributed to some of the problems facing America's inner cities. Chapter 4 of this *Report* describes some of the efforts the Administration has made to make government work better, while Chapter 5 examines the role of policy in making markets work better.

In sum, government has a place, but government must know its place. We now turn to exploring what government's place should be with regard to the three principles enunciated above: embracing change, creating opportunity, and promoting personal responsibility.

Box 1–1.—Programs That Raise Living Standards

Many public sector programs have been extremely successful in improving living standards:

- *Social Security*. The Social Security system, created in 1935, provides monthly benefits to retired workers and their dependents and to survivors of insured workers. The program has dramatically reduced old-age poverty: only 12 percent of elderly Americans now live in poverty, down from almost 30 percent in 1966. The Social Security Administration is also remarkably businesslike. A leading financial news publisher recently ranked the quality of the agency's telephone customer service above those of several private companies renowned for their excellent customer service. And administrative costs only amount to about 1 percent of Social Security outlays.
- *The G.I. bill*. The first G.I. bill of rights, signed by President Franklin D. Roosevelt on June 22, 1944, transformed American society. It provided education benefits for all honorably discharged World War II veterans who had served at least 90 days during the war. Almost 8 million received education benefits under the first G.I. bill; more than 10 million veterans have received benefits under its extensions. The G.I. bill also provided loan guarantees for veterans to buy a home or a farm.
- *Student grants and loans*. The government provides various forms of financial assistance to students. Pell grants provide aid to financially needy students for educational costs at participating postsecondary institutions. Under the Perkins loan program, the Federal Government contributes the capital for qualifying institutions to make long-term, low-interest loans to needy students. Under the Stafford loan program, commercial loans to students are backed by the government. And the new direct lending program for college students is designed to provide educational finance in a less costly, less cumbersome fashion. Under the program, the government provides loans to students directly, rather than guaranteeing loans from financial intermediaries, and offers a variety of repayment schemes (including a new option to link repayments to students' incomes). Chapter 7 discusses the role of government in education.

EMBRACING CHANGE

Our continued prosperity and well-being depend on our embracing, not retreating from, the constant succession of new opportunities and challenges of an ever-changing world. During the past few years American firms have been through a technological revolution. 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. U.S. computer firms continue to lead the industry at a breakneck pace of technical innovation, of which the explosive growth of the Internet and the increasing popularity of the World Wide Web are merely the newest manifestations. When firms and workers embrace change as these 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 average living standards, not everyone is 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 reemployment at much lower wages. Estimates suggest that about one-third of full-time workers who lose their jobs and are subsequently rehired at another full-time job take a pay cut of 20 percent or more. By providing retraining, and by establishing one-stop career development centers where workers can find out about both training and job opportunities, the government can increase the efficiency of the economy even as it reduces the burden on those who otherwise would be harmed by economic change.

This Administration has actively promoted change, by opening up markets here and abroad, by sponsoring research and development, by devising tax policies to stimulate the growth of new enterprises, and by easing the burden of government regulation. Critics sometimes claim that open trade and investment harm the economy. But as Chapter 8 of this *Report* argues, outward-looking trade and investment policies remain the best choice for America. They boost living standards by encouraging firms to innovate and become more competitive, by stimulating the flow of ideas across national borders, and by providing a wider variety of goods—at lower prices—to consumers and firms.

This Administration has not only promoted change for others—the workers and firms affected by its policies—but has embraced it in its own practices. The Administration recognizes that what the Federal Government does, and how it does it, is sometimes the result of a seemingly haphazard accumulation of functions rather than a coherent, concerted response to a present need. Programs inaugurated yesterday with great optimism in response to yester-

day's exigencies too often survive long after their usefulness has passed. In an era of difficult budget choices, those programs that have outlived their purpose, or whose benefits no longer justify their costs, have to be cut back or eliminated to make room for programs that may be needed for success in the 21st century. Efforts to reinvent government over the past 3 years are explored in more detail below.

CREATING OPPORTUNITY

The Administration is committed to extending opportunity to all Americans. Opportunity means allowing each individual to live up to his or her full potential, and ensuring that those who suffer temporary setbacks have a chance to bounce back. The commitment to opportunity is not only a fundamental American value; it is also necessary for achieving faster growth rates and higher standards of living.

Education and training are essential tools for expanding opportunity. Educational opportunities must be available at all stages of a person's life: from the preschool years through high school or college, and continuing through one's career. But these opportunities are not universally available. Children from low-income families, for example, do not enter formal schooling with the same readiness as their more economically advantaged peers—a disparity that Head Start (a government program that provides a range of preschool services to young children and their families) helps redress. And the difficulties involved in borrowing against future income highlight the importance of government student loan programs. Although college is an investment that usually pays high returns to the student and to society, private lenders view these loans without collateral as simply too risky. Chapter 7 of this *Report* examines the government's role in the student loan market.

Opportunity entails more than just education and training: having learned the requisite skills, Americans should have the opportunity to obtain jobs. During the Great Depression, when the unemployment rate soared to over 25 percent, our economy failed to offer the opportunity to work to millions of Americans, unemployed through no fault of their own. The Employment Act of 1946 committed the government to combating unemployment. The act declared that "it is the continuing policy and responsibility of the Federal Government to use all practicable means . . . to foster and promote . . . conditions under which there will be afforded useful employment opportunities, including self-employment, for those able, willing, and seeking to work. . . ." The Administration's macroeconomic policies, described in Chapter 2, have provided opportunity to millions of Americans by fostering job growth and reducing unemployment.

Opportunity in the labor market requires much more than active education, training, and macroeconomic policies. It also requires policies that make work pay for low-skilled workers and eliminate labor market discrimination for all. Today a full-time, year-round minimum wage worker with a family does not earn enough to stay out of poverty. To help these low-income working Americans and their families, in 1993 the President and the Congress expanded the Earned Income Tax Credit (EITC), and the President has since proposed an increase in the minimum wage from $4.25 to $5.15 an hour.

All forms of discrimination contradict a fundamental tenet of American society: that every American should have a fair chance to succeed. Our Nation has made tremendous strides in reducing discrimination, but the job is not finished. "Audit" studies, in which white and minority job seekers are given similar resumes and sent to the same sets of firms for interviews, indicate that discrimination remains a problem in the labor market. Our civil rights statutes and affirmative action programs combat such discrimination and seek to ensure equal opportunity, and the Administration is fully committed to promoting opportunities in employment, education, and government contracting for Americans subject to discrimination or its lingering effects.

Finally, opportunity also means that those who suffer temporary setbacks have the ability to put themselves back on the right track. The EITC can help, and it does more than help those who directly benefit: it also provides an enhanced sense of security to the millions of other Americans who know they might need assistance at some time in their careers.

PROMOTING PERSONAL RESPONSIBILITY

It is each individual's responsibility to make use of the opportunities that society offers, and not to abuse the protections that society affords. The Administration is firmly committed to designing policies and programs to bolster personal responsibility. But ultimately it is up to each and every American to assume responsibility for his or her own life.

Policies must encourage people to assume responsibility for their own lives, not discourage them from it. And policies intended to address other challenges—for example, ensuring equity—must be carefully designed to minimize any adverse impact on individual incentives. A number of government programs provide, or can be thought of as providing, insurance. Yet a problem common to all types of insurance is *moral hazard*: having the insurance makes the insured-against event more likely to occur. For example, fire insurance reduces the incentives for homeowners to take precautions against fire, and thus may make fires more likely. In the policies

they write, private insurance companies include mechanisms, such as deductibles and copayment provisions, aimed at minimizing moral hazard. Similarly, government programs that compensate for misfortune—such as employment and disability insurance, and welfare programs—must be designed so as to promote responsibility, minimize adverse incentive effects, and diminish moral hazard, including dependence on government programs.

In summary, an appropriate role for policy—an effective partnership between the public and the private sector—is crucial to raising living standards. Markets are the engine of prosperity, but sometimes government must help markets to work more efficiently.

THE ADMINISTRATION'S ECONOMIC POLICIES

Embracing change, creating opportunity, and promoting personal responsibility—these principles are a common thread running through the Administration's economic policies. Those policies are intended to bolster, not replace, the underlying strength of markets in building a better society and raising living standards. Raising living standards entails more than just raising incomes; it also includes providing educational opportunities for our children, protecting the environment, and supplying security against devastating adversity. The Administration's economic policies include expanding markets; investing in human, physical, and technological capital; making government more efficient; and reducing the budget deficit.

EXPANDING MARKETS

Promoting Competition

Competition is the driving force of efficiency and innovation. But as we all know, life is often more comfortable with less rather than more competition. Over 200 years ago, Adam Smith recognized that, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices." It is all too easy to advocate competition for others while seeking protection from competition for oneself. Such protection is often rationalized by claims of "unfair" competition. Economists have long criticized such self-serving arguments and have advocated strong antitrust laws to secure the advantages of effective competition: lower prices, greater efficiency, increased output, more rapid growth, and enhanced innovation. Under the leadership of the Justice Department's Antitrust Division, the Administration has implemented an aggressive policy to prevent unhealthy concentrations of market power and promote competition.

Competition policy issues in telecommunications provide a trenchant example of how ongoing change in the economy necessitates change in economic policies. The telecommunications sector not only has grown by leaps and bounds during the past 3 years, but has also provided a spur to changes in other sectors. Government has played a long and useful role in telecommunications, from its financing of Samuel Morse's first telegraph line between Baltimore and Washington to the development of what has become the Internet. But the 60-year-old legislation that regulated the industry until this year was out of tune with the times and stifled innovation. Passage of the new telecommunications bill in February 1996 is expected to stimulate competition and ease access to the information superhighway.

Most analysts agree that the telecommunications regulatory structure needed reform. But effective reform proved more complicated than simply repeating a mantra of deregulation: an unregulated private monopoly can be just as stifling, if not more so, than a regulated one. Deregulation done the wrong way could result in the growth of firms with market power that suppress competition and innovation; equally important, deregulation that permitted excessive media concentration could hamper the public's access to the full panoply of viewpoints. To avoid these pitfalls, the new legislation is designed in a way that fosters competition, recognizing that today's bottlenecks to competition might be removed in a few years. Chapter 6 details the constructive approach the Administration has taken to regulatory reform in this and other areas.

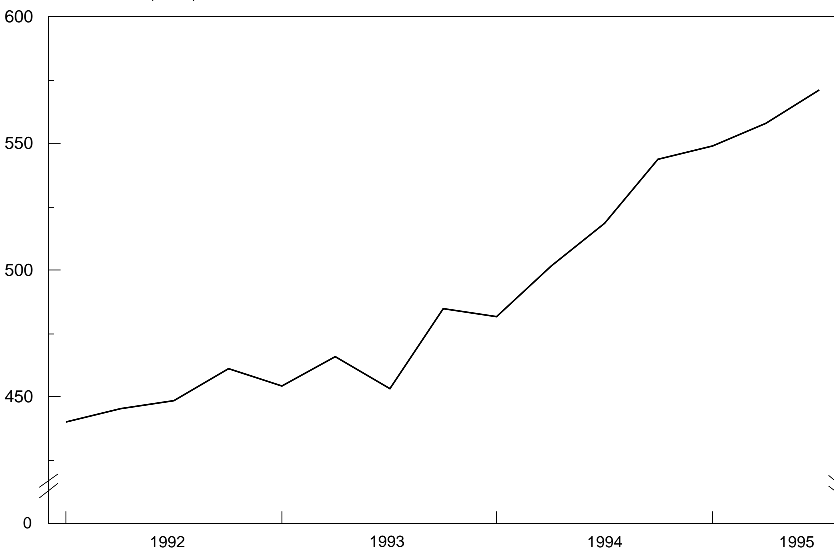
Promoting Exports

Both theory and evidence demonstrate that outward-looking trade and investment policies raise wages and living standards: jobs supported by merchandise exports pay 13 percent more than the national average. Chapter 8 of this *Report* presents the rationale for the Administration's continued support of "compete, not retreat" trade policies. It also explores what trade policy can achieve (higher living standards) and argues that the trade balance is not the proper measure by which to judge the success of trade policies.

The Administration's trade policy record includes several historic trade agreements that have opened foreign markets. Over the past 3 years the Administration has brought the Uruguay Round to a successful close; created the North American Free Trade Area with our largest and third-largest trading partners; reached agreement with 33 other countries to seek a Free Trade Area of the Americas by 2005; set the vision for achieving free trade and investment in the Asia-Pacific by 2020; concluded 20 bilateral trade agreements with Japan; and promoted macroeconomic and trade policies that have contributed to strong export growth (Chart 1–5). The Admin-

istration's aggressive support of intellectual property rights has benefited not only American firms, which lead the world in research and innovation, but also other innovative firms throughout the world, providing a spur to innovation everywhere. U.S. living standards have benefited and will continue to benefit from the Administration's efforts to promote trade.

Chart 1-5 **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.

INVESTING IN PHYSICAL, HUMAN, AND TECHNOLOGICAL CAPITAL

Increases in productivity are largely the consequence of investment: in physical capital (plant, equipment, and infrastructure), human capital, and in the development of new technology. Government can promote all three. Through the sound macroeconomic policies of the kind pursued during the past 3 years, the government can create an economic climate conducive to physical capital investment. But the government must play an even more direct role in making investments in people and in technology.

Investing in People

Preserving and extending lifelong investments in people has been central to the Administration's economic strategy. Investments in people are estimated to account for approximately a fifth of the annual increase in productivity achieved over the past three decades, and economic studies have demonstrated the high returns of *public*

investments in this area. As Benjamin Franklin once put it, "An investment in knowledge pays the best interest." Early childhood programs such as Head Start, seem to produce fewer repeated grades, a lower likelihood of being assigned to special education classes, and a higher likelihood of graduating from high school.

The Administration has expanded investments in education and training not only as a pro-growth policy, but also as an essential ingredient in breaking the vicious cycle of poverty. As Chapter 7 of this *Report* argues, past cutbacks in public support for education have aggravated trends in inequality. Between 1980 and 1994 the average tuition at public 2-year colleges increased by 70 percent, and that at public 4-year colleges by 86 percent, while the value of the maximum Pell Grant—the primary Federal program for low-income students—fell by more than 25 percent in real terms. The results of these changes are not unexpected. Returns to education have risen sharply in the past 15 years, but the expected response—increased enrollments—has occurred disproportionately among the children of the better off: over the same time period, the gap in enrollment rates between high-income and low-income children has actually increased.

This Administration is working to revitalize the Federal role in education and training. It has supported rigorous academic standards and comprehensive school reform through the Goals 2000: Educate America Act, which provides funding for the implementation of voluntary content standards and local educational innovation; created a new direct lending program for college tuition, to reduce costs and inefficiencies and make the terms of repayment less onerous; and encouraged a smooth transition from school to the workplace through the School-to-Work Opportunities Act. That piece of legislation is especially important because it funds programs to prepare high school students for today's careers. The Administration has also begun to transform the Nation's unemployment system into a reemployment system, by creating one-stop career centers and proposing a system of skill grants (job training vouchers) for low-income and dislocated workers. The Administration's policies to improve both the quantity and quality of expenditure on education and training are examined in more detail in Chapter 7 of this *Report*.

Investing in Research and Development

The Federal role in research and development and technology—both in conducting research and in disseminating the ideas that research generates—dates back to the 19th century. That investment has produced impressive returns: from a more productive agricultural sector to the underpinnings of what is today one of America's largest export sectors, aeronautics, and to the basic science that has given rise to one of America's most prominent high-technology

sectors, biotechnology. Recent studies suggest that half or more of all increases in productivity are due to improvements in technology, and these studies have verified the high total returns to such investments—returns far in excess of those from investments in plant and equipment. As the 21st century approaches, our technology programs must be both strengthened and reoriented to emerging sectors. The Administration has promoted public sector investments in technology through programs such as the Advanced Technology Program and the Manufacturing Extension Partnerships (at the Department of Commerce's National Institute of Standards and Technology) and the Technology Reinvestment Project (at the Department of Defense's Advanced Research Project Agency).

MAKING THE GOVERNMENT MORE EFFICIENT

The Administration recognizes the need for change not only in *what* the government does, but also in *how* it does it.

Reinventing Government

The reinventing government initiative was undertaken to improve the efficiency of government, learning from the private sector wherever possible, while acknowledging the differences between public and private sector activities. The National Performance Review, headed by the Vice President, has focused on making government agencies more performance- and customer-oriented, developing performance measures, and ensuring that those measures are used for evaluation. These efforts are already beginning to bear fruit, in the form of better customer service and greater efficiency.

The Administration is committed to continuing the reinvention of the Federal Government, eliminating outmoded programs designed for the 19th and 20th centuries, and promoting new ones designed for the 21st. For example, 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. It has also plowed under a bumper crop of paperwork: America's farmers this year will fill out 3 million pages fewer of government forms than in years past. Meanwhile the Administration has cut the overall Federal workforce by 200,000 positions. As a percentage of total employment in the United States, Federal employment is smaller today than at any time since the early 1930s.

In its efforts to reinvent regulation, the Administration has attempted to ensure that each regulation it reviews is consistent with its identified objectives, and that the benefits from the regulation justify its costs. Many of the proposals for reinventing government are intended to reduce those costs by fundamentally changing our regulatory philosophy. In its regulatory role, government should seek to facilitate compliance, not to act as a disciplinarian. And

regulations should be as market-friendly and performance-oriented as possible. They should encourage innovation and cost-effective ways of achieving the objectives of the regulation. They should take advantage of incentives and market mechanisms, rather than try to suppress them.

One set of regulations that the Administration has examined is those affecting some private sector pensions. Two objectives of these regulations are to prevent pension plans from becoming a vehicle for tax evasion, and to keep them from discriminating against low-wage workers. But in the aggregate these provisions have discouraged firms from offering pensions, thus failing to encourage national saving. The Administration therefore proposed simplified pension arrangements. The proposal would provide substantial safe harbors from nondiscrimination rules if employers match employee contributions; this should reduce the costs to small businesses of administering pension plans.

Other strides have been made in reducing the burden of environmental regulations and those affecting the banking and telecommunications sectors. The proposals recognize the fundamental changes in the economy that call for reform of regulatory structures, but also the need for real safeguards to be kept in place to promote competition and innovation, and to protect consumers and the environment. These reforms are described in greater detail in Chapters 5 and 6.

Protecting the Environment

Americans want to know that the air they breathe, the water they drink, and the rivers and lakes in which they swim and fish are safe. They want to be sure that the places where they live and work do not harbor threats to their health from contamination by dangerous chemicals, and that the Nation's natural resources are properly protected and managed. Protecting the environment is one of the best investments we can make on behalf of our children. Preserving and improving our environmental heritage is an essential part of maintaining and raising overall living standards.

The country has made enormous progress in this area. The air we breathe today is cleaner than before the Clean Air Act was passed. Substances that pose real dangers to human health and the environment, such as lead and DDT, have been eliminated or their use sharply reduced. Rivers and lakes have been restored to health: 25 years ago Lake Erie was all but dead; today life thrives in it again. With U.S. leadership, the international community has made considerable progress in phasing out substances that damage the earth's stratospheric ozone layer, which shields us from dangerous radiation.

But the battle is far from over. Air quality in some locations remains unacceptably poor. The outbreak of water poisoning in Mil-

waukee in 1993, and other episodes in which drinking water in our major cities has failed to meet quality standards, do more than just raise anxiety. Chemical runoff from cities, subdivisions, and farms into our rivers and lakes is a constant challenge. Pressures from economic development and increased demand still threaten the Nation's wetlands, fisheries, and other natural resources.

Although we all enjoy the benefits of cleaner air and cleaner water, as individuals—whether managers of steel companies or of oil refineries, or the producers or the drivers of automobiles—we have little incentive to spend our own money to make these things happen. Few are willing to shoulder all the costs of something for which all share the benefits. Acceptable environmental quality cannot be achieved without collective action. With appropriate policies—including cooperation with States and localities, partnerships with the private sector that engender creative solutions as well as set standards, and careful assessment of the advantages and disadvantages of alternative government action—environmental protection can be secured at an affordable cost.

The Administration is improving the way in which we protect the environment, making government a partner rather than an overseer. The Environmental Protection Agency is eliminating 1,400 pages of obsolete regulations and revising 9,400 more. In the process it is cutting paperwork requirements by 25 percent, saving private industry about 20 million hours of labor per year. Chapter 5 of this *Report* examines environmental policy in more detail.

Devolution

The Administration has been examining not only what roles government should play, but also at what level—Federal, State, or local—government should play its role. It has reexamined the partnership between the Federal Government and the States and localities, to ensure that public funds are used most efficiently. In some areas, such as national defense, the Federal Government has a clear responsibility that cannot be delegated. Other areas have traditionally been matters of local responsibility. Chapter 4 of this *Report* reviews the basis on which different responsibilities should be assigned to different levels of government, and stresses that what is usually required is a careful balancing of roles and responsibilities between the different levels.

Redesigning Welfare Policies

The government has a crucial role to play in increasing economic independence, rewarding work, and ensuring that children are not trapped in poverty. This is important not only for social cohesion; it is an economic imperative as well. Each year that a child spends in poverty raises the probability of that child later dropping out of school. And dropouts tend to contribute less to national income: in

1994, mean annual earnings for a full-time, year-round worker aged 25 to 34 who had dropped out of high school were $18,679. Mean earnings for high school graduates in that age range were $23,778.

Although individuals must ultimately be responsible for their own actions, opportunities at least partially affect our behavior. The limited economic opportunities available to dropouts make recourse to antisocial behavior all the more likely. On any given day in 1992, 25 percent of men aged 18 to 34 who lacked a high school diploma were in prison, on probation, or on parole, compared to only 4 percent of high school graduates. This is not merely a tragic outcome for those young men: increased crime imposes a wider social cost, in the form both of greater expenditure by the criminal justice system and of reduced personal security for all of us.

The policies adopted in the past to reduce income inequality and poverty are in need of reform. Everyone agrees that the current welfare system is broken. Welfare dependency does enormous harm to individuals and families, by discouraging work and undermining personal responsibility. Welfare recipients are robbed of their dignity, and administrators spend too much time determining eligibility and to little time helping families get back on their feet.

Figuring out how to fix the welfare system, however, is a great challenge. With no easy answers, the Administration has worked to give States the flexibility they need to experiment with new approaches to welfare. As of February 1996, 37 States have received waivers allowing them to pursue a wide range of reforms. For example, Wisconsin has received a waiver to impose stringent work requirements and time-limited benefits.

In order to help move parents from welfare to work, the Administration has proposed to impose a time limit nationwide. Within 2 years, parents would be required to work. Within 5 years, they would lose their benefits. Children would receive vouchers for support if their parents' benefits were terminated. Chapter 4 of this *Report* discusses many of these issues in more detail.

REDUCING THE DEFICIT

Before it could pursue the rest of its economic agenda, the Administration had to bring the Federal budget deficit under control. One of the most detrimental legacies left by previous Administrations was the perilous state of public finances. The large budget deficits run up during the 1980s and early 1990s, and the associated increase in public debt, were restricting the private investment that is so crucial to growth and were deepening our indebtedness to foreigners.

Borrowing to finance the deficit absorbs funds that could otherwise be used to finance investment in plant and equipment—in-

vestment that would increase the productivity of the American economy. Combined with a low rate of private saving, government borrowing forces America to borrow more abroad, increasing our indebtedness to foreign countries. As discussed in Chapter 8, one of the fallouts from previous Administrations' economic policies was that the United States went from being the world's largest creditor country to being the world's largest debtor country in the space of a few years.

Deficit reduction can right many of these wrongs and provide the springboard for faster economic growth. But throughout the recent debate over the budget, the Administration has stressed that there is a right way and a wrong way to reduce the deficit. Deficit reduction is not an end in itself, but a means to the end of higher living standards for all Americans. How the deficit is cut may determine whether or not those ends are accomplished.

Deficit reduction done the wrong way will reduce living standards and worsen inequality. Cutting spending to reduce the deficit requires hard choices. In making these hard choices, we must assess what the government does now and what it should do in the 21st century. The Federal budget is not just a bland accounting statement—it is an expression of the Nation's priorities and values and should reflect a vision of where the country is going and the problems it faces. Some proposed budget cuts, such as those that would reduce equality of educational opportunity, represent attacks on fundamental American values. Others, such as in programs that protect the environment and Americans' health and safety, would have adverse effects on living standards in the future, and thus undermine the very purpose of deficit reduction.

Deficit Reduction and Public Investment

Investment is a key factor in stimulating growth. Reducing the deficit should lower interest rates and stimulate private investment. Cutting the deficit by cutting high-return *public* investments makes little sense: it merely substitutes one worthwhile investment for another. Indeed, deficit reduction that reduces high-return public investments—like those in research and development, technology, education, and training—may compromise long-term economic growth. Deficit reduction should not be achieved by running down our public infrastructure, by failing to invest in research and development, or by neglecting education and training.

Deficit Reduction and the Social Safety Net

Deficit reduction financed through ill-conceived and excessive cutbacks in social programs is also counterproductive. Reducing inequality not only is essential to keep from shredding the common fabric of our Nation, but may also be important in the more limited objective of promoting economic growth.

Economic growth would suffer if opportunities were reduced for those Americans—and especially the children—at the bottom of the income distribution. We would only worsen the inequality in our society by reducing support for the most vulnerable members of society while handing out large tax benefits to the richest. The better course is to ensure that all Americans who work hard and play by the rules have a chance to escape poverty. To do so would increase national output at the same time that it reduces inequality.

Deficit Reduction and Health Care

As the President has long emphasized, growth in health care expenditures must be contained. Failing to do so would not only pose the renewed threat of large budget deficits; it could also force unacceptable cuts in other programs that are vital to the country. It would be wrong, however, for the richest country in the world to abandon its commitment to increase access to basic health care.

Ongoing changes in our health care system not only allow us to take advantage of structural reforms (such as more extensive use of managed care), but also offer the hope that market forces will help contain rising health care costs. The restraint exercised by health maintenance organizations, for example, should serve to increase the relative supply of health care services in other segments of the market and, through the usual workings of supply and demand, help bring down costs. But more is needed, and experiments could provide the information required to implement effective reforms in the coming decade—reforms that would protect the elderly even as they reduce the growth rate of public expenditures. Possible demonstration initiatives include reforming the reimbursement system, developing a system of regional hospitals specializing in certain high-cost treatments, and cutting administrative costs at hospitals.

Deficit Reduction and Taxes

Fifteen years ago, marginal tax rates and the progressivity of the tax system were dramatically reduced. Some suggested that these policies would so spur economic growth that tax revenue would actually increase. The outcome of that experiment is now a matter of record: not only did this response not occur, but the national debt quadrupled in the span of a dozen years. Chapter 3 of this *Report* reviews the arguments and evidence concerning the efficacy of new tax proposals.

In developing its tax proposals, this Administration has emphasized fairness. The Administration has proposed tax cuts for the middle class and argued forcefully against increasing taxes on low-income families through a reduction in the EITC. And the Administration objects to proposals that would give a disproportionate share of tax relief to upper income individuals.

At the same time, the Administration has argued that existing expenditure and tax provisions that benefit particular sectors of the economy, and that cannot be justified in terms of some market failure, should be reduced. Although the Administration succeeded in persuading the Congress to eliminate some of the most obvious examples—the subsidies for mohair and honey, for example, and the tax deductions for lobbying expenses—billions of dollars in corporate subsidies and other loopholes remain.

APPROACHING THE 21ST CENTURY

The U.S. economy has changed profoundly in this century. It will continue to change as we enter the 21st century. Advances in technology will continue at a rapid pace. The globalization of economies will also continue. American firms will face competition from abroad, and all the evidence indicates that they can and will rise to the challenge. Lower priced imports and increased export sales will play a role in increasing living standards, as the United States is able to exploit its comparative advantage on an increasingly global scale.

Some sectors of the economy, such as the services sector, will expand, while others will contract. In 1850, the majority of Americans worked on farms; by 1950 only 12 percent did. In 1900, 20 percent of the workforce was employed in manufacturing; by 1950 this had increased to 24 percent. The manufacturing share has since declined and now stands at 16 percent. Today, the main growth sectors of the economy include service industries such as telecommunications services. Service industries in the private sector accounted for 46 percent of employment in 1950; today they account for 63 percent.

People naturally tend to recall the past in a softened light that obscures its blemishes, and to see in the future adversities that may never materialize. For some, the prospect of a future in which the service economy dominates even more than it does today is one that raises anxieties. To be sure, some of the service sector jobs that are being created are not good jobs. On the other hand, many new service sector jobs—in computer programming and management consulting, for example—are high-tech, high-wage jobs.

Markets and government will need to respond to ongoing changes in the economy. For government, change will require rebalancing: more emphasis on new problems, less emphasis on those of the past. The best combination of policies to address the problems of 2030 will be markedly different from those that got us through the problems of 1930 or 1830. Ideological and extremist solutions reflect neither the realities of today nor the tradition of American pragmatism. Rather, the problems of the 21st century need to be

addressed with a balanced perspective. Markets are at the core of our economy, but they do not always operate fully efficiently and do not adequately meet all the needs—even all the economic needs—of Americans. It is then that the government can often help. In the face of increased income inequality, for example, it can make greater efforts to enhance educational opportunity so that the vicious cycle of poverty is not perpetuated.

Government cannot solve all of society's problems, and it certainly cannot solve the more persistent problems overnight. But even if the benefits do not manifest themselves immediately, government must continue to invest in the future. Only by making such investments can the long-term problems of slow productivity growth and increasing inequality be addressed. This Administration firmly believes that government—through selective, focused, and well-designed policies—can help American workers and families achieve higher living standards and develop a more humane, more just society.