CHAPTER 1

Meeting Challenges and Building for the Future

THE ECONOMIC POLICIES of the past 6 years have nurtured and sustained what is now the longest peacetime expansion on record. By December 1998, the 93rd month since the bottom of the last recession, 18.8 million jobs had been created (17.7 million of them since January 1993). More Americans are working than ever before, the unemployment rate is the lowest in a generation, and inflation remains tame. This record of achievement is especially noteworthy in light of the troubles experienced in the international economy in 1998. The United States has not entirely escaped the effects of this turmoil—and calm has not been restored completely abroad. But the fundamental soundness of the U.S. economy prevented it from foundering in 1998's storms.

This Administration laid a strong policy foundation for growth in 1993 when the President put in place an economic strategy grounded in deficit reduction, targeted investments, and opening markets abroad. Since then the Federal budget deficit has come down steadily, and in 1998 the budget was in the black for the first time since 1969. This policy of fiscal discipline, together with an appropriately accommodative monetary policy by the Federal Reserve, produced a favorable climate for business investment and a strong, investment-driven recovery from the recession and slow growth of the early 1990s. Even while reducing Federal spending as a share of gross domestic product (GDP), the Administration has pushed for more spending in critical areas such as education and training, helping families and children, the environment, health care, and research and development. And although international economic conditions have led to a dramatic widening of the trade deficit, the United States has succeeded in expanding exports in real (inflation-adjusted) terms by almost 8 percent per year since 1993.

Clearly, there is much for Americans to be proud of in the economic accomplishments of the past 6 years. But as recent events in the rest of the world have reminded us, our prosperity is threatened when the global economy does not function well. Our immediate challenge on the international front is to help ensure that the global economy rebounds and begins to regain strength. Our longer run challenge as we enter the 21st century will be to continue to build and refine the international economic arrangements within which countries can embrace opportunities to grow and develop through international trade and investment.

Challenges remain at home as well. The restoration of fiscal discipline is one of the most important accomplishments of the past 6 years. But one very important challenge in the years ahead will be to maintain that discipline and to ensure that fiscal policy contributes to preparing the country for the demographic challenges it faces in the next century. That is why, in his 1998 State of the Union address, the President called for reserving the future budget surpluses until Social Security is reformed. In this year's State of the Union message, the President put forward his framework for saving Social Security while meeting the other pressing challenges of the 21st century.

A second major development of the past 6 years has been the reform of the Nation's welfare system, which, together with the strong economy, has produced a dramatic reduction in welfare case loads. Here the challenge will be to continue to make work pay for all Americans who play by the rules and want to work, while preserving an adequate safety net. Finally, the strength of the American economy over the past 6 years should not blind us to the inevitability of change and the threat of disruption that is always present in a dynamic market economy. For example, difficult agricultural conditions in 1998 put stress on the new, market-oriented farm policy enacted in 1996. Similarly, the ongoing wave of mergers among large companies in the financial, telecommunications, and other industries has raised questions about the disruptions these reorganizations cause for communities and workers—questions that go beyond traditional antitrust concerns. Such questions may be better addressed by broader policies such as maintaining full employment and promoting education and training. The challenge here is to capture the long-run benefits from productivity-enhancing change without ignoring the short-run costs to those hurt by that change.

This chapter provides an overview of these challenges and the Administration's responses. First, however, we provide some background by putting the current economic expansion in its historical context.

POLICY LESSONS FROM THREE LONG EXPANSIONS

The current economic expansion is only the third that has lasted at least 7 years, according to business-cycle dating procedures that have been applied back to 1854 (Box 1-1). It is useful to review and compare the histories of each of these long expansions in order to understand the role of macroeconomic policy in promoting balanced and noninflationary growth.

Box 1-1.—The Dating of Business Cycles

Although all signs indicate that the current economic expansion has continued into 1999, its precise length will not be known until some time after it has ended. The dating of business cycles is not an official U.S. Government function. Instead, once it has become clear that the economy has reversed direction, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) meets to determine the turning point for historical and statistical purposes. For example, the July 1990 business-cycle peak was announced April 25, 1991, and the March 1991 trough was announced December 22, 1992. A popular recession indicator is two consecutive quarters of decline in real GDP, but the NBER does not use this approach. Rather, it defines a recession as a recurring period of decline in total output, income, employment, and sales, usually lasting from 6 months to a year.

The Employment Act of 1946 (which created the Council of Economic Advisers) established a policy framework in which the Federal Government is responsible for trying to stabilize short-run economic fluctuations, promote balanced and noninflationary economic growth, and foster low unemployment. Although the U.S. economy has continued to experience fluctuations in output and employment in the more than half a century since then, it has avoided anything like the prolonged contraction of 1873-79, or the 30 percent contraction in output and 25 percent unemployment rate of the Great Depression. Moreover, the three longest expansions of the past century—including the current one—have all occurred since the Employment Act was passed.

Each of these three long expansions can be interpreted as an experiment in macroeconomic policy. The longest—the expansion of 1961-69, which lasted 106 months—was associated with the first self-consciously Keynesian approach to economic policy. It was also associated with Vietnam War spending. The longest peacetime expansion before the current one was the expansion of 1982-90, which lasted 92 months. Although the economic philosophy underlying the policies of that period is often characterized as anti-Keynesian, this expansion, too, featured a stimulative fiscal policy. The current expansion is the only one of the three in which fiscal policy was *contractionary* rather than expansionary, reflecting the budget situation at the time and the view that fiscal discipline would lower interest rates and spur long-term economic growth.

KEYNESIAN ACTIVISM IN THE 1961-69 EXPANSION

In the early 1960s the Council of Economic Advisers advocated activist macroeconomic policies based on the ideas of the British economist John Maynard Keynes. The Council diagnosed the economy at that time as suffering from "fiscal drag" arising from a large structural budget *surplus*. (The structural budget balance is the deficit or surplus that would arise from the prevailing fiscal stance if the economy were operating at full capacity.) The marginal tax rates then in effect, which were far higher than today's, were seen as causing tax revenues to rise rapidly as the economy approached full employment, draining purchasing power and slowing demand before full employment could be achieved. The problem was not the fact that Federal Government receipts and expenditures were sensitive to changes in economic activity—this sensitivity plays an important automatic stabilizing role, particularly when economic activity falters, as reduced tax payments and increased unemployment compensation help preserve consumers' purchasing power. The problem was that the automatic stabilizers kicked in too strongly on the upside, not only preventing the economy from reaching full employment but also, ironically, preventing the actual budget from balancing. Thus, President John F. Kennedy proposed a tax cut in 1962, which was enacted in 1964, after his death.

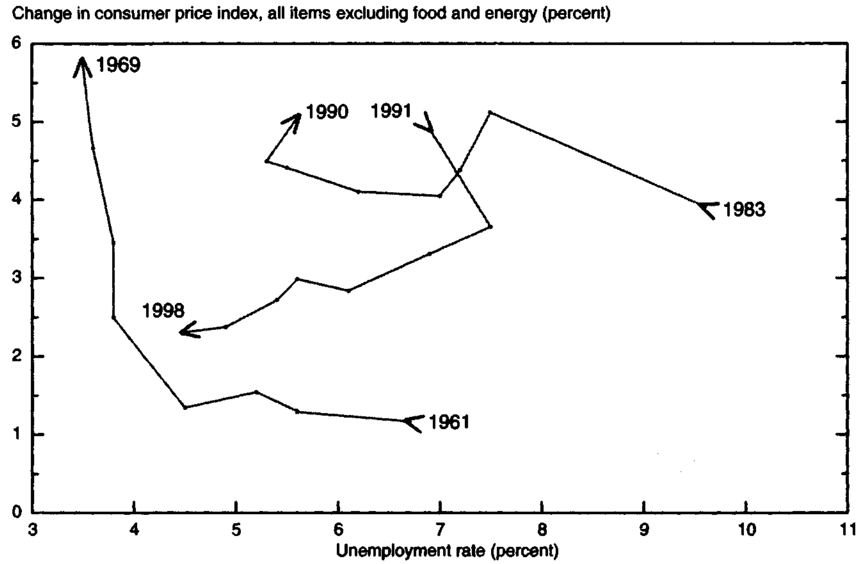
This tax cut provided further stimulus to the economic recovery that had begun in 1961. The unemployment rate continued to fall, until early in 1966 it dropped below the 4 percent rate that was considered full employment at the time. Inflation had been edging up as the unemployment rate came down, but it then began to rise sharply (Chart 1-1). Although the changed conditions appeared to call for fiscal restraint, President Lyndon B. Johnson was reluctant to raise taxes or scale back his Great Society spending initiatives. Meanwhile Vietnam War spending continued to provide further stimulus.

At the time, policymakers believed that the rise in inflation could be unwound simply by moving the economy back to 4 percent unemployment, but when restraint was finally applied it produced a rise in unemployment with little reduction in inflation. This so-called stagflation, together with a slowdown in productivity and a series of oil price shocks in the 1970s, dealt a serious setback to the prevailing view among economists that economic policy could be easily adjusted to achieve the goals of the Employment Act.

THE SUPPLY-SIDE REVOLUTION AND THE 1982-90 EXPANSION

At the beginning of the Administration of President Ronald Reagan in 1981, the economy was bouncing back from the short 1980 recession, but it was also experiencing very high inflation. President Reagan's program for economic recovery called for large tax cuts, increased defense spending, and reduced domestic spending. Although advocates of these policies invoked the 1964 tax cut as precedent, the justification offered for this policy was not Keynesian demand stimulus. Rather it was the "supply-side" expectation that substantial cuts in marginal tax rates would call forth so much new work effort and investment that

Chart 1-1 **Core Inflation and Unemployment in Three Long Expansions**
Inflation rose late in both the 1960s and 1980s expansions, but inflation has remained low in the current expansion.



Source: Department of Labor (Bureau of Labor Statistics).

the economy's potential output would grow rapidly, easing inflationary pressure and bringing in sufficient new revenue to keep the budget deficit from increasing. In the short run, however, this expansionary fiscal policy collided with an aggressive anti-inflationary monetary policy on the part of the Federal Reserve. The budget deficit ballooned in the deep recession of 1981-82, and it stayed large even after the Federal Reserve eased and the economy began to recover.

Compared with the 1961-69 expansion, the 1982-90 expansion was marked by higher levels of both inflation and unemployment. But the main distinguishing feature of this expansion was the large Federal budget deficits and their macroeconomic consequences. In the early 1980s the combination of an expansionary fiscal policy and a tight monetary policy produced high real interest rates, an appreciating dollar, and a large current account deficit. (The current account, which includes investment income and unilateral transfers, is a broader measure of a country's international economic activity than the more familiar trade balance.) Although borrowing from abroad offset some of the drain on national saving that the budget deficit represented, and prevented the sharp squeeze on domestic investment that would have taken place in an economy closed to trade and foreign capital flows, the effect of this policy choice was a decline in net national saving and investment after 1984. As in the 1961-69 expansion, inflation began to rise as the economy moved toward high employment. By this time, however, the prevailing view was that inflation could not be reversed simply by returning to the full-employment unemployment rate (Box 1-2). Instead the economy would have to go through a period of subnormal growth in order to squeeze out inflation.

Box 1-2.—Full Employment and the NAIRU

Maintaining full employment is a major goal of macroeconomic policy, but how exactly is that objective defined? The prevailing view in the 1960s was that lower unemployment rates were associated with higher rates of inflation, and that full employment was defined by the unemployment rate associated with a tolerable inflation rate. At that time, the full-employment unemployment rate was thought to be about 4 percent. The experience of the 1970s helped persuade economists that, once the unemployment rate dropped below a certain level, prices would not just rise but accelerate (that is, the inflation rate would rise). The full-employment unemployment rate came to be defined as the nonaccelerating-inflation rate of unemployment, or NAIRU.

Statistical studies suggest that the NAIRU was higher from the mid-1970s through the 1980s than it was in the 1960s and that it has come down somewhat in the 1990s. This evolution has been attributed to a variety of factors, including changes in the demographics of the labor force. For example, the United States now has a more mature labor force, as a consequence of the aging of the baby-boom generation, and more mature workers tend to experience less unemployment than younger ones. Although the NAIRU is an indicator of the risk of inflation, estimates of the NAIRU have a wide band of uncertainty and should be used carefully in formulating policy. The NAIRU implicit in the Administration's forecast has drifted down in recent years and is now within a range centered on 5.3 percent.

DEFICIT REDUCTION AND THE CURRENT EXPANSION

The economy was out of the 1990-91 recession when President Bill Clinton took office, but the recovery was weak and job growth appeared slow. Budget deficits were very large, partly because of the recession but also because the structural deficit remained large. The President's economic program sought to get the economy moving again while bringing the budget deficit under control. It was based on the idea that reducing the Federal budget deficit would bring down interest rates and stimulate private investment. With a responsible fiscal policy in place, and with favorable developments in inflation and productivity, the decline in the unemployment rate to less than 5 percent did not lead to interest rate hikes that could have choked off the expansion prematurely. In fact, the economy witnessed a combination of low consumer price inflation and low unemployment that compared favorably with the low "misery index" achieved in the late 1960s. (The misery index is the sum of the inflation and unemployment rates.) This time, however, inflation is tame rather than rising.

Judged by the objectives of stabilization policy (inflation and unemployment), the current economic expansion has been very successful (Table 1-1). Three-quarters of the way through the eighth year of expansion, inflation remains low even though the unemployment rate has been below most estimates of the NAIRU. This situation stands in marked contrast to the sharply rising inflation experienced at the end of

TABLE 1-1.— *Stabilization Policy Indicators in Three Long Expansions*

Item	First 6 years	7th year	Last 12 months
1961-69			
Core inflation rate[1]	1.8	4.4	5.9
Unemployment rate[2]	5.1	3.8	3.5
1982-90			
Core inflation rate[1]	4.4	4.4	5.1
Unemployment rate[2]	7.2	5.3	5.3
1991-present[3]			
Core inflation rate[1]	3.1	2.3	2.5
Unemployment rate[2]	6.3	4.8	4.5

[1] Average annual percent change in the consumer price index for all items excluding food and energy.
[2] Average rate for the period (percent).
[3] Through December 1998.

Note. Based on seasonally adjusted data.

Sources: Department of Labor (Bureau of Labor Statistics) and National Bureau of Economic Research.

the 1960s expansion and the milder price acceleration seen at the end of the 1980s expansion. To be sure, this good inflation performance has been aided by favorable conditions such as a continuing sharp decline in computer prices, a drop in oil prices, rapid growth of industrial capacity, and downward pressure on prices of traded goods due to weakness in the world economy. And, as discussed in Chapter 2 of this Report, the Administration (as well as the consensus of private forecasts) projects a moderating of growth over the next 2 years. What is significant, however, is that the actions taken over the past 6 years to reduce the budget deficit created conditions in which the Federal Reserve could accommodate steady noninflationary growth. And, of course, the strong economic performance helped improve the budget balance even further.

Growth in GDP has also been solid. With slower growth in the working-age population and slower trend productivity growth since the early 1970s, it is understandable that GDP has grown more slowly than it did in the 1960s (Table 1-2). Moreover, growth over the 1980s expansion partly reflects how far below potential output the economy was at the start of that expansion, which followed a deep recession, rather than a particularly strong underlying growth trend. Finally, growth in aggregate income matters for some purposes, but productivity growth is what matters for real wages and a rising standard of living over the longer term. And productivity growth has continued relatively strong well into this expansion—it has not exhibited the decline that often occurs late in expansions. Nevertheless, the rate of productivity growth over this expansion remains well below that achieved in the 1960s, before the productivity slowdown.

TABLE 1-2.—*Economic Growth Indicators in Three Long Expansions*

[Average annual percent change]

Item	From trough	From previous peak[1]
1961-69		
Real GDP	4.8	4.3
Civilian noninstitutional population	1.5	1.5
Civilian labor force	1.7	1.7
Nonfarm business sector productivity	3.0	2.8
1982-90		
Real GDP	3.7	2.6
Civilian noninstitutional population	1.2	1.2
Civilian labor force	1.6	1.6
Nonfarm business sector productivity	1.3	1.0
1991-present[2]		
Real GDP	3.0	2.6
Civilian noninstitutional population	1.0	1.0
Civilian labor force	1.2	1.1
Nonfarm business sector productivity	1.5	1.4

[1] Peaks of 1960 II, 1980 I, and 1990 III.

[2] Through 1998 III.

Note. Based on seasonally adjusted data, except population.

Sources: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and National Bureau of Economic Research.

Relatively slow productivity growth continues to prevent the kind of wage and income growth that produced a doubling in living standards between 1948 and 1973. As discussed in Chapter 3, however, the sustained tight labor market that this expansion has created in the past few years has brought benefits to the vast majority of American workers, including groups that had fallen behind over the past two decades or so, such as low-wage workers and minorities. A labor market like that of today has numerous benefits. It increases the confidence of job losers that they will be able to return to work; it lures discouraged workers back into the labor force; it enhances the prospects of those already at work to get ahead; it enables those who want or need to switch jobs to do so without a long period of joblessness; and it lowers the duration of the typical unemployment spell. It can reduce long-term structural unemployment by providing jobs and experience to younger and less skilled workers, thus increasing their longer run attachment to the labor force. In short, a sustained tight labor market helps the rising tide of economic growth lift all boats.

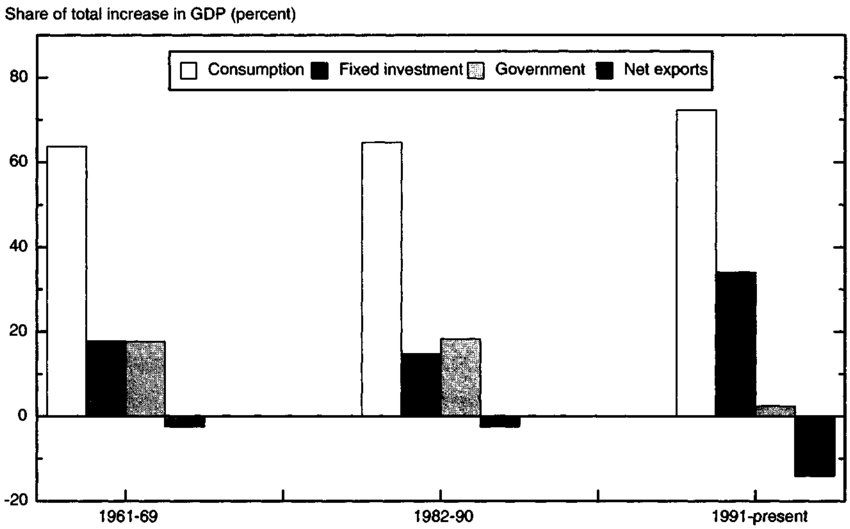
This expansion has illustrated how the mix of monetary and fiscal policy can affect the composition of output. Unlike the expansion of the 1980s, which saw an expansionary fiscal policy restrained by tight monetary policy, the current expansion has taken place under conditions of fiscal restraint and an accommodative monetary policy. The 1980s policy mix brought with it relatively high real interest rates, declining net national saving and investment, and a large current account deficit, which changed the United States from the world's largest creditor Nation to its largest debtor. Strong performance by the U.S. economy in the 1990s is again associated with a strong dollar and, most recently, a widening trade deficit, as the United States has continued to absorb foreign goods while weakness abroad has reduced demand for U.S. goods. On balance, however, the current account deficits of the 1990s have been the result of generally rising net national investment remaining greater than generally rising net national saving.

The current account balance depends on the *gap* between saving and investment. But future growth depends on the *levels* of saving and investment. Since 1993, net national saving has increased by about 3 percentage points as a share of GDP, to better than 6½ percent in the first three quarters of 1998. The current expansion has been distinguished by the large contribution of private fixed investment to GDP growth and the negligible contribution of government spending (Chart 1-2). Strong investment has already been associated with strong growth in capacity, which has helped keep inflation in check, and may have contributed to maintaining growth in productivity as the expansion has matured. Chapter 2 discusses this investment boom in greater detail.

CONCLUSION

Through a combination of sound policy, other favorable conditions, and of course the energetic efforts of millions of American workers and businesses, the current economic expansion has achieved both high employment and low inflation. Longer run trends in productivity and population growth will ultimately determine how fast the economy grows. But the investment that has driven the current expansion should pay off in stronger growth and productivity and higher future standards of living than otherwise would have been the case. With the Federal budget once more under control, large deficits will not constrain future policy choices.

Chart 1-2 **Contributions to Economic Growth in Three Long Expansions**
More than a third of the increase in real GDP in the current expansion came from fixed investment.



Sources: Department of Commerce (Bureau of Economic Analysis), National Bureau of Economic Research, and Council of Economic Advisers.

PRESERVING FISCAL DISCIPLINE

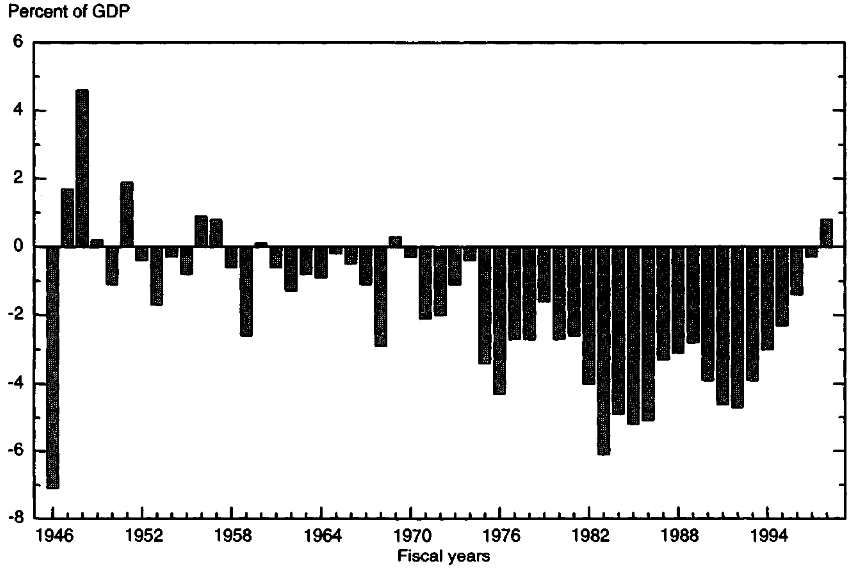
Reducing the Federal budget deficit has been a centerpiece of this Administration's economic policy. Between 1993 and 1997 the deficit came down steadily. Last year, for the first time since 1969, the budget was in the black, with the largest surplus as a share of GDP in over 40 years.

The Administration now projects substantial surpluses in the unified Federal budget well into the future. (The unified budget includes both on-budget and off-budget Federal Government programs.) With no further action, however, the aging of the U.S. population and continued growth in health care spending per person would eventually push the budget back into deficit. The favorable near-term outlook has provided an important opportunity to address these longer term problems. In his 1999 State of the Union address, the President presented his plan to use much of the projected budget surpluses to help save Social Security and strengthen Medicare, while preserving the fiscal discipline that has been so hard won over the past 6 years.

REACHING SURPLUS

Except during wars and economic downturns, the Federal budget has stayed roughly balanced for most of the Nation's history. Yet the large budget deficits that emerged in the early 1980s persisted throughout that decade of peace and economic expansion, and then worsened in the 1990-91 recession (Chart 1-3). In 1992 outlays exceeded receipts by $290 billion, or 4.7 percent of GDP. When the President took office in January 1993, the deficit was projected to reach almost $400 billion in 1998 and over $600 billion in 2003, assuming no change in policy. By 1998, however, receipts exceeded outlays by $69 billion, or 0.8 percent of GDP. (All references to years in this section are fiscal years running from October through September, unless otherwise noted.)

Chart 1-3 **The Federal Budget Balance, 1946-98**
After a period of persistent large deficits in the 1980s, the Federal budget surplus in 1998 was the largest as a share of GDP since 1957.



Source: Office of Management and Budget.

Between 1992 and 1998 the Federal budget balance improved by about 5½ percent of GDP. In an accounting sense, this dramatic change is attributable in roughly equal parts to an increase in receipts and a decline in outlays, both as shares of GDP. More fundamentally, three forces have been at work: policy changes, faster-than-anticipated economic growth, and higher-than-expected tax revenues, even after adjusting for faster economic growth.

In 1993 the President and the Congress enacted a deficit reduction package designed to cut over $500 billion from the deficits expected to accumulate over the following 5 years. The program slowed the growth of entitlements and extended the caps on discretionary spending put in place in 1990. It raised the tax rates of only the 1.2 percent of taxpayers with the highest incomes, while cutting taxes for 15 million working families. Four years later the President and the Congress finished the job of reaching budget surplus by passing the Balanced Budget Act of 1997, which incorporated additional deficit reduction measures.

Strong economic growth also played an important role in reducing the deficit. Faster-than-expected growth created more income and more tax revenue. In addition, it reduced unemployment insurance benefits and outlays for other means-tested entitlement programs—although the effect of better economic performance is considerably smaller on the spending side than on the revenue side.

Finally, technical factors boosted receipts and depressed outlays over and above what policy changes and macroeconomic conditions can account for. In 1997 and again in 1998, higher-than-anticipated individual income tax collections were by far the largest source of technical differences on the revenue side. These appear to have arisen from higher capital gains realizations and changes in the distribution of income among taxpayers (a shift toward more taxable income in the higher brackets), most likely reflecting strong stock market performance. An important technical factor on the spending side has been lower-than-expected outlays for Federal health programs (primarily Medicare and Medicaid), most likely reflecting slower growth in health care costs economy-wide.

FISCAL POLICY IN AN ERA OF SURPLUSES

Achieving a surplus in the Federal budget has provided the foundation for tackling longer term problems. Indeed, balancing the budget has been the critical first step in improving the Nation's future fiscal and economic strength. The most important of the longer term problems is posed by the aging of the population, with its implications for future imbalances in Social Security and Medicare.

Before turning to this issue, however, it is worth emphasizing that achieving long-run fiscal discipline does not, and should not, preclude the possibility of running a short-run deficit if needed for stabilization purposes. The automatic stabilizers in the budget will continue to be the most important instrument of fiscal policy for muting short-term fluctuations in economic activity. But as Japan's current problems remind us, an economy can become mired in stagnation to such an extent that discretionary fiscal stimulus may be appropriate. The elimination of large structural budget deficits frees fiscal policy to undertake such a role if needed.

The Demographic Challenge and Social Security

Social Security is an extremely successful social program. For 60 years it has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity—a package that has been difficult if not impossible to obtain in the financial marketplace. In any case, fewer than half of all individuals aged 65 and older received any private pension benefits in 1994. Social Security benefits are the largest source of income for two-thirds of those in this age group and the only source for 18 percent of them. Social Security has achieved dramatic success in helping reduce the poverty rate among the elderly from 35 percent in 1959 to 10.5 percent in 1997. But Social Security is more than just a pension plan: it is a family protection plan, and nearly every third beneficiary is not a retiree. For example, one of every six 20-year-olds will die before reaching retirement age. For the average wage earner who dies leaving a spouse and two children, Social Security provides survivors' benefits roughly equivalent in value to a $300,000 life insurance policy. In addition, three of every ten 20-year-olds will become disabled for some period during their working lives, and for them Social Security provides disability protection.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance—the difference between expected income and costs over the next 75 years. The Social Security actuaries now project that the current balance in the trust fund, together with projected revenues over the next 75 years, will be insufficient to fund the benefits promised under current law. By 2013 payroll contributions, together with the part of income tax receipts on Social Security benefits that is deposited in the trust fund, are expected to fall short of benefits. By 2021 the shortfall is expected to exceed the trust fund's interest earnings, so that the fund will begin to decline. And by 2032 the trust fund is expected to be depleted, although contributions would still be sufficient to pay about 75 percent of current-law benefits thereafter. Of course, future taxes and benefits will depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller—or larger—than we now believe. Nevertheless, the actuaries' intermediate projections imply that the imbalance in the old age, survivors, and disability insurance program (OASDI, the main component of Social Security) over the next 75 years amounts to around 2¼ percent of taxable payroll (which equals about 1 percent of GDP today).

The key factors contributing to the projected OASDI imbalance are improvements in life expectancy and a reduction in birth rates, which have put the United States on a path of rapid decline in the number of employed workers for every retiree. When the Social Security Act was passed in 1935, the life expectancy of a 65-year-old American was about 13 years. Today, life expectancy for a 65-year-old is 18 years and rising. Meanwhile people are retiring earlier. In 1950 the average age for first receiving Social Security retirement benefits was 68; today it is 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about five to one in 1960 to three and a half to one today. In only 30 years' time it will be just two to one and still falling.

In addition to its effects on Social Security retirement and disability benefits, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the broader economic environment. Medicare is a Federal program that pays for health care for the elderly and certain disabled persons; Medicaid is a joint Federal-State program that provides medical assistance, including nursing home care, to those with low incomes among the elderly, the disabled, pregnant women, children, and members of families with dependent children. Both programs face steeply rising costs over time as the population ages and as the cost of providing medical care likely rises further. Federal spending on Medicaid is financed out of general revenues. Spending on Medicare is financed in two parts: hospital insurance (part A) is funded through the hospital insurance payroll tax, whose proceeds go to a dedicated trust fund, and supplementary medical insurance (part B) is funded through general revenues and monthly premiums paid by beneficiaries. The intermediate projections of the Medicare actuaries imply that the hospital insurance trust fund will be exhausted in 2008.

For the Nation as a whole, the core of the problem is how to provide a high standard of living for both workers and retirees in the next century, even though a smaller share of the population will be in the work force than today. A natural solution is to make workers more productive, by increasing investment in both physical and human capital. Investing in productive capital expands the total economic pie, and that is the prerequisite to meeting the retirement costs of the baby-boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving. The Federal Government can play its part by maintaining fiscal discipline. Indeed, the President's proposal to use much of the currently projected budget surpluses for Social Security and Medicare reform would add about 2 percent of GDP to the contribution of government saving to national saving over the next 15 years.

The Administration's Policy

In his 1998 State of the Union address, the President proposed to reserve the budget surplus until agreement had been reached on a plan to secure the financial viability of Social Security. To accomplish this task, the President suggested a process of public education and discussion, followed by the forging of a bipartisan agreement. The President later set forth five principles to guide the reform process:

- *Strengthen and protect Social Security for the 21st century.* This is an overriding goal, and it rules out proposals that fail to provide a comprehensive solution to the solvency problem. For example, a plan to divert existing payroll taxes into a new system of individual accounts, without other, offsetting changes, would fail the test to the extent that it would reduce Social Security's revenues and make the existing imbalance even larger.

- *Maintain universality and fairness.* The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged.
- *Provide a benefit that people can count on.* Any proposed reform of Social Security must continue to offer people a secure base for retirement planning.
- *Preserve financial security for low-income and disabled beneficiaries.* The commitment to the disability and survivors' insurance aspects of the OASDI program must be maintained.
- *Maintain fiscal discipline.* Fiscal discipline is essential to ensure that the emerging budget surpluses are not drained before Social Security reform has been addressed, and that fiscal policy plays a helpful role in preparing for the retirement of the baby-boomers.

In his 1999 State of the Union address, the President put forward a comprehensive framework for Social Security reform that satisfies these principles. First, about three-fifths of the projected budget surpluses over the next 15 years would be transferred to the Social Security trust fund. Second, about a fifth of the transferred surpluses would be invested in equities to achieve higher returns, just as private and State and local government pension funds do. The Administration intends to work with the Congress to ensure that these investments are made by the most efficient private sector investment managers, independently and without political interference. These two steps alone would extend the solvency of the Social Security system until 2055. Third, the President called for a bipartisan effort to make further reforms to Social Security that would extend its solvency to at least 2075.

The President repeated his commitment to "save Social Security first." He also stated that—if Social Security reform is secured—the remaining projected surpluses over the next 15 years should be dedicated to three purposes. First, about 15 percent of the projected surpluses would be transferred to the Medicare trust fund. The Administration, the Congress, and the Medicare commission should work to use these funds as part of broader reforms. Even without such reforms, however, the transfers would extend the projected solvency of the Medicare trust fund to 2020. Second, about 12 percent of the projected surpluses would be used to create Universal Savings Accounts, which would help people save more for their retirement needs. The government would provide a flat tax credit for Americans to put into their accounts and additional tax credits to match a portion of each dollar that a person voluntarily puts into his or her account. These accounts would not be part of the Social Security system but would provide additional retirement resources. The remainder of the projected surpluses over the next 15 years would be reserved to improve military readiness and to meet pressing domestic priorities in such areas as education and research.

Within this framework, the national debt of the United States would decline dramatically. Debt held by the public would fall from about 45 percent of GDP today to less than 10 percent in 2014. That would be the smallest burden of government debt on the economy since the United States entered World War I in 1917.

MEETING THE INTERNATIONAL CHALLENGE

This Administration has been committed from the start to outward-looking trade and investment policies. And in his 1999 State of the Union address the President called for a new consensus in the Congress to grant him traditional trade-negotiating authority that permits trade agreements negotiated with other nations to be submitted to an up-or-down Congressional vote without amendment. At the same time he proposed the launch of an ambitious new round of global trade negotiations within the World Trade Organization. The general principle behind the Administration's international economic policy is that open domestic markets and an open global trading system are a better way to raise wages and living standards over the longer term than are trade protection and isolationism. Recent strains on the fabric of the international economy have increased the allure of protectionism in some quarters. But the main lesson should be that it is essential to promote growth in the world economy, to help crisis-stricken economies recover, and to reform the international financial system in ways that make future crises less likely without abandoning the benefits that come with increased international trade and investment flows.

During the year and a half that has elapsed since the collapse of the Thai currency in July 1997, Asia's currency crisis has developed into a more widespread crisis affecting many countries around the globe. As the crisis has spread, it has impacted global commodity markets, impaired economic development, and imposed extraordinary hardship in the crisis-afflicted countries, all the while posing risks to growth worldwide, including in the United States and other industrial countries. According to projections by the International Monetary Fund (IMF), global growth is now expected to reach a modest 2.2 percent in 1999, which represents a decline both from the 4.2 percent rate attained in 1997 and from its long-run historical average of 4 percent.

CONTAINING THE CRISIS AND PROMOTING RECOVERY

Since the crisis began, the United States has led the international community's efforts to promote world economic growth, to stabilize international financial conditions, and to implement reforms to reduce the vulnerability of the international system to future crises. These initiatives are described in detail in Chapters 6 and 7.

A first prerequisite for restoring strong world economic performance is strong growth in the industrial countries that are the main customers of the crisis-afflicted economies. This need has been clearly recognized and addressed in both words and deeds by the United States and its partners among the Group of Seven (G-7) large industrial nations. In October the G-7 finance ministers and central bank governors issued a joint statement indicating that, in their view, the balance of risks in the world economy had shifted. With inflation low and well controlled, countries should commit themselves to preserving or creating the conditions for sustainable domestic growth. Monetary conditions were subsequently eased in the key industrial countries. In the United States, the Federal Reserve reduced the Federal funds rate three times, helping restore confidence and liquidity. Japan, Canada, and most of the major European countries also lowered interest rates. Japan, a country in deep recession whose recovery is particularly critical to the growth prospects of its crisis-afflicted Asian trade partners, has also taken steps to provide fiscal stimulus and has committed substantial resources to strengthen its financial system. Much remains to be done, however, and many private forecasts are for continuing contraction in Japan. Although it is premature to conclude that the rest of the world economy is out of peril, conditions have improved noticeably since October, when it appeared that the world might be headed into a generalized global credit crunch.

It is important to emphasize that, in serving as an engine of global growth during this period, the United States will inevitably see an increase in its already sizable trade deficit, and some sectors, particularly those heavily exposed to trade, will experience disproportionate impacts. The result may be a rise in calls for protection, and it will therefore be important to find constructive approaches to the disruptions caused by trade. The United States remains committed to outward-looking, internationalist policies and has urged the crisis-impacted countries to keep their own markets open.

Beyond working to ensure growth in the industrial world, the Administration has focused since the onset of the crisis on the need to contain the international contagion of financial disruption and to restore the confidence of market participants. The Administration has supported the IMF in its goal of providing financial assistance to countries in crisis that are willing to implement the reforms needed to restore economic confidence and strengthen the underpinnings of their economies, including their corporate and financial sectors. The emphasis of IMF programs on financial sector reform reflects the growing consensus, discussed in Chapter 6, that structural weaknesses, particularly in the process of financial intermediation, were a key element in initiating the crisis. It appears that many countries in East Asia have now made considerable progress toward establishing the foundation for recovery. In addition, an IMF stabilization package for Brazil, supplemented by bilateral financing, was arranged in November.

As the crisis spread, the Administration recognized that its contagion threatened even countries that had taken great strides in implementing sound macroeconomic and structural policies and had worked to strengthen the fundamentals of their economies. The President therefore proposed, and the G-7 leaders agreed to establish, an enhanced IMF facility to provide contingent, short-term lines of credit that could be drawn upon by countries pursuing strong, IMF-approved policies, accompanied, as appropriate, by additional bilateral finance. As the scope of the crisis widened, the resources of the IMF became increasingly strained. A key step in expanding them was for the United States to meet its own financial obligations to the organization. The Administration proposed, and in October the Congress approved, $18 billion in funding, opening the way for about $90 billion of usable resources to be provided by all IMF members to the liquidity-strapped institution.

To address the suffering inflicted by the crisis on the citizens of the affected countries, the Administration has proposed policies to stimulate economic recovery and alleviate hardship. Another decade of lost growth like that endured during the debt crisis of the 1980s would be intolerable, and the Administration recognizes that the industrial countries must do more than just serve as good customers for the products of crisis-impacted countries. One problem that is delaying recovery in several of the Asian crisis countries is that large numbers of companies and banks, including many that were in good health before the crisis, now face unmanageable debt burdens. Companies and financial institutions in Indonesia, the Republic of Korea, and Thailand, for example, face substantial overhangs of bad debt as a result of high interest rates and currency depreciations. To address this systemic problem, the President proposed the exploration of comprehensive plans to help countries restructure debt and restore the flow of credit needed for firms to operate. The Asian Growth and Recovery Initiative, jointly announced by the United States and Japan in November 1998, is designed to promote this goal. In addition, many crisis-afflicted countries lack effective social safety nets. Therefore the Administration also sought, and agreement was reached, to establish a new World Bank emergency facility to support social safety net spending focused on the most vulnerable citizens of these countries.

STRENGTHENING THE INTERNATIONAL FINANCIAL ARCHITECTURE

The most important issue raised by the recent international crisis is how to make sure the world never again faces another one like it. Unfortunately, there is no silver bullet—no simple solution that would simultaneously guarantee countries access to global capital flows and eliminate the risk of a crisis of confidence once again withdrawing that access. Even so, international agreement is finally emerging on some steps that can and should be taken to strengthen the architecture of the financial system, to make it less crisis prone. Chapter 7 is devoted to a discussion of potential reforms, including those proposed in recent reports by working groups of central bank governors and finance ministers from a group of industrial and key emerging market countries, informally dubbed the G-22.

The G-22 reports focus on measures to increase transparency and accountability in the financial operations of individual countries, of private financial and corporate institutions, and of international financial institutions such as the IMF and the World Bank. Greater transparency and accountability will enhance the availability, relevance, and reliability of information that investors need to evaluate the risks in lending. The reports also propose a series of reforms to strengthen domestic financial institutions: improvements in prudential supervision and regulation are particularly needed to create stronger incentives for borrowers and lenders to weigh risks and act with appropriate discipline, thereby reducing the odds of a crisis. Finally, the reports identify policies that could improve the coordination of creditors' interests during a future crisis and promote its orderly, cooperative, and equitable resolution.

Again, no magic formula can prevent the recurrence of currency and financial crises. But things can be done to limit their frequency, their impact, and their pernicious tendency to spread from country to country. Therefore, even as the United States works to contain the current crisis and help restore growth in the affected parts of the world, it will also work with the G-7 and through other international forums to implement reforms of the international financial architecture that will help achieve this longer term goal. Such reform is crucial for restoring support in an international economic system based on trade and investment flows that can contribute to rising global living standards in the 21st century. Additional necessary steps are described in Chapter 7.

EMBRACING CHANGE WHILE PROMOTING FAIRNESS

The tradeoff between efficiency and fairness is a classic problem in formulating economic policy. Policies that confer benefits broadly sometimes confer them unevenly, imposing relatively high costs on a relative few. In well-functioning markets, the broadly distributed gains usually outweigh the concentrated losses—often many times over. But those who are hurt naturally seek relief through the political process, and if government responds by substituting political remedies for market outcomes, it can dissipate the aggregate gains.

Increases in the Nation's standard of living over the longer term require that we embrace change and do not retreat from the constant succession of new opportunities and challenges of an ever-changing world. However, considerations of fairness require that we ensure that no part of our society bears disproportionate losses for the sake of achieving net gains for the rest. More pragmatically, achieving political consensus to embrace worthwhile change sometimes requires looking out for the interests of those who are visibly harmed, even if that means sacrificing some portion of the potential gains. Three very different areas of current policy concern—agriculture, corporate mergers, and international trade—illustrate these difficult choices.

AGRICULTURE

For more than a decade, a new, bipartisan farm policy has directed farmers to seek income increasingly from markets rather than from Federal subsidies. The 1994 Crop Insurance Reform Act and the Federal Agriculture Improvement and Reform (FAIR) Act of 1996 sought to replace the farm income safety net, based on government-managed price and income supports, with a system in which farmers manage their own risk through crop diversification, transactions in futures markets, and government-subsidized crop and revenue insurance. However, when the President signed the FAIR act, he expressed his concern that it failed to provide an adequate safety net for family farmers, and he reiterated his commitment to work with the Congress to strengthen that safety net.

Farmers prospered in the first few years under the FAIR act. Net farm income rose to a record $53.4 billion in 1996 and remained high in 1997, as export demand grew and world commodity prices rose from 1995 levels. In addition, farmers benefited from the transitional payments provided by the 1996 act, which boosted farm income by about $6 billion in both 1996 and 1997. In 1998, however, farm income fell, as commodity prices dropped sharply and farmers confronted a number of weather-related problems. In response, the Administration insisted on a $6 billion emergency assistance package to boost farm income. Net farm income in 1998 is estimated to have been about $48 billion, only slightly less than the 1997 figure of $50 billion. The President has also pledged to work with the Congress this year to reform the crop insurance program and farm income assistance.

The experience of 1998 reflected the tension inherent in a farm policy that is market oriented yet tries to provide an adequate safety net for family farmers. Current farm policy encourages farmers to make their planting decisions on an economic basis rather than with an eye to government support, while helping them manage risk by subsidizing insurance against both poor harvests and low prices. But to the extent that farmers have a reasonable expectation that the government will step in to provide assistance in the event of an emergency, they are unlikely to take all the appropriate risk management steps themselves. This gives rise to a moral hazard problem that cannot be eliminated entirely, because the government will always be under strong pressure to address what are perceived to be legitimate disasters.

MERGERS

The United States is in the midst of its fifth corporate merger wave of the century. The value of all mergers and acquisitions announced in 1997 was almost $1 trillion, and activity in 1998 was over $1.6 trillion. By almost any quantitative standard the current boom is substantial. Measured relative to the size of the economy, only the spate of trust formations at the turn of the century comes close to the level of current merger activity. Measured relative to the market value of all U.S. companies, however, the 1980s boom was roughly comparable in size.

Qualitatively, the current merger wave is similar to those before the 1980s in that it is taking place in a strong stock market, with stock rather than cash the preferred funding source. But unlike the pre-1980s transactions, many recent mergers are neither purely horizontal (between firms in the same or similar industries) as in the 1890s and 1920s, nor purely conglomerate (between firms of different industries) as in the 1960s and 1970s. Rather, they represent market extension mergers, in which the merging companies are in the same industry but serve different and noncompeting markets, or synergy-seeking mergers, in which companies in related markets combine to take advantage of economies of scope. In contrast to the 1980s, when many mergers were primarily motivated by financial considerations, today's mergers are primarily motivated by business strategy and the need to respond to fundamental shifts in a rapidly changing economy.

The main reason managers give for undertaking mergers is to increase efficiency. Mergers can encourage greater efficiency by reducing excess capacity, taking advantage of economies of scale and scope, and stimulating technological progress. Over time, such efficiencies translate into lower prices and better products and services for consumers. However, mergers that increase market concentration can raise prices and reduce consumer benefits. In addition, mergers, like other forms of economic change, can disrupt established patterns of economic and social activity.

When the antitrust agencies—the Federal Trade Commission and the Antitrust Division of the Department of Justice—review mergers, they do so with an eye to protecting competition for the benefit of consumers. They pay considerable attention to market definition—over how large a market the merged firm might exert market power, and what competitors it faces in that market—so that the effects of a merger are evaluated in the proper context. Antitrust enforcement has been rigorous in this Administration, and mergers receive careful scrutiny. Most have been found to be procompetitive or competitively neutral. But the minority that would reduce competition and harm consumers have been challenged. The current approach, which is aggressive without being heavy handed, stands in contrast to both the strong antimerger bias of the 1960s and 1970s and the much more lax enforcement of the 1980s.

Antitrust enforcement does not and probably should not encompass the broader range of possible economic and social effects that may be associated with mergers, such as job loss, change in ownership structure (including reduced diversity of ownership), and localized service disruptions. Such effects result not only from mergers but from many other forces as well, including technological change, deregulation, and international competition. Indeed, mergers may be more a symptom of broad change in the economy than a cause. The policies that are best for dealing with these changes include promoting full employment and macroeconomic stability, developing a skilled and well-trained work force, providing adequate unemployment insurance and other safety net programs, and helping communities adapt to economic change. All of these have been part of the Administration's economic strategy of the last 6 years.

INTERNATIONAL TRADE

International trade policy has long been a laboratory for addressing the challenge of balancing efficiency and fairness and for providing political safeguards for those who might be hurt by change and would otherwise work to block it. For example, U.S. trade law recognizes that imports can sometimes be associated with labor displacement and other disruptions, and it provides for several kinds of relief in these circumstances. So-called escape clause relief allows temporary measures to be adopted in cases where rising imports are judged to have been a substantial cause of serious injury to an industry. And antidumping duties may be imposed in cases where foreign producers are judged to have dumped their products in U.S. markets (that is, sold them at less than fair value).

Trade adjustment assistance is an alternative way of dealing with disruptions associated with trade. Since 1962 U.S. trade laws have provided for some kind of cash assistance for workers who have lost their jobs as a result of trade. In addition, the North American Free Trade Agreement (NAFTA) provides assistance to workers displaced from companies that have shut down their U.S. plants and moved production to Mexico or Canada, and the Administration has supported extending such assistance to all workers displaced by the movement of work to another country. In theory, trade adjustment assistance provides compensation from the broad class of those who gain from trade (represented by the taxpayers generally) to those who lose from it (workers in trade-impacted industries), without interfering with the efficiency-enhancing effects of freer trade. In practice, of course, things are more complicated if adjustment assistance interferes unduly with workers' incentives to find new jobs—another moral hazard issue.

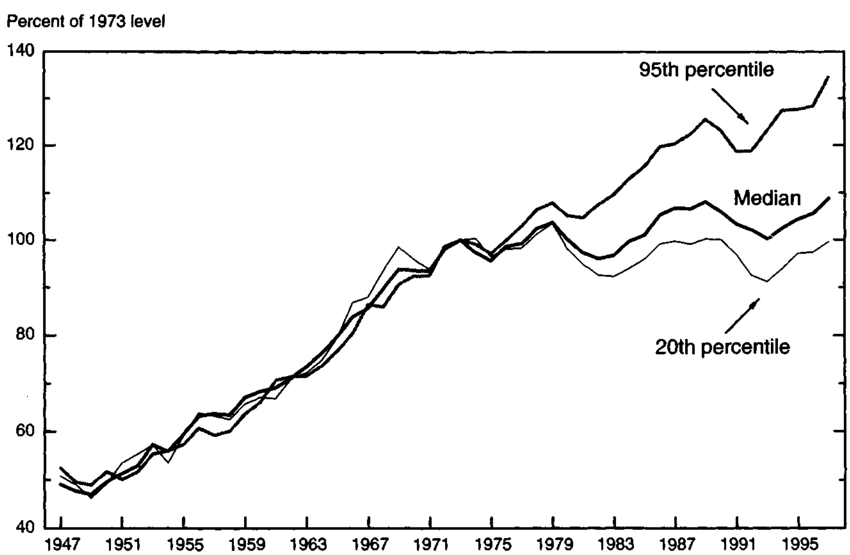
Nevertheless, adjustment assistance illustrates the general principle that it is desirable to address the disruption caused by positive change rather than block the change itself.

PROMOTING PROSPERITY FOR ALL AMERICANS

From the end of World War II until the early 1970s, the rising tide of economic growth raised wages and incomes uniformly for American families of all incomes. For example, just as the median family income approximately doubled between 1947 and 1973, so did the incomes of families near the top and the bottom of the income spectrum (Chart 1-4). Since the early 1970s, however, the pace of income growth has slowed and income inequality has increased. Median family income in 1997 was about 10 percent higher than in 1973, but income at the 95th percentile (that is, an income exceeded by that of only 5 percent of American families) was more than a third higher, whereas income at the 20th percentile was virtually unchanged.

This Administration has recognized from the start that the stubborn problems of slow productivity growth and rising income inequality were among the greatest challenges it would face. And there are heartening signs that we may have turned the corner. As mentioned earlier, productivity growth has remained relatively strong in this expansion, whereas in past expansions it has tended to flag as the expansion matures. Moreover, as detailed in Chapter 3, low-wage and minority

Chart 1-4 **Growth in Real Family Income, 1947-97**
Growth in real family income has slowed and inequality has increased since 1973.



Source: Department of Commerce (Bureau of the Census).

workers are enjoying some of the best labor market conditions they have seen in decades. The Bureau of the Census reports that the Gini coefficient (a standard measure of income inequality) has recorded no statistically significant increase since 1993, and the poverty rate fell to 13.3 percent by 1997, from 15.1 percent in 1993. These trends are encouraging. However, it is difficult to disentangle the cyclical effects arising from the particular strengths of this expansion from possible improvements in underlying trends.

Maintaining macroeconomic stability is a necessary condition for ensuring that all Americans participate in the country's growing prosperity. But it is also important to continue to develop policies that address the challenges of a changing economy and a changing society, especially in the areas of education and training. Chapter 3 discusses the Administration's initiatives to improve schools, open the doors of college to all Americans, strengthen America's work force development system, and promote lifelong learning.

CONCLUSION

The U.S. economy remained strong in 1998 despite a serious weakening in the international economy and considerable financial turmoil. The economy's ability to weather these storms is testimony to the soundness of the policies of the past 6 years and to the underlying strength of the current economic expansion. Although there is much for us all to be proud of in this economic success, the Nation still faces important challenges as it prepares for the 21st century. Chapter 2 of this Report reviews domestic macroeconomic developments in 1998 and presents the Administration's forecast for 1999 and beyond. Chapter 3 analyzes the benefits of the strong labor market in this expansion. Chapter 4 provides a context for the national discussion of Social Security reform by analyzing work, retirement, and the economic well-being of the elderly. Chapter 5 examines the role of innovation and regulation as determinants of long-term economic performance, with particular emphasis on antitrust policy, environmental regulation, and restructuring of the electric power industry. Finally, Chapters 6 and 7 analyze recent events in the international economy from the standpoint of increased globalization of capital flows and the evolution and reform of the international financial system.