

EXECUTIVE SUMMARY

Since 1983 the U.S. economy has enjoyed a Great Expansion. This era has occurred because of a sea-change in economic thought. Beginning with the Reagan Administration, policy makers rejected fine-tuning monetary policy and taxes in favor of a long-term focus on price stability and lower marginal tax rates to spur growth. To continue the Great Expansion, this report makes the following recommendations:

- M** The federal budget has turned from deficit to surplus, helped by favorable demographics, the post-Cold War “peace dividend,” and unexpectedly large tax revenues from gains related to the stock market. However, the aging of the “baby boomers” will strain the Social Security and Medicare programs. We have a window of opportunity to improve the solvency and fairness of Social Security while increasing retirement benefits. Allowing workers to channel part of their payroll tax into Personal Savings Accounts would enable them to benefit from the higher average returns that private investments yield. Similarly, health care could become more efficient by allowing workers to channel part of their payroll tax into Medical Savings Accounts.
- M** For the U.S. economy to continue growing, the next generation of workers needs a better education. Spending per elementary and secondary student has increased rapidly in the last 30 years, but achievement scores have fallen. Federal action should encourage innovative approaches that promote school choice.
- M** International trade is an important source of prosperity. The Clinton Administration’s injection of labor and environmental regulations into world trade negotiations is counterproductive and may delay progress in those areas.

- M** Currency crises in the 1990s caused worldwide economic distress. The United States should promote official dollarization, which would help to eliminate currency crises. It should also institute recommendations by the bipartisan International Financial Institution Advisory Commission to give international financial institutions more clearly defined goals.
- M** Federal taxes now take \$1 out of every \$5 produced in the United States. The federal tax system needs to be simpler, with lower marginal rates. In addition, the marriage penalty should be eliminated; medical insurance should be fully tax deductible for individuals; the Alternative Minimum Tax and the Social Security earnings test should be repealed for persons 62 to 64 as it has been for those 65 to 69; and double taxation of income from corporate ownership should be eliminated.
- M** The trade deficit is the product of relatively high recent economic growth in the United States and good possibilities for future growth. Trade deficits do not reduce employment or growth.
- M** U.S. Treasury securities contribute to the efficient operation of domestic financial markets, enhancing the dollar's status as an international currency. Reducing the debt can produce positive effects, but completely eliminating it is not desirable.

CONTENTS

FOREWORD	1
Introduction	3
1. The Great Expansion	4
I. The Great Change in Policy, 1979-81.....	4
II. Factors Underlying the Great Expansion.....	6
III. Why Has the Budget Shifted from Deficit to Surplus?	18
IV. Can the Great Expansion Continue?	20
2. Improving Social Security, Health Care, and Education	22
I. Social Security	22
II. Health Care	28
III. Education	33
3. Promoting a More Open Economy	37
I. The Trade Record of the Clinton Administration	40
II. The Future Direction of Trade Policy.....	41
4. Promoting Sound Monetary Policy at Home and Abroad	43
5. Making the International Monetary Fund More Effective	46
I. Problems with IMF Lending.....	46
II. Reforming the IMF.....	47
6. Reducing the Burden of Federal Taxes	50
I. The Size of the Federal Tax Burden	50
II. Who Pays Federal Taxes?	50
III. Problems Created by the High Tax Burden	54
IV. First Steps to a Simpler and More Efficient Tax System	55
7. Economics, Trade Deficits, and Paying Off the Debt	61
I. Is the Trade Deficit a Problem?	61
II. Should the Federal Debt Be Fully Paid Off?.....	64
8. Conclusion	67
Appendix	69
Table 1. Real Federal Spending per Person.....	70
Table 2. Civilian Labor Force	72
Table 3. National Health Care Expenditures	73
Table 4. Health Care Price Indexes	74
Table 5. Real Education Spending and Student Performance ...	75
Table 6. Trade Openness Index.....	76
Table 7. Individual Income Tax Shares	77
Table 8. Trade Deficit and Net Foreign Investment.....	78

FOREWORD

Since 1983 the United States has had nearly continuous economic growth, interrupted briefly by a recession from August 1990 to March 1991. This is the longest period of economic expansion in American history.

The roots of this Great Expansion lie in changes in economic ideas and economic policy that came to fruition in the early 1980s with the presidency of Ronald Reagan. The focus of monetary policy changed from stimulating demand and tolerating high inflation to providing price stability. As a result, inflation has been low and stable, restoring the dollar to its status as a currency trusted throughout the world. The focus of tax policy changed from imposing high marginal rates in the name of progressivity to cutting marginal rates to spur greater economic growth. As a result, entrepreneurship has blossomed, creating millions of new jobs and a higher standard of living.

Other factors that have contributed to the Great Expansion are openness to international trade, a reduction in federal spending as a share of the economy, favorable demographics as the “baby boom” generation has moved into its peak working years, developments in high-technology industries, and reforms to welfare that have encouraged more people to work. Except for the demographics, these factors are outcomes of good choices in economic policy, not merely the result of circumstance.

How can we sustain and improve the Great Expansion? This report examines what we have learned from it: what we have done right, what we could do better, and how to avoid past mistakes. With proper policies, we can continue to be confident that the future will bring progress for ourselves and for subsequent generations of Americans.

**Senator Connie Mack, Chairman
Joint Economic Committee**

INTRODUCTION

There are competing visions for the future direction of the U.S. government. One prominent vision claims we are best served by an activist government, another that we are best served by controlling and reducing the size of the federal government.

The activist vision proposes more government involvement for the problems facing our country. President Clinton's February 2000 State of the Union message, advocating more than 60 new federal spending initiatives, is an example. If it is followed, government spending will soon begin to rise as a share of the economy.

The limited-government vision focuses on controlling and reducing the size of government by offering people greater choice and more options for addressing the nation's problems. It stresses that the keys to economic progress are price stability, secure property rights, freedom of exchange in international markets, a small federal government and low taxes.

Which vision we follow will greatly influence how prosperous America's future will be. As the experience of Europe indicates, slow growth and stagnating living standards will result if government is too big. No country has been able to achieve and sustain high rates of economic growth when government spending has risen to 40 percent or more of the economy. (In the United States, total *spending* by all levels of government in 1999 was 28 percent of GDP, down from the plateau of 30 to 32 percent that existed for most years from 1975 to 1995. Total government *receipts* were 29.9 percent of gross domestic product [GDP], the highest level ever.¹)

In contrast, countries following policies consistent with price stability and free trade while restraining the size of government have persistently achieved solid growth. This mix of policies has been the key to the strong economic performance of the United States during the 1980s and 1990s. It has also been the prescription for the economic success of Ireland, Australia, Hong Kong, Singapore and several other countries in recent years.

¹These and some other statistics in this report reflect the recent revisions to U.S. national income statistics.

1. THE GREAT EXPANSION

In terms of economic performance, government policy, and effect on the thinking of professional economists, the 1980s and 1990s form a continuous era radically different from what preceded it.

Former Federal Reserve governor
Lawrence B. Lindsey

I. The Great Change in Policy, 1979-81

During the 1970s, the U.S. economy was plagued with inflation and economic instability. It performed poorly mainly because policy makers, influenced by incorrect economic theories, sought to achieve goals beyond their means. At the time, many economists and policy makers believed government could smooth business cycles by “fine-tuning” fiscal and monetary policy. The result was ill-conceived policies that caused stop-go cycles of economic growth. Many economists and policy makers also believed government could stimulate economic demand to reduce unemployment. The result was double-digit inflation.

Chastened by the combination of high unemployment and double-digit inflation that conventional economic models claimed should not occur, policy makers began to change their goals. In October 1979, President Jimmy Carter appointed Paul Volcker chairman of the Board of Governors of the Federal Reserve System. The emphasis of monetary policy shifted toward constraining inflation and achieving price stability. In 1981, newly elected President Ronald Reagan refocused fiscal policy on the long run. He proposed, and Congress passed, sharp cuts in marginal tax rates. The cuts increased incentives to work and stimulated growth. These were fundamental policy changes that provided the foundation for the Great Expansion that began in December 1982.

As Exhibit 1 shows, the economic record of the last 17 years is remarkable, particularly when viewed against the backdrop of the 1970s. The United States has experienced two of the longest and strongest expansions in our history back-to-back. They have been

Exhibit 1: The Great Expansion, 1983-Present

Both segments of the Great Expansion have delivered growth in consumption, production, jobs, and stock market valuation.

	1983-90*	1991-99*	Entire expansion
<hr/>			
<i>Real GDP</i>			
Total growth	35.7%	33.0%	80.9%
Average annual growth	4.1%	3.3%	3.6%
<hr/>			
<i>Real GDP per person</i>			
Total growth	26.7%	22.4%	54.2%
Average annual growth	3.2%	2.3%	2.6%
<hr/>			
<i>Real consumption per person</i>			
Total growth	26.8%	24.1%	56.9%
Average annual growth	3.2%	2.5%	2.7%
<hr/>			
<i>Industrial production</i>			
Total growth	28.9%	38.7%	78.9%
<hr/>			
<i>Employment</i>			
Total growth	19.9 mil.	16.4 mil.	35.0 mil.
<hr/>			
<i>Dow Jones Industrial Average</i>			
Average annual growth	14.5%	16.1%	15.0%

Sources: Industrial production data are annual figures from *Economic Report of the President, 2000*. DJIA data are quarterly averages from Economagic.com. Changes in real GDP and consumption are based on figures for 4-quarter moving averages, derived from data extracted from Haver Analytics.

Note: *The 1983-90 expansion is measured from 1983:q1 - 1990:q2. The 1991-99 expansion is measured from 1991:q2 - 1999:q4.

interrupted only by a shallow eight-month downturn in 1990-91. The years from 1983 are best viewed as a single expansion, with its roots in the policy changes of the late 1970s and early 1980s. There has never been a period of comparable length with so much growth and so little contraction in the history of the United States.²

During the last 17 years:

- Real GDP expanded 81 percent (3.6 percent a year).
- Real GDP per person rose 54.2 percent; real consumption per person rose 56.9 percent.
- Employers created more than 35 million new jobs.
- Industrial production jumped 78.9 percent.
- The Dow Jones Industrial Average ballooned 11-fold (15 percent a year).

II. Factors Underlying the Great Expansion

Economic growth is no accident: it is influenced by the policies and organization of an economy. Countries must establish an appropriate economic environment if they want to achieve and sustain rapid growth.³ The key elements of this environment are monetary stability, secure property rights, a legal structure that enforces contracts, free trade, limited government, and low taxes. The Great Expansion has occurred within this framework.

Price stability. Price stability enhances the efficiency of an economy. Low and steady rates of inflation reduce uncertainty in making long-term decisions, such as buying a house or business machinery. When inflation is low, people can spend more time producing and less time trying to protect themselves from inflation.

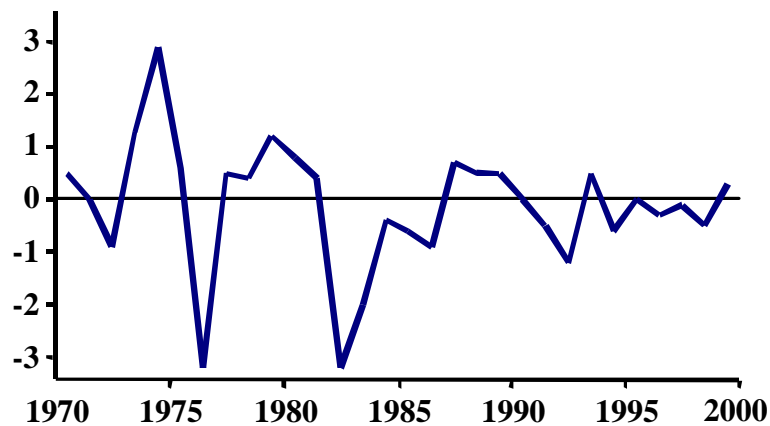
²To put the period in perspective, consider that the U.S. economy was in recession approximately 33 percent of the time from 1910 to 1959 and 23 percent of the time from 1960 to 1982, but only 4 percent of the time since 1982. This is by far the lowest percentage of any comparable period in American history.

³See Joint Economic Committee, Office of the Chairman, "Economic Growth and the Future Prospects of the U.S. Economy," October 1999, available online at <<http://www.senate.gov/~jec/gp1.htm>>.

Exhibit 2: Inflation Volatility

Inflation has been far less variable during the Great Expansion than it was in the 1970s.

**Year-to-year
change**
(percentage points)



Source: *Economic Report of the President*, 2000, table B-3.

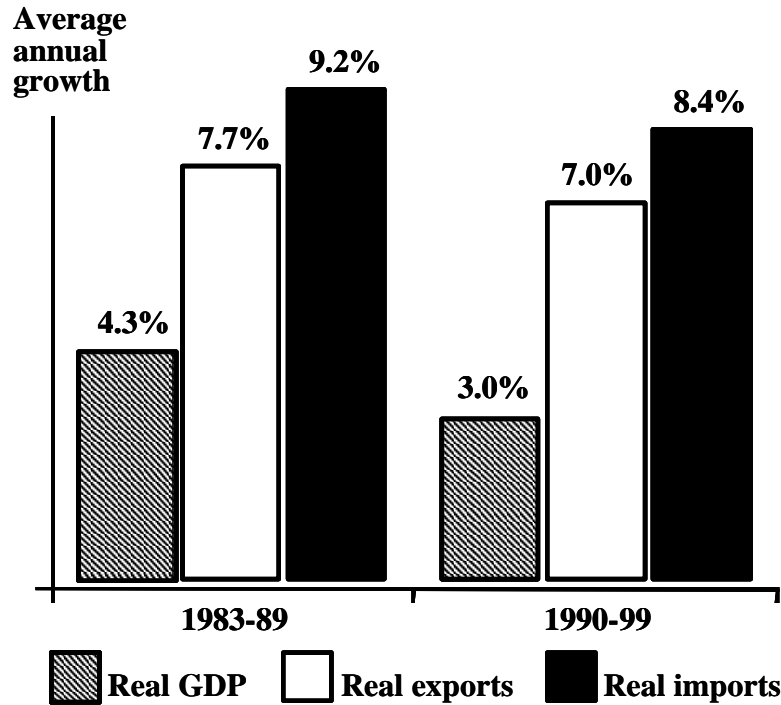
Note: Based on implicit GDP price deflator.

In addition, low inflation avoids imposing the extra tax that in effect falls on earnings if taxes are not indexed for inflation.

Under the chairmanships of Paul Volcker and Alan Greenspan, the Federal Reserve has successfully focused on price stability. As Exhibit 2 shows, the year-to-year change in the rate of inflation has never exceeded 1.2 percentage points since 1983. Low inflation during the 1980s contributed to the strength of that decade's expansion. With the passage of time, confidence increased that the Federal Reserve would continue striving for price stability, contributing substantially to the growth of the economy during the 1990s.

Exhibit 3: Growth of Trade

During the Great Expansion, international trade has grown faster than GDP, helping to propel economic growth.



Source: *Economic Report of the President*, 2000, table B-2.

When the monetary authorities achieve price stability, they have done their part to enhance growth and prosperity. In this regard, the performance of the Federal Reserve during the last two decades has been outstanding.

Increases in the size of the trade sector. Both parties in a trade gain. Buyers, whether consumers or businesses, gain because trade enables them to buy things more cheaply. Sellers gain because trade

enables them to sell more goods at better prices. Each party to a trade can focus more on producing those things it does most efficiently. Together, trading partners produce more and achieve higher standards of living than they could do separately. Trade also increases the competitiveness of markets and generates additional gains from economies of scale, the introduction of new products, innovative methods of production, and the spread of technology. All this enhances efficiency and promotes growth.^{4,5}

During the Great Expansion, the size of the U.S. trade sector has increased dramatically. Adjusted for inflation, exports more than tripled from 1983 to 1999; imports expanded even more rapidly. As is seen in Exhibit 3, imports and exports alike rose roughly twice as fast as GDP in the 1980s and the 1990s.

Trade liberalization and reductions in the cost of transportation and communications have helped boost U.S. and international trade during the last 15 years. Some countries have reduced their trade barriers unilaterally, while others have done so as an outgrowth of the “Uruguay round” negotiated by the United States and other members of the General Agreement on Tariffs and Trade (GATT). The United States has particularly reduced trade barriers with Canada and Mexico, concluding the U.S.-Canadian Free Trade Agreement in 1988 and the North American Free Trade Agreement (NAFTA) in 1994.

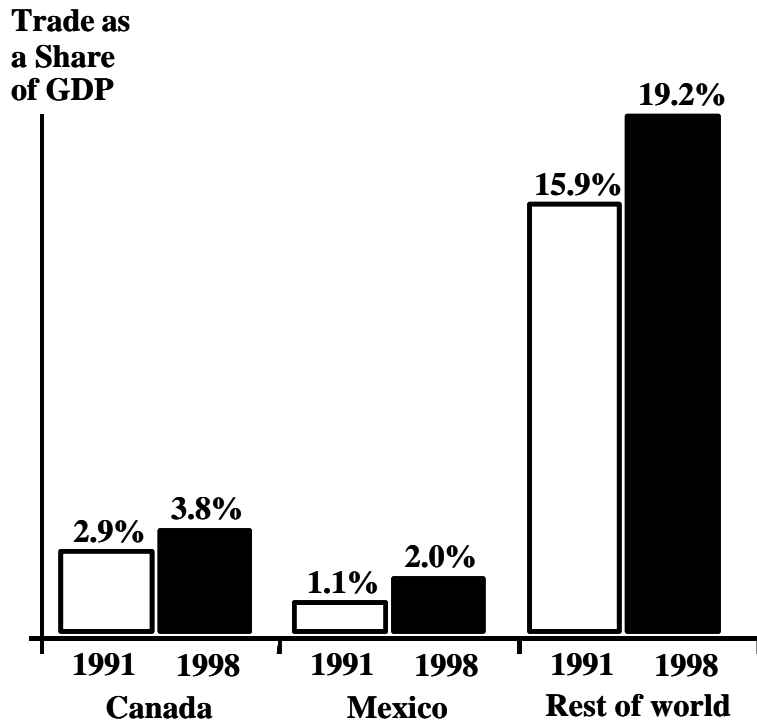
⁴For more on the impact of trade on the economy, see Joint Economic Committee, Office of the Chairman, “12 Myths of International Trade,” July 1999, available online at <<http://www.senate.gov/~jec/trade1.html>>.

⁵The positive impact of trade on growth is also stressed by the *Economic Report of the President 2000*, which states:

The freedom of firms to choose from a wider range of inputs, and of consumers to choose from a wider range of products, improves efficiency, promotes innovation in technology and management, encourages the transfer of technology, and otherwise enhances productivity growth. These benefits in turn lead to higher real incomes and wages. (*Economic Report of the President Transmitted to the Congress February 2000*, Washington: Government Printing Office, 2000, p. 282).

Exhibit 4: U.S. Trade with Canada, Mexico, and the Rest of the World

U.S. trade with Canada and Mexico has grown rapidly under NAFTA. So has trade with the rest of the world.



Sources: *Economic Report of the President*, 2000, table B-1; Department of Commerce, International Trade Administration Web site, <http://www.ita.doc.gov>.

Note: Trade share represents (imports + exports) / GDP.

From 1991 to 1998, trade with Canada rose from 2.9 percent to 3.8 percent of U.S. GDP, while trade with Mexico jumped from 1.1 percent to 2.0 percent. U.S. trade with other countries also expanded, increasing from 15.9 to 19.2 percent of GDP, indicating that NAFTA

not only expanded U.S. trade with Canada and Mexico, but contributed to an expansion in the overall size of the trade sector. Exhibit 4 illustrates the growth of U.S. trade in goods and services with Canada, Mexico, and other countries.

Economists of almost all persuasions accept that economies open to trade produce more value from their resources and achieve higher levels of income than closed economies. In contrast, protectionists argue that increased openness and expansion in trade creates unemployment, capital flight to low-wage economies, and economic stagnation. The facts support the free trade position. As the U.S. economy has become more open, employment has increased by 35 million and the rate of unemployment has fallen to its lowest level in 30 years. From 1983 to 1998, foreigners invested \$1.5 trillion more in the United States than Americans invested abroad. From 1983 to 1999, real GDP per person in the United States rose from \$21,102 to \$32,439, an increase of 54 percent. Both Congress and the Clinton Administration have generally supported open markets and rejected protectionist calls for trade restraints. Their actions have contributed to the growth and strength of the U.S. economy.

Lower marginal tax rates. When Ronald Reagan became president in 1981, the top marginal rate on federal income taxes stood at 70 percent. At Reagan's urging, Congress cut rates across the board by about 30 percent and indexed taxes for inflation. In 1986, it cut marginal tax rates again and the top rate fell to 28 percent. In just a few years, after-tax returns for the top earners jumped from 30 cents to 72 cents per dollar of additional earnings, a 140 percent increase in the incentive to earn. The effects of lower tax rates were smaller but still substantial in other brackets. Although Congress raised marginal rates in the early 1990s, marginal rates in almost all tax brackets are still well below the levels of the 1970s.⁶ These lower rates continue to enhance the growth of the economy.

⁶For a detailed analysis of how reductions in marginal tax rates during the 1980s helped strengthen the U.S. economy, see Joint Economic Committee, Office of the Chairman, "The Supply-Side Revolution: 20 Years Later," March 2000, available at <<http://www.senate.gov/~jec/ssreport1.htm>>. Some claim the Reagan tax cuts were a mistake. But to return to the steeply progressive rate structure that Reagan inherited, with a confiscatory top rate

Reductions in the size of government. Governments contribute to economic growth when they provide an environment conducive to peaceful interaction among citizens and the smooth operation of markets. As we discussed in a prior report,⁷ the following factors are particularly important:

- National defense and police services that protect people and property from aggression.
- Monetary arrangements that provide citizens with access to sound money.
- A legal system that enforces contracts and provides a forum for settling disputes.
- Provision of a limited set of goods that are difficult to provide through markets.

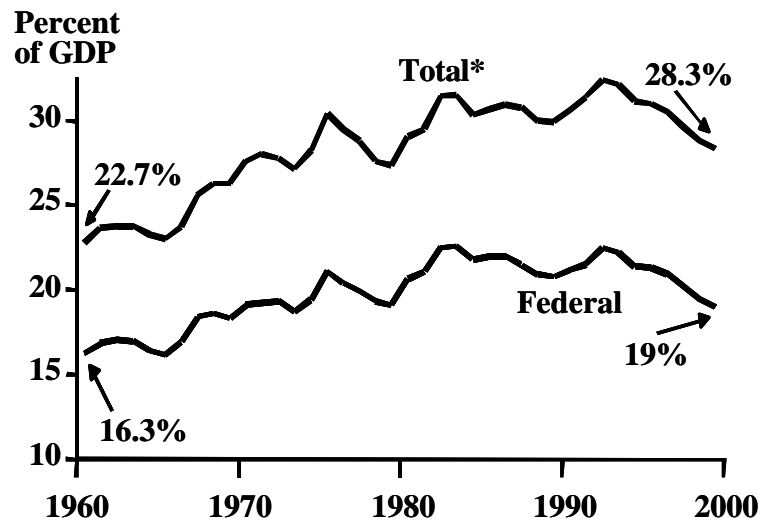
When governments handle these core activities well, they enhance economic growth. However, if they move beyond these functions and become producers of goods and redistributors of income, they generally do more harm than good. Economies with high government spending usually have sluggish economic growth. For example, in the last four decades, among countries that belong to the Organisation for Economic Co-operation and Development (OECD), a 10 percentage point increase in government spending has

of 70 percent and no adjustments for inflation, would be a severe blow to the American economy. According to estimates by the Joint Committee on Taxation of the U.S. Congress, under static analysis this would increase the tax burden by \$871 billion in 2000 alone, nearly doubling individual income taxes and raising overall taxes 54.7 percent. A middle-class family earning \$30,000 would see its taxes increase 45 percent. Because of the economic distortions resulting from such an increase, actual revenue collected would be less than this amount, perhaps even less than under current law.

⁷Joint Economic Committee, "Economic Growth and the Future Prospects of the U.S. Economy," pp. 22-7.

Exhibit 5: Government Spending as a Share of GDP

Measured as a share of GDP, government spending rose during the 1960s and 1970s, leveled off during the 1980s, and fell during the 1990s.



Source: *Economic Report of the President*, 2000, table B-80.

Note: *Total government spending includes federal, state, and local.

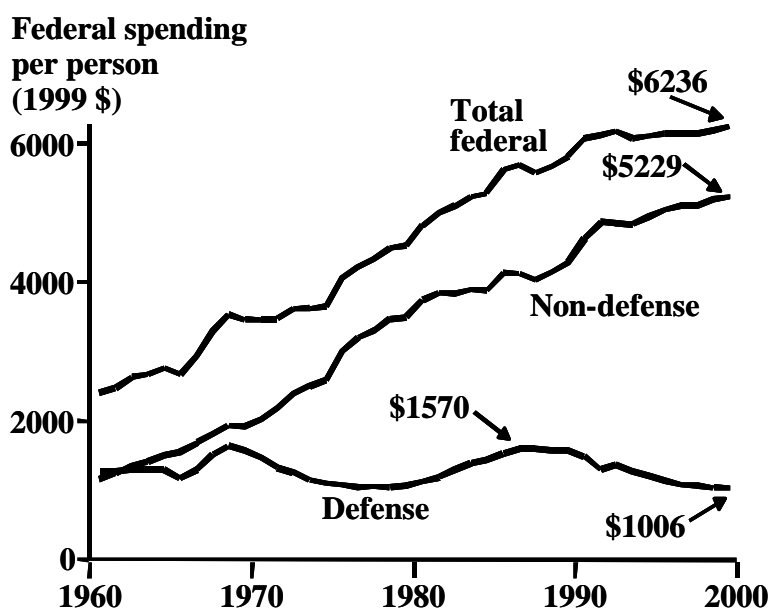
been associated with a 1 percent reduction in the long-term rate of annual economic growth.⁸

The changes in government spending as a share of GDP is shown in Exhibit 5. Federal government spending in the United States persistently rose as a share of GDP between the mid-1960s

⁸James Gwartney, Robert Lawson, and Randall Holcombe, "The Size and Functions of Government and Economic Growth," Joint Economic Committee, April 1998; the full text is available online at <<http://www.house.gov/jec/growth/function/function.htm>>.

Exhibit 6: Real Federal Spending per Person

Non-defense spending has driven the growth of the federal government. Defense reductions after the Cold War victory have slowed real federal spending per person in the 1990s.



Sources: *Economic Report of the President*, 2000, tables B-1, B-3, B-82; population data from Haver Analytics.

Note: Federal spending data are for fiscal years. For underlying data, see Appendix, table 1.

and the early 1980s. After leveling off during the 1980s, the relative size of government declined during the 1990s. Federal spending has fallen approximately 4 percentage points as a share of GDP in the last seven years. The relationship mentioned in the previous paragraph suggests that the shrinkage of government during the

1990s enhanced growth by approximately one-tenth this amount, or 0.4 percent a year.

Exhibit 6 presents data on real federal spending per person, measured in 1999 dollars. This figure rose from \$2,379 in 1960 to \$6,169 in 1992. Real spending per person on programs other than defense more than quadrupled, from \$1,137 in 1960 to \$4,837 in 1992. During the 1990s, the growth of real federal spending per person slowed substantially, mainly as a result of lower defense spending following the end of the cold war. From 1992 to 1999, total real federal spending per person was nearly unchanged, rising from \$6,169 to \$6,236, an increase of \$67. During the same period, defense spending fell \$326 per person. Both changes reflect the priorities of the Clinton Administration, which has been keener to cut defense spending and less interested in restraining non-defense spending than the Republican Congress.

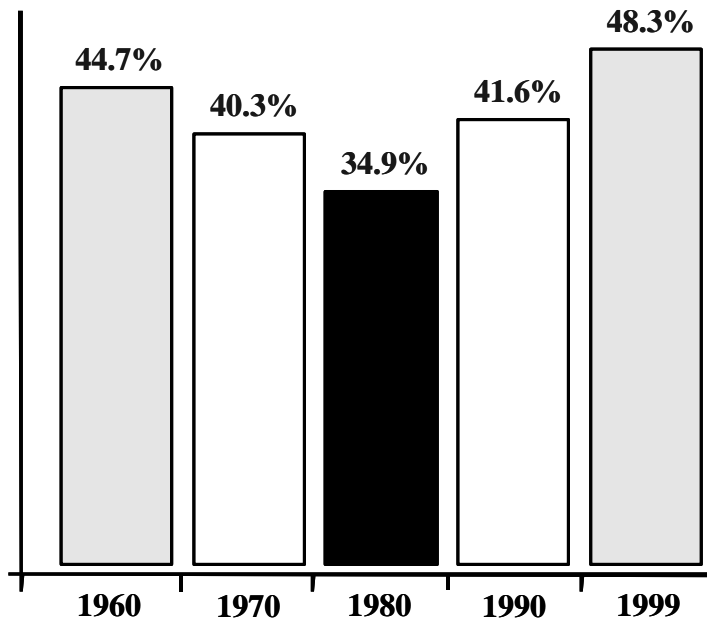
Demographics. The changing demographics of the workforce has been an overlooked factor facilitating faster economic growth in the Great Expansion. Most people spend their twenties and early thirties developing skills through higher education, training, and job experience. During these years, their productivity and earnings are below average. At the other end of their careers, as they approach retirement their productivity often declines because their health declines and because their job skills may not be as up-to-date as before. Thus, the productivity and earnings of people in their late fifties and over are also below average. People 35 to 54 generally have the combination of education, experience, and health that results in the highest levels of productivity. Therefore, an increase in the share of the population 35 to 54 years old tends to push average productivity and earnings upward.

In the 1980s, the “baby boom” generation began moving into their prime earning years. The share of the labor force in the prime years rose sharply during the 1990s. We estimate that the expansion in prime-age workers increased the total productivity of the labor force by about 0.5 percent a year from 1991 to 1998. Since World War II, labor productivity has grown an average of about 2 percent a year, so an increase of 0.5 percent is substantial. The changing share

Exhibit 7: Prime-Age Earners as a Share of the Labor Force

Prime-age earners (35-54) fell as a share of the labor force during the 1960s and 1970s but rose during the 1980s and 1990s, enhancing growth during the Great Expansion.

Share of labor force



Source: Haver Analytics.

Note: For underlying data, see Appendix, table 2.

of the labor force made up by prime-age workers across the past 4 decades is shown in Exhibit 7.

High technology. High technology has played a starring role in the dynamic economic climate of 1980s and 1990s. High-tech industries now account for over 8 percent of U.S. GDP, up from 4.5

percent in 1980. U.S. software, semiconductor, biotechnology, pharmaceutical, and Internet companies dominate world markets.

Coincident with the rapid growth in high-tech industries has been an explosion of entrepreneurship. Entrepreneurs have created thousands of fast-growing technology firms that were nonexistent two decades ago. While many pundits believed that “strategic” federal action was needed to shore up America’s high-tech sector a decade ago, it is now clear that it was the energetic and forward-looking actions of many individual entrepreneurs that put the U.S. economy back on top.

Technology has given new entrepreneurial businesses the tools needed to compete against the largest corporations. The growth in personal computers, sophisticated software applications, and the Internet has allowed new businesses to shake up many formerly stable industries. To respond to the new competitive realities, big businesses have invested billions in information technology equipment. Real business equipment and software investment have grown over 11 percent a year since 1991.

At the same time, revolutions in the nation’s capital markets, spurred by financial deregulation and technology, have channeled huge investment flows to new, entrepreneurial businesses. High-yield debt securities provided needed capital to fast-growing businesses and helped fund the corporate restructuring boom during the past two decades. Big corporations became more entrepreneurial to respond to intensified competition at home and in foreign markets.

Deregulation and capital gains tax cuts helped the venture capital market take off in the early 1980s. Venture capital investment in fast-growing companies in Silicon Valley and other hot spots has exploded from \$3 billion in 1990 to \$48 billion in 1999. Venture capital is flowing into new companies in fast-growing industries such as computers, telecommunications, and biotechnology. Complementing the growth in venture capital is the great success of the NASDAQ stock market, which has allowed thousands of young technology companies access to the funds they need to grow and compete. The NASDAQ now hosts hundreds of initial public offerings each year. The value of initial public offerings rose from \$2 billion in 1990 to \$50 billion in 1999.

The success of the U.S. high-tech sector illustrates the mutually reinforcing strengths of entrepreneurship and dynamic capital markets. Entrepreneurs have flooded into competitive high-tech industries because of the huge opportunities and rewards available to successful innovators. America's diverse sources of financial and human capital have ensured that good ideas are not overlooked, and that many paths to innovation and economic growth are pursued.

Welfare reform. The federal government enacted sweeping welfare reforms in 1996. It ended the "entitlement" status of welfare, whereby anyone with children who had a sufficiently low income automatically qualified for federal benefits. States were given much greater latitude in setting eligibility requirements and time limits for those receiving benefits. Since then, the share of the U.S. population on welfare has fallen dramatically--substantially more than can be attributed to the general strength of the economy.

Before welfare reform, the unemployment rate had been hovering around 5.5 percent for about 18 months. This was a higher rate than near the end of the 1983-90 expansion. Not until welfare reform was enacted did the unemployment rate drop below the low of the previous expansion toward the 30-year low we enjoy today.

For the economy as a whole, the cost of hiring workers includes not only compensation directly paid to workers and the taxes on their earnings, but transfer payments to potential workers who are not working. By making work less attractive for those entering the labor force in low-paying jobs, transfer payments to the able-bodied unemployed tend to increase the unemployment rate. By reducing transfer payments to the able-bodied unemployed, welfare reform reduces the cost of hiring, thereby increasing employment in the private sector and stimulating economic growth. Once in the labor force, workers in low-paying jobs acquire skills that help them stay employed and move into higher-paying jobs, whereas if they had remained unemployed they never would have acquired the skills.

III. Why Has the Budget Shifted from Deficit to Surplus?

From 1987-89, the federal budget deficit was approximately \$150 billion each fiscal year. The deficit rose during the contraction

of 1990-91 and fell as the economy began to recover. The Clinton Administration claims that its 1993 tax increase reduced the budget deficit and led to lower interest rates that propelled the expansion of the 1990s.⁹ The facts are inconsistent with this view. Interest rates, which had fallen steadily throughout 1992 and the first half of 1993, began rising almost immediately following the Clinton tax increase and passage of the 1993 budget. By July of 1994, the interest rate on 30-year Treasury bonds had risen to 7.6 percent, up from 5.9 percent in October of 1993. Other rates followed a similar path. President Clinton's scenario that his 1993 tax and budgetary policies lowered interest rates and unleashed the current expansion is simply mythology.¹⁰

If the Clinton tax and budgetary policy had little to do with the transformation of the federal budget, what accounts for the turn around? Aside from the cyclical effects of the expansion, a variety of other factors caused the federal budget to turn from deficits to projections of large and growing surpluses.

Higher defense spending in the 1980s enabled spending to be lower in the 1990s. Higher real defense spending in the 1980s proved to be an excellent investment. It led to victory in the Cold War. Following the collapse of the Soviet Union, however, real defense spending declined as the American people asked for a "peace dividend." As the Clinton Administration often highlights, the unemployment rate remained high in 1991 and 1992, the last years of President George Bush's administration, even though the economy was expanding. The transitional movement of resources out of defense and into non-defense industries was a major factor underlying the unusually high unemployment of the period. The United States was able to shift more than 2 million jobs out of

⁹In 1999, for example, President Clinton stated, "Our new economic strategy was rooted first and foremost in fiscal discipline....The market responded by lowering long-term interest rates." *Economic Report of the President Transmitted to the Congress February 1999* (Washington: Government Printing Office, 1999), p. 3.

¹⁰For additional details on this topic, see Joint Economic Committee, Office of the Vice Chairman, "Assessing the Current Expansion," January 2000, available online at <<http://www.house.gov/jec/growth/assess/assess.pdf>>.

defense-related industries between 1989 and 1993. In the short run, this was a major contraction of an important sector, resulting in sluggish growth and upward pressure on the unemployment rate. However, our free market economy created new jobs to use the talents of the displaced defense workers. This exerted a positive impact on the long-run health of the economy.

Favorable demographics. During the 1990s, prime-age workers grew rapidly as a share of the work force, while the elderly population grew much more slowly. The rapid growth of the prime-age workers propelled federal revenues, while the slow growth of the elderly population restrained spending.

Flow of funds into and out of tax-favored savings accounts. Tax legislation during the 1980s encouraged individuals and families to channel funds into tax-free Individual Retirement Accounts (IRAs) and 401(k) accounts. As funds flowed into these accounts in the 1980s, federal revenues were reduced. Funds began to flow out of these accounts in the late 1990s because federal law requires people to start withdrawing from them by age 70-1/2 or face penalties. The withdrawals are taxable. In early 1999, the Congressional Budget Office estimated that withdrawals from taxable IRAs would rise from \$93 billion in 1999 to \$195 billion by 2008. Currently, 401(k) assets are about 60 percent as large as IRA assets, indicating that withdrawals from them will also generate significant tax revenue in the coming years.

IV. Can the Great Expansion Continue?

When analyzing the factors underlying the Great Expansion, one thing is clear: a major paradigm shift occurred between the 1970s and 1980s. In the 1970s, economists and policy makers alike believed that inflationary policies would reduce unemployment. The policy makers of the 1980s rejected this view and redirected economic policy toward price stability and long-term goals regarding taxation and spending. In the 1970s, it was widely believed that stop-go monetary and fiscal policy could smooth the ups and downs of the business cycle. Only the demand-side effects of fiscal policy were recognized; the supply-side incentive effects were ignored until the

1980s. These were fundamental changes in economic thought that shifted economic policy toward an environment more conducive to economic growth.

Can the Great Expansion continue? It is unlikely that the business cycle has been repealed. Surprise shocks will no doubt occur in the future and they will exert a destabilizing influence on the economy. In this regard, the recent dramatic rise in the price of crude oil is a source of concern. When oil prices rise, oil importing nations like the U.S. have to give up more of other things for each barrel of oil imported. This adversely affects their potential output and short-term growth. Energy consumption, however, is now a smaller portion of the U.S. economy than was true two decades ago. In 1981, energy expenditures comprised 14 percent of GDP; today the comparable figure is 7 percent. Petroleum expenditures were over 8 percent of GDP in 1980; today they are just 3 percent. Sustained high oil prices may cause the U.S. economy to slow, but given its current strength, they are unlikely to throw it into a recession.

The most important lesson of the Great Expansion is a positive one: monetary and price stability, free trade, small government, and low taxes provide the prescription for stability and prosperity. The Federal Reserve has kept its focus on achieving price stability during the Great Expansion. This should continue to be its focus in the future. Lower trade barriers will enhance the growth of an economy for years to come. The U.S. economy can expect to reap gains from NAFTA for at least another decade, and additional gains can be achieved from further reducing trade barriers. Favorable demographics--the large share of the work force in the prime-age category--will continue for another decade. However, around 2010 the demographic trend will become less favorable. This will not only slow growth; it will also tend to expand the size of government unless Social Security and Medicare are reformed.

The lesson of the last two decades is clear: a continuation of the strong and steady growth experienced during the last 18 years is achievable if we follow sound policies. Now we turn to the steps that need to be taken to provide prosperity for the next generation of Americans.

2. IMPROVING SOCIAL SECURITY, HEALTH CARE, AND EDUCATION

Social Security, health care, and education now account for more than half of combined federal, state, and local government spending. As Exhibit 8 shows, spending in these three areas rose from 10.8 percent of GDP in 1970 to 15.5 percent in 1996. Despite the increase in spending, all three areas continue to suffer from poor performance. In each case, the problem is the same: too much uniformity and too little personal choice. Central planning and regulation have replaced personal choice and market competition. As the experience of centrally planned economies illustrates, a “one size fits all” approach is ultimately a recipe for disaster. Good intentions are no substitute for sound policies. The problems of Social Security, health care, and education are structural, and will not be solved by spending more money in the same old way.

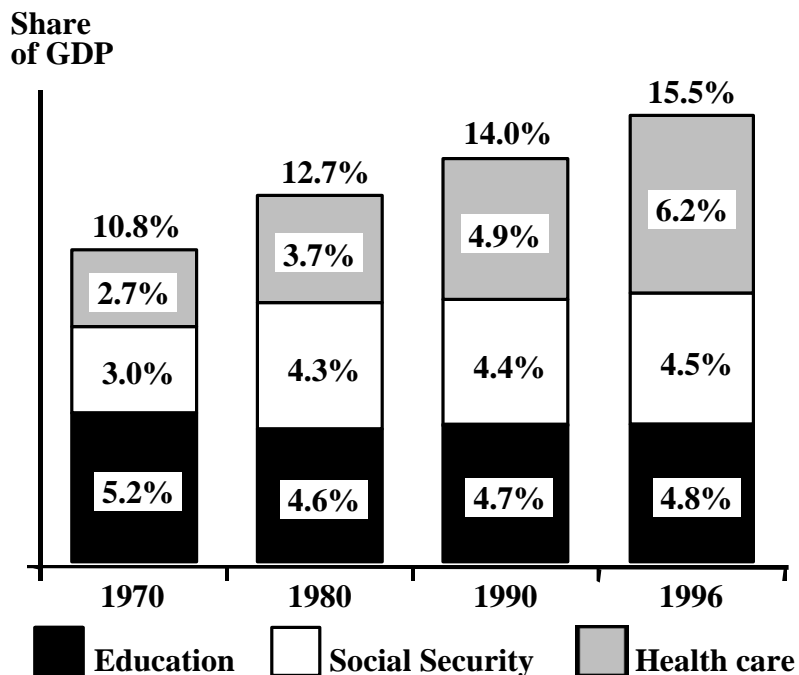
I. Social Security

The pay-as-you-go Social Security system was initiated in 1935 in favorable demographic circumstances. The population was growing rapidly, life expectancy past the retirement age of 65 was low, and the number of workers per retiree was consequently high in the system’s early years (16 workers per retiree in 1950). The system was designed for this environment and for many years it was adequate. Today the world is vastly different. The population is growing more slowly, people live longer, and there are only 3.4 workers per retiree. By 2034, the aging of the baby boom generation will reduce the ratio to two workers per retiree.

The retirement of the baby boom generation will make the Social Security system unsustainable in its present form. According to projections by the system’s trustees, by 2037 the trust fund will be exhausted and the current payroll tax rate will be unable to fund promised retirement benefits. Under reasonable population projections, promised benefits will exceed projected revenues by \$5 trillion to \$11 trillion. The retirement payroll tax already absorbs

Exhibit 8: Spending on Major Domestic Programs as a Share of GDP

Federal, state, and local spending on education, Social Security, and health care is now 15.5% of GDP -- more than half of all government spending. Since 1970, spending on Social Security and health care has risen sharply.



Sources: *Digest of Education Statistics*, various issues; *Budget of the United States Government, FY 2001, Historical Tables*; Health Care Financing Administration Web site, <http://www.hcfa.gov>.

Note: Due to rounding, column totals may not equal the sum of their represented parts.

10.4 percent of the take-home pay of each worker. Without reform, an even higher rate will be required to keep Social Security solvent.

Life expectancy is difficult to predict. During the last century, the life expectancy of Americans has increased from 47 to 77 years,

or approximately 65 percent. As we move into the 21st century, developments in drugs and biogenetics may greatly increase the number of Americans over age 70 and substantially improve their health. Like the retirement of the baby boomers, this will erode the solvency of the current Social Security system.

Under the current system, the link between taxes paid and benefits received is weak. This undermines the property rights of workers to their earnings and reduces their incentive to earn. It also results in complex redistributive effects, many of which are unintended.

The Lottery-Like Nature of the System

Social Security has become a complex redistribution program that treats several groups unfairly. Reflecting the labor force participation at the time the program was initiated, individuals can draw benefits based on their own earnings or 50 percent of their spouse's earnings, whichever is greater. For many women, benefits based on their husband's earnings exceed benefits based on their own earnings, so many working women derive little or no additional benefits from the Social Security taxes they pay.

Although the system is financed with a flat tax, benefits are highly skewed toward those with lower incomes. Retirement benefits are set at 90 percent of the first \$6,372 per year of base earnings, but additional benefits fall to only 32 percent of earnings between \$6,372 and \$38,424 and just 15 percent of earnings above \$38,424. Thus, those with earnings above \$38,424 a year gain very little from the additional taxes they pay into the system. On its face, this appears to favor the poor. Before jumping to this conclusion, however, it is important to consider that people who earn more generally live longer. High-income beneficiaries generally draw benefits longer than low-income beneficiaries. People with low incomes are more likely to pay taxes for years and then die before collecting a penny in benefits. They may pay tens of thousands of dollars to Social Security that benefit neither themselves nor their heirs. Taking this into consideration, Social Security may actually increase economic inequality.

Differences in life expectancy also redistribute income across ethnic groups. For example, the life expectancy of blacks is lower than that of whites, so blacks are more likely to pay Social Security taxes for years and draw few or no retirement benefits. As a result, the Social Security system tends to redistribute income from blacks to whites. This is not the intent of the system, but it is a consequence of its current structure.¹¹

The current system is highly unfair to those with diabetes, heart disease, AIDS, and other life-shortening diseases. On top of the burden imposed by their health condition, Social Security forces them to hand over approximately 10 percent of their earnings even though they have little or no hope of ever deriving retirement benefits.

The design of the system is also biased against families with children. Consider two families with the same income, one with four children and the other with none. Both families will one day depend on the children to generate Social Security taxes to pay for their retirement benefits. Viewed across generations, Social Security transfers income from those with children to those without. Again, this is not necessarily the intent of the system, but it is a consequence of its current structure.

The bottom line is this: the current Social Security system redistributes income in complex, opaque ways. Much of the redistribution is unintended and would be considered perverse if more people were aware of it. The complexity of the system makes it difficult for policy makers and citizens to figure out what is going on. Furthermore, the lottery-like nature of the program weakens the property rights of workers over their own earnings and thereby reduces their incentive to earn.

¹¹See Gareth Davis, "Ethnic and Racial Differentials in the Return from Social Security Old Age and Survivors' Insurance," unpublished paper, Heritage Foundation Center for Data Analysis and George Mason University, presented at Western Economic Association meetings, San Diego, July 8, 1999.

The Savings-Investment Approach to Retirement

Given the nature of the Social Security system and the difficulties that are sure to arise with the retirement of the baby boomers, this is an excellent time to consider modifications appropriate for the environment of the 21st century. Meaningful reform of the system involves shifting from a pay-as-you-go arrangement to a savings-investment approach. The current pay-as-you-go system taxes today's workers to fund payments to today's retirees. Under a savings-investment approach, each generation of retirees would fund its own retirement benefits through savings during its working years.

There are several advantages of a retirement system financed by personal savings rather than taxes. First, a savings-investment system will lead to higher capital formation. Under a savings-investment system, current savings finance real assets that will generate income in the future for retirement benefits. In contrast, there is no additional capital formation under a pay-as-you-go system. Only the promise to levy the required future taxes underlies the benefits promised to workers. Because of the additional capital formation accompanying a savings-investment system, the productivity of workers will grow faster, producing higher economic growth than would occur with a pay-as-you-go system.

Second, the incentive effects of a retirement system financed by personal savings accounts (PSAs) differ sharply from those of a tax-financed system. Taxes reduce the take-home pay of workers and reduce their incentive to earn. In contrast, PSAs provide workers with property rights to the funds paid into their accounts. Additional payments into PSAs result in higher retirement benefits or, in the case of death before retirement, larger bequests to heirs. There is a direct link between payment into the system and the benefits derived from it. The disincentive effects of the current system would be removed.

Third, PSAs would give retirees more independence by giving them clearly defined rights to the assets producing their income. Payments by Social Security are not a right; they can be reduced from their promised levels, and there is a strong possibility they will

be in future decades, when according to projections the Social Security system will run large deficits.

A wide range of proposals for PSAs has been introduced in Congress, by Democrats and Republicans alike. Generally, these plans would allow individuals to channel a portion of their payroll taxes into PSAs in exchange for accepting lower Social Security retirement benefits in the future. The PSA funds would be invested and eventually used to provide annuities during retirement. Most proposed PSA plans would be voluntary, but some would be mandatory for young workers or those initially entering the work force. In some cases, the PSA funds would be administered centrally, as in the Thrift Savings Plan to which federal employees belong. In other cases, the proposals would contract out the management of funds to private investment firms. Most proposals would provide individuals with some choice over allocating funds between stocks and bonds.¹²

The Transition to Personal Savings Accounts

Moving to a system based on PSAs would solve the primary problems of the current system. However, many people are worried about the transition from a pay-as-you-go system to a savings-investment system. Some argue that the current generation of workers would pay twice: once for the benefits of current retirees and again for their own retirement benefits.

If action is taken quickly, this potential problem can be overcome. Because the baby boom generation is in its prime earning years, during the next decade the Social Security system will need only about 80 percent of its projected revenues to fund the benefits of current retirees. The remaining 20 percent will be available to fund PSAs without having to raise the payroll tax. Moreover, the

¹²For a summary of current reform proposals that would establish personal savings accounts, see "Personal Account Options for Social Security Reform: A Side-by-Side Comparison," Joint Economic Committee, Office of the Chairman, January 2000; the full text is available online at <<http://www.senate.gov/~jec/ss22000.htm>>. The Joint Economic Committee will publish a further report on reforming Social Security later this year.

average real rate of return on private investment has been substantially greater than the 2 percent that future retirees can expect from Social Security. For example, the U.S. stock market has yielded an average long-run real return of 7 percent, and the long-run real return of a portfolio comprised 60 percent of bonds and 40 percent of stocks has averaged approximately 5.5 percent a year. Because of the substantially higher real return that can be expected from private investment compared to Social Security, only a portion of the current retirement payroll tax will be required to fund retirement benefits equal to those of Social Security.

Benefits promised under the current system can be maintained while still allowing current workers the option to channel 60 or 70 percent of their payroll tax into PSAs. In turn, contributions of 6 or 7 percentage points of earnings to PSAs can be expected to produce retirement benefits higher than those of Social Security. In contrast, if the current system is not reformed, the retirement payroll tax will have to increase from the current 10.4 percent to approximately 15 percent to fund promised benefits to the baby boom and subsequent generations.

Compared to the current pay-as-you-go system, the savings-investment approach will increase the rate of capital formation and largely eliminate the disincentive effects of the payroll tax. It will place the United States at a competitive advantage in international markets. All of these factors will enhance economic growth and the future prosperity of Americans.

II. Health Care

The Rising Cost of Health Care

There is considerable dissatisfaction with the cost of health care in the United States. Total spending on health care rose from 5.7 percent of GDP in 1966 to 13.3 percent in 1998. *Government* spending on health care soared from 1.7 percent of GDP in 1966 to 6.2 percent in 1998. The worst is yet to come: there will be a huge increase in the cost of Medicare, the largest government health care program, when the baby boomers retire. Like Social Security, Medicare transfers wealth from workers to retirees. The funds

derived from the 2.9 percent payroll tax for Medicare are immediately paid out to current beneficiaries. Presently, Medicare spending accounts for 2.6 percent of GDP and 13 percent of the federal budget. Under current law, these figures are projected to double by 2045.

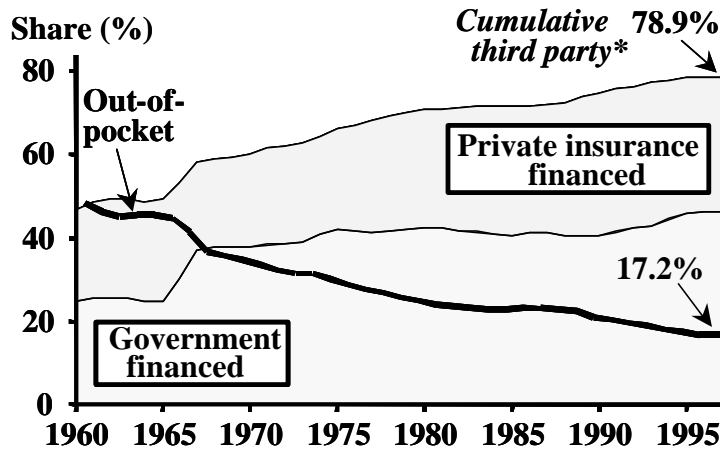
The rapid growth of health care spending to a large extent reflects the nature of the government's involvement. Since 1965, Medicare and Medicaid have subsidized health care for the elderly and the poor. One reason these programs have pushed up prices and spending on health care is that they have increased demand for medical care. The supply of key health care services is highly inelastic, that is, higher prices do not lead to much increase in output. This is perhaps most evident in the case of the services of doctors. Training for doctors is long and rigorous, so an increase in doctors' fees will not quickly increase the number of practicing doctors. Rather, fees will tend to stay high for quite a while.

An even more important reason why government health care programs drive prices upward is they virtually eliminate incentives for consumers and suppliers to economize. In a normal market, consumers have a strong incentive to shop around in search of value for money. Because consumers bear the cost of unwise purchases, they seek to avoid high-cost, inefficient suppliers. At the same time, suppliers have a strong incentive to produce efficiently and provide goods at economical prices. Failure to do so will lead to the loss of customers to rivals. Third-party payment of medical bills—the dominant practice in the United States—erodes incentives to keep costs low. When someone else is paying the bill, consumers have little incentive to economize or seek out low-cost suppliers. That reduces incentives for suppliers to produce economically and keep costs low.

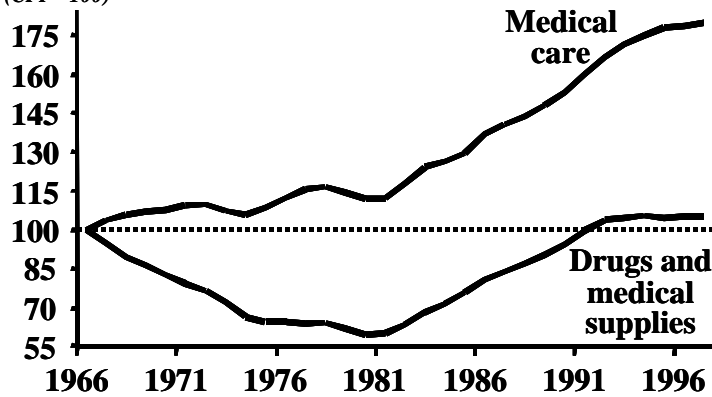
In 1960 consumers paid directly for about half of all health care spending, while insurance companies and government financed less than a quarter each. The shares changed rapidly after the Medicare and Medicaid programs were established. By the late 1970s, government financed more than 40 percent of all health care spending, and today it finances almost half. Private insurance covers

Exhibit 9: Third-Party Payments and Health Care Inflation

Since 1960, third-party payments for health care have soared while out-of-pocket spending has fallen. The cost of medical services has increased faster than prices in general.



Health care prices relative to CPI
(CPI = 100)



Source: Health Care Financing Administration Web site, <http://www.hcfa.gov>.

Note: *There remains a small portion of third-party financing (not included above) composed principally of charitable contributions. For underlying data, see Appendix, tables 3 and 4.

another 31.9 percent, and consumers pay only 17.2 percent directly. This relationship is shown in the top panel of Exhibit 9.

As government subsidies have expanded and direct spending by consumers has fallen, health care prices have risen sharply. The bottom panel of Exhibit 9 details how much faster the prices of medical services have grown than the general level of prices during the last four decades. There is no evidence that the trend is about to subside.

The Future of Health Care

Public policy is the main culprit behind rapidly rising medical costs. Neither suppliers nor consumers have much incentive to economize. The incentive to patronize low-cost, low-price suppliers is weak. Because lower prices will not attract many additional consumers, health-care suppliers have little incentive to keep prices low. As the price of health care continues to rise rapidly, policy makers impose additional mandates and regulations; some even want price controls. The experience of other countries indicates where this will lead. The health care industry is too large, complex, and diverse to centrally plan and regulate. Efforts at central planning will waste resources and produce disappointing results.

Health care costs so much because consumers directly pay for so little of it. When consumers spend their own money, they try to choose wisely and this provides suppliers with a strong incentive to control costs and offer quality service. If health care is to become more efficient and cost-effective, consumers must have both freedom of choice and incentives to consider costs.

There are two ways to make consumers more aware of costs and give them more freedom of choice than many now have. One way is to encourage increased use of personal Medical Savings Accounts (MSAs). MSAs could be particularly effective combined with medical insurance that carries a high deductible. Retirement MSAs could be used to establish a nest egg for medical expenses during retirement. Under this approach, individuals would pay into MSAs during their working years and the funds would be invested. During retirement, the funds would be used to finance health care and lifetime insurance policies with high deductibles covering

catastrophic medical expenses. Like personal savings accounts, MSAs would be the property of individuals. Funds in MSAs could be rolled over from year to year and the unused portion could be passed on to heirs.

Retirement MSAs would induce consumers and suppliers to economize, while stimulating capital formation and economic growth. Research indicates that a payroll contribution of approximately 1.3 percent (rather than the current 2.9 percent) during the working years would be sufficient to cover the cost of medical service during retirement.¹³ Equally important, the percentage would not be affected by demographic changes because each generation would finance its own costs of health care in retirement.

A second way to make consumers more aware of costs would be to shift Medicare at least partly from a reimbursement service to a defined-benefit plan. Under this approach, Medicare recipients would receive a specific amount each year for paying medical bills directly and purchasing private insurance. All Medicare recipients would be required to purchase at least a catastrophic insurance plan. The funds not used in one year could be rolled over for use in subsequent years. This approach would increase the freedom of Medicare recipients to choose the combination of medical services that best fits their personal situation.

One thing is certain: current policy places too much emphasis on the demand side (paying bills) and not enough on the supply side (expanding supply and encouraging economical decisions). Current policy is inefficient because what works for an individual does not necessarily work for a group. One person can spend more on health care and thereby obtain more care. However, when members of a large group simultaneously spend more on health care, prices go up, and because of rigidities in supply, prices can stay up for a long time.¹⁴ This highlights the need for a more balanced approach to

¹³Andrew J. Rettenmaier and Thomas R. Saving, *The Economics of Medicare Reform* (Kalamazoo, Michigan: W. E. Upjohn Institute for Employment Research, forthcoming), chapter 6. Calculations are based on data from the Continuous Medicare History Sample File, 1974-97.

¹⁴Higher prices resulting from Medicare also drive up the health care costs and insurance rates of younger people. As health care insurance becomes

health care policy. Rather than merely increasing demand, it should also focus on the need to expand the supply of medical resources (more doctors and nurses, for example).

III. Education

Increasingly, brains rather than brawn or resources are the basis of economic development and individual wealth. A good education is more important than ever to economic success. For several decades, high-level officials have been telling us that additional funds would improve the quality of public education. This promise is beginning to have a hollow ring. Spending on elementary and secondary education in the United States is high. In 1996, the latest year for which international data are available, public spending on education was 5.4 percent of GDP for the United States versus 5.3 percent for all high-income countries.¹⁵ Public spending per pupil is among the very highest in the world. Moreover, this omits private spending, which is more extensive in the United States than in many other countries.

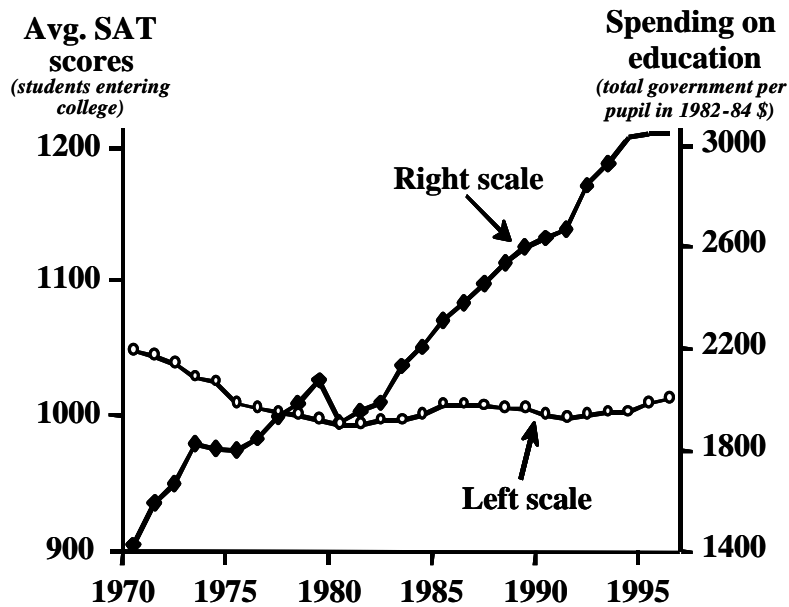
Despite spending that compares well to other nations by almost any measure, the performance of public elementary and secondary schools in the United States is widely perceived to be mediocre. This reflects too little choice. Empowerment comes from the freedom to choose. With choice, consumers, including students and their parents, shop for and choose the most attractive options. This induces suppliers to cater to their needs and produce efficiently. If consumers do not like the products or prices of a supplier, they seldom complain or organize protests. They have a much stronger weapon: shifting their business elsewhere.

more expensive, more households decide that it is unaffordable. Thus, the increase in the number of persons without health care insurance accompanying the expansion in Medicare spending is precisely what one would expect.

¹⁵World Bank data. The figure here for the United States differs slightly from that of Exhibit 8 because of recent revisions to U.S. national income accounts.

Exhibit 10: Real Educational Spending and Student Performance

Real spending per pupil on public elementary and secondary education doubled from 1970 to 1996, yet SAT scores fell.



Sources: *Digest of Education Statistics*, various issues; College Board Web site, <http://www.collegeboard.org>; Haver Analytics.

Note: For underlying data, see Appendix, table 5.

When choice is absent, consumers are unable to weed out inefficient suppliers and those that fail to provide desired products. This is precisely the problem in education. In most states, primary and secondary education is a monopoly. Students are assigned to a particular public school, and it is virtually impossible to escape the grasp of a failing school, particularly for children of parents with low incomes.

As Exhibit 10 illustrates, since 1970 real spending per pupil on elementary and secondary education has approximately doubled. Despite this increase, achievement scores fell in the 1970s, held steady in the 1980s, and crept up only a little during the 1990s. Cross-country comparisons of achievement scores also illustrate the weak performance of U.S. schools. The Third International Mathematics and Science Study, which compared achievement in 41 countries, found that even though U.S. fourth-graders scored above the international average in math and science, the scores of twelfth-graders were well below average. The achievement scores of older U.S. elementary students and secondary students lag well behind those of most developed countries.

The situation is quite different at the college and university level. In higher education, students choose the schools they attend and financial aid is more readily available, increasing the effective competition between private and public schools. The United States leads the world in the variety of programs offered, eminence of researchers, quality of facilities, and percentage of high school graduates who participate.

In its proposed budget for 2001, the Clinton Administration seeks to boost federal spending on primary and secondary education from \$17.2 billion to \$26.8 billion. Unfortunately, its approach is to continue federal direction of resources. The federal government is ill suited for assessing the diverse needs of the more than 50 million students in America's primary and secondary schools. State and local governments are much closer to the students and better able to assess how best to spend money on education. It is desirable to give state and local governments flexibility over the use of federal funds given to them for education, because the needs of students vary from place to place.

It is also desirable to encourage more choice in primary and secondary education. Several promising choice initiatives are already underway at the state and local level. These include Florida's A-Plus Education Plan, which sets clear standards for public schools and pays for students in poorly performing schools who wish to transfer to other public schools or participating private schools; state and locally funded school voucher programs in Milwaukee, Cleveland,

and elsewhere; and privately funded efforts to offer scholarships to low-income families in some of the country's worst-performing school districts.

Choice is essential for the improvement of elementary and secondary education. Without choice, experience indicates that more money will yield only further disappointing results. The federal government should encourage the initiation and expansion of choice programs. Voucher programs that pay some or all of the tuition at private primary and secondary schools already exist in other countries, including Chile, Colombia, the Netherlands, Sweden, and even post-communist Russia. If the United States is to keep up and excel in this crucial area, Americans, including those with low incomes, must have greater opportunity to choose the schools that best meet the educational needs of their children.¹⁶

¹⁶For an international perspective on choice in education, see Harry Anthony Patrinos, "Market Forces in Education," World Bank paper, July 1999, available at <http://www.worldbank.org/edinvest/Market_HP.html>.

3. PROMOTING A MORE OPEN ECONOMY

Openness to trade plays a crucial part in improving living standards. Imagine how wasteful it would be if each of the 50 states had to grow all its own oranges, produce all its own oil, or make all the movies shown within its borders. It is far more efficient for Florida to grow oranges, Texas to produce oil, California to make movies, and so on, then trade those things for the goods other states make best. In essence, the United States is a large free trade zone. This is an important factor that has contributed to our growth and long-term success. Just as domestic trade makes it possible for Americans in each of the 50 states to achieve higher income levels, international trade makes it possible for citizens in different countries to achieve higher living standards.

Economics indicates that residents of a country will be more prosperous when they are allowed to buy from suppliers offering the best deal and sell to purchasers willing to pay the most. To test this proposition, the staff of the Joint Economic Committee developed a Trade Openness Index, which measures the degree to which citizens in various countries are free to exchange goods, services, and capital assets with residents of other countries. The index is based on four factors: tariff rates, presence or absence of a black market for foreign currency, size of the trade sector as a share of the economy, and restrictions on capital movements. High ratings correspond to low tariffs, no black market for foreign exchange, a large trade sector (given the country's size and locational characteristics), and few restrictions on the inflow or outflow of capital.¹⁷

¹⁷The four components of the index were weighted equally. Country data on tariffs, black market exchange rate premiums, actual size of the trade sector relative to the expected size, and a categorical rating indicative of capital market restrictions were each placed on a 0 to 10 scale. For details, see James Gwartney and Robert Lawson, *Economic Freedom of the World: 2000 Annual Report* (Vancouver: Fraser Institute, 2000). The expected size of the trade sector is influenced by country size and location. Thus, the model used to estimate the expected size of the trade sector is adjusted for size of country (population and geographic area) and locational characteristics (length of coastline and distance from concentrations of

It was possible to derive the index for 97 countries and four time periods during the last two decades (1980-82, 1985-87, 1990-92, and 1995-97). Exhibit 11 illustrates the relationship between openness and economic growth for the countries with the 12 highest and 12 lowest average ratings for openness during these four periods. The 12 most open economies had low tariffs, liberal currency conversion policies, large trade sectors, and few restraints on the inflow and outflow of capital. Hong Kong, Singapore, Belgium, Panama, Luxembourg, and Germany head the list; the United States ranks seventh, tied with the United Kingdom and the Netherlands. In contrast, the least open economies--Myanmar, Bangladesh, Sierra Leone, Burundi, Iran, Uganda, and Syria--persistently followed policies that restricted trade.

If trade makes a difference, countries that are open over a long time should both achieve higher levels of income and grow faster.¹⁸ As Exhibit 11 shows, this has indeed been the case. The GDP per person of the 12 most open economies in 1997 averaged \$23,730—more than eight times the average of \$2,783 for the 12 least open economies. The 12 most open economies grew on average 2.3 percent a year during 1980-97, compared to *minus* 0.3 percent a year for the 12 least open economies. The striking differences in both the income levels and growth rates illustrate the importance of international trade as a source of growth and prosperity.¹⁹

demand). The Joint Economic Committee will publish a comprehensive report on international trade and economic growth later this year.

¹⁸For an excellent technical analysis of the relationship between international trade in economic growth, see J.A. Frankel and D. Romer, "Does Trade Cause Growth?," *American Economic Review*, June 1999.

¹⁹The high incomes of open economies reflect factors other than the direct impact of international trade. More open economies have also followed monetary, fiscal, and regulatory policies more consistent with high rates of investment and rapid economic growth. This highlights another point: openness gives policy makers strong incentives to establish an environment that is attractive for investment in physical capital, education, and technology. Failure to do so will result in low investment rates, capital flight, and a "brain drain." Thus, in addition to its direct effects, openness indirectly promotes growth by encouraging the adoption of sound policies in other areas.

Exhibit 11: Trade Openness, Income, and Growth

	Trade Openness Index (avg) 1980-97	Real GDP per person 1997	Avg annual growth of real GDP per person 1980-97
<i>Most open economies</i>			
Hong Kong	9.9	\$26,150	4.7%
Singapore	9.8	\$30,756	5.8%
Belgium	9.0	\$23,763	1.7%
Panama	8.8	\$7,521	0.7%
Luxembourg	8.5	\$36,190	3.7%
Germany	8.5	\$22,693	1.6% *
United Kingdom	8.4	\$21,825	1.8%
United States	8.4	\$30,610	1.6%
Netherlands	8.4	\$22,717	1.6%
Switzerland	8.1	\$27,985	0.8%
Malaysia	7.9	\$11,274	4.2%
Canada	7.7	\$23,272	1.2%
<i>Average</i>	8.6	\$23,730	2.3%
<i>Least open economies</i>			
Algeria	3.0	\$4,887	-0.9%
Madagascar	3.0	\$971	-2.2%
Nigeria	2.9	\$935	-0.9%
Argentina	2.8	\$10,600	0.4%
Ghana	2.8	\$1,913	-0.1%
Syria	2.4	\$3,182	1.0%
Uganda	2.4	\$1,117	2.2% *
Iran	2.0	\$6,206	-0.2%
Burundi	1.4	\$646	-1.2%
Sierra Leone	1.4	\$538	-3.9%
Bangladesh	0.6	\$1,117	2.4%
Myanmar	0.2	\$1,287	1.7%
<i>Average</i>	2.1	\$2,783	-0.3%

Sources: Trade openness (0-10 scale) derived by JEC staff. Data are from CIA, *Handbook of International Financial Statistics*; World Bank, *World Development Indicators, 1999*; IMF, *International Financial Statistics Yearbook, 1999*. GDP per person is in 1998 dollars, derived by purchasing power parity method. Growth rates derived from real local currency units.

Note: *Data for Germany are for West Germany only prior to unification. Due to data restrictions, Uganda's average annual growth is based upon growth only since 1982. For entire series, see Appendix, table 6.

I. The Trade Record of the Clinton Administration

The Clinton Administration has generally supported economic openness and the President's Council of Economic Advisers has consistently presented the case for free trade.²⁰ President Clinton deserves high marks for lobbying reluctant members of his own party on behalf of the North American Free Trade Agreement (NAFTA). Without these efforts, the agreement could not have been passed. Recently, however, Administration leadership on behalf of free trade has been lacking. The Administration's insistence on bringing labor and environmental regulations into the World Trade Organization (WTO) has, at least for now, undermined the WTO's effectiveness as a force for trade liberalization.

The focus of the General Agreement on Tariffs and Trade (GATT), the predecessor of the WTO, was on the reduction of tariffs and the elimination of quotas and other regulatory barriers that restrict trade. GATT was effective precisely because it focused on deregulation. If the WTO is going to be effective, it must follow the same course. It would be a major mistake to burden the WTO with new regulatory responsibilities. Other organizations, notably the International Labor Organization and the United Nations Environmental Program, already exist as forums for handling labor and environmental issues, and they are more likely to achieve progress by keeping their affairs separate from those of the WTO.

Low-income countries resent the imposition of labor and environmental regulations by the United States and other high-income countries.²¹ They argue that such regulations are nothing more than a disguised form of protectionism. They have a strong case. Their labor and environmental standards are much like those the United States itself had a century ago, when it had a comparable

²⁰See *Economic Report of the President 2000*, chapter 6.

²¹Labor and environmental standards were part of NAFTA. NAFTA, however, was an agreement among just three countries in the same region that had considerable experience in negotiating a wide range of issues related to their common borders. WTO agreements are far different. They involve 135 countries scattered across the globe. It is difficult to get a substantial majority of 135 countries to agree on anything.

income level. In 1900, most Americans began their working lives by the time they finished eighth grade. The air in American cities was thick with coal dust from thousands of stoves and furnaces, and drinking water was often infested with disease-causing organisms from raw sewage dumped by cities upstream. In those days, Americans wanted education for their children and a clean environment just as much as they do now; the problem was how to afford them.

The United States now has universal education through twelfth grade and better pollution control mainly because we are far wealthier than our great-grandparents were, not because we have better regulations or more noble intentions. Pressuring developing countries to adopt our labor and environmental standards prematurely may actually impede their advance toward the standards by slowing their economic growth. Most already have met or are striving to meet minimum standards governing such areas as prohibition of forced labor and cross-border pollution. As they grow richer, their own citizens will want them to have standards more like ours. Moreover, the United States remains free to set standards so that imported goods meet our norms for health and safety.

If the Clinton Administration is really interested in improving labor standards and environmental regulations around the world, the most constructive thing it could do would be to push for free trade. As both economic theory and historical experience illustrate, open markets will promote growth and prosperity. As the income levels of countries improve, so too will working conditions, educational levels, and the demand for stricter environmental controls. Free trade and improvements in working conditions and environmental quality are friends, not enemies.

II. The Future Direction of Trade Policy

What specifically should the United States be doing to promote more open markets and freer trade across national borders? The House and Senate have approved legislation that would reduce tariffs and liberalize trade with Caribbean and African countries. The legislation, now in conference committee, should be enacted.

Steps need to be taken to repair the recent damage imposed on the WTO and restore it as an effective organization for trade liberalization. In the short term, however, a more promising course may be to expand NAFTA, and thereby create an even larger free trade zone. Several Latin American and Pacific Rim countries--including Argentina, Chile, Australia, New Zealand, and Singapore--are leading candidates for NAFTA expansion. These countries already have labor standards and, to a lesser extent, environmental standards similar to those embodied in the NAFTA treaty.²²

Finally, it may be time for the United States to consider seriously unilaterally phasing out its tariffs and quotas. If they were phased out over 10 or 15 years, domestic industries would have ample opportunity to adjust to the more competitive environment. All trade barriers, whether imposed domestically or by one's trading partners, reduce the volume of trade and deter the achievement of maximum sustainable output. In addition, quotas also result in wasteful use of resources in an effort to circumvent trade barriers. The United States could both help itself and set an example for the rest of the world to emulate by following this course of action.²³

²²In contrast with President Clinton's praise for the demonstrators in Seattle, Mexican president Ernesto Zedillo denounced them as self-appointed representatives out to "save the people of developing countries from development." Despite the setback in Seattle, Mexico continues to move toward trade liberalization. Most recently, it signed a far-reaching free trade agreement with the European Union. Previously, Mexico had reached free trade agreements with Bolivia, Chile, Colombia, Costa Rica, Israel, Nicaragua, and Venezuela. The United States should follow a similar path and continue to expand the area in which Americans are permitted to enjoy the benefits of free exchange.

²³Currently, the United States imposes more than 1,000 import allotments that set the quantities of various products that a country can supply to the U.S. market. Quotas enable foreign suppliers to sell to U.S. consumers at prices above world market levels. Politically powerful foreigners often control quotas, which they trade like stock options. Foreign producers use circuitous shipping routes, fraudulent labeling, political contributions, and bribes in order to sell their goods in the U.S. market. In an effort to stifle the process, the U.S. government employs additional customs officials. All of this results in waste, corruption, higher taxes, and higher prices.

4. PROMOTING SOUND MONETARY POLICY AT HOME AND ABROAD

A sound currency facilitates trade by providing a reliable means of making payments, whereas a bad currency hinders trade by creating doubt that it is worthwhile to accept the currency. An unsound currency is a type of trade barrier, because a sudden depreciation of the currency--such as occurs during a currency crisis--can temporarily boost exports and choke imports much as a tariff would. For liberalization of trade to achieve its full potential, it needs to occur in a context of sound currencies. The implication for economic growth is that the United States should promote sound monetary policy both at home and abroad.

In the 1980s and 1990s, the Federal Reserve System painstakingly rebuilt the credibility it had lost in the 1970s. It had support from succeeding administrations to do so, including the Clinton Administration under Treasury Secretary Robert Rubin. Today, people around the world have confidence that inflation will remain low in the United States. This benefits lenders and borrowers alike: lenders are reassured that inflation will not rob them of their savings, while borrowers pay lower rates of interest than they would in most other currencies. It is highly desirable that the dollar continue to have high credibility. A good way to ensure that is to reform the legislative mandate of the Federal Reserve System. Agreement is spreading among economists that central banks in countries with floating exchange rates should focus on price stability as their main long-term goal. The Humphrey-Hawkins Act gives the Federal Reserve multiple, contradictory goals. The act should be revised to conform to the policy the Federal Reserve is already following in fact. That would strengthen the ability of the Federal Reserve to resist pressure for inflation.²⁴

The high credibility the dollar enjoys is rare. Among the world's 150 or so currencies, only the dollar, the euro, the Japanese

²⁴Senator Connie Mack's Economic Growth and Price Stability Act (S. 1492) would make price stability the main long-term goal for the Federal Reserve.

yen, and a few others such as the Swiss franc and British pound are trusted enough to be internationally acceptable. Most other countries have currencies that are unsound and suffer periodic currency crises as a result. In 1997, East Asian countries were affected; in 1998, Russia; and in 1999, Brazil and Ecuador. The frequency of currency crises in the 1990s has resulted in calls for a “new international financial architecture.” The Group of Seven (G-7) nations and other official and unofficial groups have held numerous meetings and issued many papers on various aspects of the subject. So far, proposals for reform have produced few concrete results.

International agreement on a new international financial architecture is likely to be slow and move in small steps. However, the United States can do much on its own to make the international monetary system more stable. Most important, it can offer countries that have unsound currencies an incentive to replace them fully with the dollar. The International Monetary Stability Act (S. 2101 and H.R. 3493), introduced by Senators Connie Mack (R-Florida) and Robert Bennett (R-Utah) and Representative Paul Ryan (R-Wisconsin), would allow the Secretary of the Treasury to share with countries that become officially dollarized some of the extra revenue the United States would earn. This would reduce the loss of revenue dollarized countries would experience from ceasing to issue their own currencies, which at present constitutes an important political obstacle to dollarization.

Until this year, Panama, which has fewer than 3 million people, was the largest independent dollarized country, and no country had become officially dollarized for decades. However, in January Ecuador, whose population exceeds 12 million people, announced its intention to become officially dollarized. Despite intervening political difficulties that included a change of government, in March Ecuador began replacing its domestic currency, the *sucre*, with dollar notes. Dollarization is expected to be complete within six months. East Timor, which recently became independent again after a quarter-century of Indonesian occupation, announced in January that it would replace the Indonesian rupiah with the dollar as its official currency. Currently East Timor is under United Nations

administration, and it is undetermined how long dollarization will persist after East Timor becomes fully self-governing.

Official dollarization has also been much discussed in a number of other Latin American countries, particularly El Salvador and Argentina. The Clinton Administration has been timid about dollarization, stressing the potential risks other countries incur when they give up the right to issue their own currency. It is in the interest of the United States to note the benefits of dollarization as well and to make a positive case for dollarization. Spreading a sound currency to more countries would benefit them by promoting higher economic growth and benefit us by reducing the cost of international transactions and expanding the number of foreign consumers able to buy American goods.

Dollarization should be completely voluntary: the United States should not exert pressure on any country to dollarize. However, it is perfectly appropriate for the United States to point out that many countries have been unable to provide sound currencies for their citizens despite experimenting with a wide range of monetary policies. Dollarization works well, whereas most other policies have not. Dollarization works because it denies a government the ability to finance budget deficits by creating inflation. That eliminates one of the main obstacles to higher economic growth in many countries. Dollarization has no preconditions; rather, by establishing a sound currency, it tends to create and enforce a framework for sound economic policies. Dollarization cannot by itself cure all of a country's economic problems, but by bringing greater stability to monetary policy and promoting transparency in government finance, it improves the chance of addressing many problems effectively.²⁵

²⁵See Joint Economic Committee, Office of the Chairman, "Basics of Dollarization," staff report, January 2000. This and other materials on dollarization are available at <<http://www.senate.gov/~jec/dollarnews.htm>>. On the benefits of a common currency for international trade, see Andrew K. Rose, "One Money, One Market: Estimating the Effect of Common Currencies on Trade," working paper, Haas School of Business, University of California-Berkeley, 17 February 2000; the full text is available online at <<http://haas.berkeley.edu/~arose/Grav.pdf>>.

5. MAKING THE INTERNATIONAL MONETARY FUND MORE EFFECTIVE

If steps are taken to establish a new international financial architecture through multinational action, they are likely to involve the International Monetary Fund (IMF). The United States has a leading role in the IMF because it is the organization's largest contributor. The IMF was established in 1945 to finance temporary balance of payments problems under the system of pegged exchange rates that existed from 1945 to 1973. Under the flexible exchange rates that have existed among the major currencies since 1973, the IMF's focus has become less clear.

I. Problems with IMF Lending

Loans by the IMF are potentially (though not always) stabilizing in the short run, but create some long-term problems.

Moral hazard. Loans may encourage reckless behavior, which economists call "moral hazard." Borrowers and lenders recognize that their national governments, backed by the IMF, will likely rescue them if they behave imprudently on a sufficiently large scale.

Inappropriate conditions attached to loans. The IMF typically imposes certain conditions on the loans it makes. Too often, one of the conditions is that recipient countries increase tax rates. That hampers economic growth by penalizing effort. Moreover, in a number of recent loans the IMF has required recipient countries to restructure entire sectors of their economies. Neither the IMF nor any other international organization has the knowledge and personnel to design such restructurings well. At the same time, the IMF has paid insufficient attention to promoting durable stabilization of currencies. The most noteworthy example is Indonesia, where the IMF in 1998 discouraged the government from using a currency board despite the success of currency boards elsewhere.²⁶ A collapse

²⁶Paul Blustein, "Suharto Reconsidering Currency Policy; IMF Opposed Indonesian Leader's Plans to Peg Rupiah to Dollar," *Washington Post*,

of the currency, economic depression, riots, and resignation of the president followed.

Cost to U.S. taxpayers. The Clinton Administration has claimed there is no cost associated with U.S. contributions to the IMF. The IMF's base rate for loans, currently less than 5 percent, is comparable to or even below the rates the United States and other highly creditworthy governments pay in open markets. But almost all IMF loans are made to less creditworthy governments who would pay much higher rates in open markets. The rates the IMF charges them do not adequately reflect their potential risk, and thereby exacerbate the moral hazard problem discussed above. Subsidized loans are not necessary to assist illiquid borrowers and are counterproductive for insolvent entities.

Lack of transparency. In response to pressure from the U.S. Congress and governments of other countries, the IMF now releases more information about its activities on its Web site and in print. This is a welcome development, but the IMF's policies (and the policies of the U.S. Treasury when it supports IMF loans) are still too ill-defined and secretive.

II. Reforming the IMF

The IMF has drifted into areas unrelated to its core mission of financing temporary balance of payments problems. Its far-flung economic development and structural lending projects duplicate the activities of its sister organization, the World Bank. To address these problems, the Congress established a bipartisan International Financial Institution Advisory Commission, which completed its work and presented a report in March 2000.²⁷ The report contains

February 22, 1998, p. A24; Steve H. Hanke, "How I Spent My Spring Vacation," *The International Economy*, July-August 1998.

²⁷The full text of the report of the commission is available online at <<http://phantom-x.gsia.cmu.edu/IFIAC/USMRPTDV.html>>. The Treasury has made some highly inaccurate criticisms of the report; see the testimony of Treasury Secretary Lawrence Summers to the House of Representatives Committee on Banking, March 23, 2000, available online at <<http://www.house.gov/banking/32300sum.htm>>. Representative Jim

many suggestions for improving the performance of the IMF and other international financial institutions. Among its findings are these:

The IMF and other international financial institutions should write off their debt to certain very poor countries that simply cannot repay it. Congressional impetus for this idea, known as the HIPC (Highly Indebted Poor Countries) initiative, was bipartisan and incorporated into law (Public Law 106-113). The IMF is making de facto writeoffs for some countries through complex accounting transactions that revalue to more realistic levels the gold it holds. In return for the writeoffs, countries agree to structural reforms to promote economic growth and prevent them from making the same mistakes again. Unlike the structural reforms agreed to in IMF loans that have more of an emergency character, these reforms are the result of more deliberation and more initiative from indebted countries.

The IMF should restrict its lending to providing temporary liquidity, and cease making long-term loans for other purposes. This would return the IMF to its core mission. The report of the commission suggests the IMF charge rates of interest above recent market rates so that countries borrow from it only when they are really in trouble. The report also proposes allowing countries to qualify automatically for loans if they meet certain international standards. Countries that do not qualify would still be eligible to borrow, but on less favorable terms and with more supervision by the IMF. The IMF should not be involved in restructuring entire sectors of national economies, such as automobiles or food distribution.

The IMF should improve its transparency further. It should disseminate its so-called Article IV reports and other country information that, at the request of some member countries, is now confidential. Also, it should publish minutes of the meetings of its executive board, with a suitable lag, and should reformat its balance sheet to be more understandable. At present, the balance sheet

Saxton (R-New Jersey) introduced the IMF Reform Act of 2000 in February (H.R. 3750) to address some of the same issues covered by the commission. The bill is available online at <<http://www.house.gov/jec/imf/2-29-leg.pdf>>.

contains no direct information on how much the IMF has lent or how liquid its various assets and liabilities are.

The IMF has sufficient assets to borrow from international capital markets should it need to expand its capacity to lend in the near future. It is not necessary for U.S. taxpayers to put more money into the IMF through an increase in the U.S. contribution.

Countries should choose either firmly fixed exchange rates (dollarization or currency boards) or fluctuating rates. As officials of the U.S. Treasury have also said, mixed systems such as pegged exchange rates have proved to work poorly. The IMF should not force countries to give up pegged exchange rates, but it should not lend to support them and should tell countries that its best advice is to avoid pegged rates. The commission was silent about the choice between fixed and fluctuating rates, but experience indicates that fluctuating rates work better in developed countries than in developing countries.

The Commission's recommendations are sound and they should be implemented. The report of the commission proposes a phase-in period of three to five years to implement these and other recommendations. That is ample time to allow countries to adjust to the new rules under which the commission recommends the IMF operate.

6. REDUCING THE BURDEN OF FEDERAL TAXES

I. The Size of the Federal Tax Burden

Just eleven years after breaching the \$1 trillion revenue barrier in 1990, the federal government is expected to top \$2 trillion in revenue in the coming fiscal year. The strong economy has fueled record tax collections from the income, payroll, and excise tax systems. Since 1992, federal revenues have risen 79 percent, compared to a 54 percent rise in nominal GDP.²⁸

In earlier times, the federal government could rely on a few simple tax mechanisms to collect the resources that it needed. In 1900, federal taxes represented just 2.4 percent of GDP, which was collected without the need for payroll taxes or individual and corporate income taxes. Customs dues and excise taxes generated 91 percent of federal taxes back then. It cost the Treasury about \$12 million to collect taxes and customs dues in 1900, and required roughly 10,000 workers.²⁹

Today, federal revenues are 20 percent of GDP, meaning that one-fifth of the value of everything produced is channeled through Washington, D.C. Numerous and complex tax collection systems are needed to tap into different pools of income in the economy. The IRS now employs 100,000 workers with an \$8.2 billion budget.

It is useful to occasionally step back and ask: who really pays the \$2 trillion in taxes, and how does its collection affect the performance of the economy?

II. Who Pays Federal Taxes?

Personal income taxes account for 49 percent of federal revenues; Social Security and Medicare payroll taxes account for 33

²⁸Data from the Office of Management and Budget for fiscal years; figure for 2001 is estimated.

²⁹*Statistical Abstract of the United States, 1902*; U.S. Treasury, *Annual Report of the Secretary of Treasury, Fiscal Year 1900*; and Joint Economic Committee estimates.

Exhibit 12: Individual Income Tax Shares
Over the last two decades, high-income taxpayers have paid an increasing share of federal personal income taxes.

Income group	Share of total federal personal income tax paid		
	1980	1990	1997
Top 1%	19.1%	25.1%	33.2%
Top 5%	36.8%	43.6%	51.9%
Top 10%	49.3%	55.4%	63.2%
Next 40%	43.7%	38.8%	32.5%
Bottom 50%	7.0%	5.8%	4.3%

Source: Internal Revenue Service.

Note: For entire series, see Appendix, table 8.

percent; corporate income taxes account for 10 percent; and other taxes account for 8 percent. Each source of federal tax revenue imposes a distinct cost on American families in their roles as workers, consumers, savers, and entrepreneurs. The actual burden of a tax may be distinct from the source of collection. Following is a brief description of the burden of each major tax.

- **Personal income taxes.** The personal income tax burden is highly skewed towards upper-income individuals. As the IRS data of Exhibit 12 show, the top 5 percent of tax-filing families paid 51.9 percent of the federal personal income taxes in 1997, up from 43.6 percent in 1990 and 36.8 percent in 1980.³⁰ The top 10 percent of earners paid 63.2 percent of the 1997 federal income tax. While the revenue collected from the top group has

³⁰Internal Revenue Service, *SOI Bulletin*, Spring 1999, and electronic data from the IRS for 1997. See Appendix, table 8, for annual data on the shares of personal income taxes paid by various income groups since 1980.

risen, the share paid by the bottom 90 percent of taxpayers has fallen. Interestingly, this was true during both the 1980s, when marginal rates were reduced, and during the 1990s, when except for the capital gains rate, the top marginal rates were increased. The standard deduction and other provisions exempt millions of lower-income families from taxation, so that just 64 percent of U.S. families are expected to pay income tax in 1999.³¹

- **Payroll taxes.** The combined Social Security and Medicare payroll tax of 15.3 percent imposes a heavy burden on all employed and self-employed families, since it applies to wages from the first dollar earned. About 80 percent of working families pay more payroll taxes than they do income taxes.³²
- **Corporate income taxes.** The corporate income tax is passed through businesses to shareholders, debt holders, workers, consumers, or some combination. The tax is highly complex and creates a hidden burden of taxation that many Americans are unaware that they pay.
- **Other taxes.** Consumers pay federal excise taxes on a variety of products including cigarettes, gasoline, alcohol, telephone service, and other items. The federal estate and gift tax, also known as the death tax, can be thought of as falling on either deceased people or their heirs. It is considered unjust by many, and can impede the transfer of family businesses such as farms and shops.

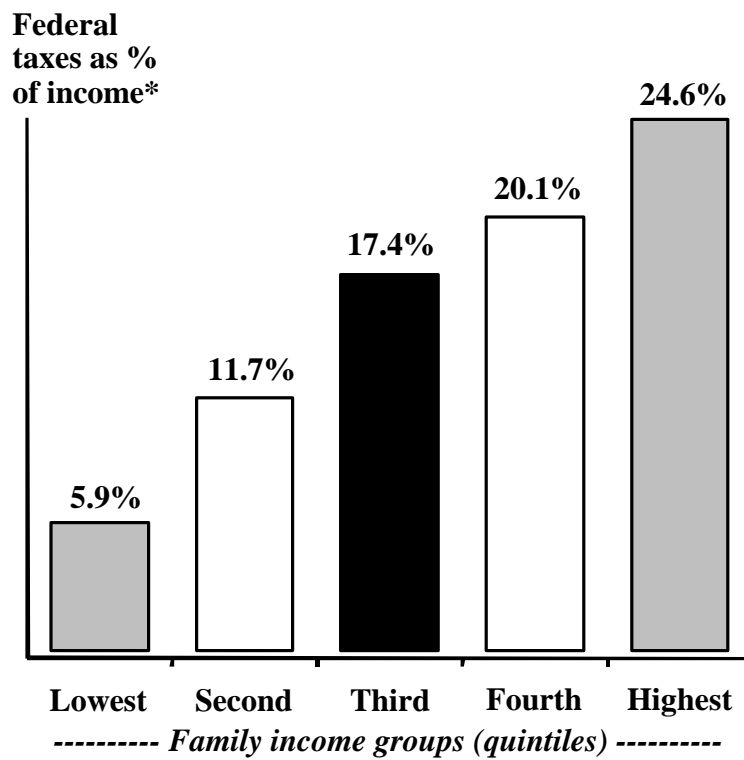
All in all, the federal tax system is highly progressive, meaning that lower-income families pay a smaller share of income in taxes than higher-income families. Exhibit 13 shows Treasury Department estimates of average tax burdens for U.S. families grouped into five income groups for 2000. Families in the highest fifth will pay 24.6

³¹U.S. Congress, Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004," JCS-13-99, December 22, 1999.

³²Congressional Budget Office, "Estimates of Federal Tax Liabilities for Individuals and Families by Income Category and Family Type for 1995 and 1999," May 1998.

Exhibit 13: Total Federal Taxes as a Share of Income

The higher the income, the greater the share of earnings a family pays in federal tax.



Source: Treasury Department. Income is "Family Economic Income."

Note: * Total federal taxes include income, excise, payroll, and estate taxes.

percent of income in federal taxes this year, on average, while families in the lowest fifth will pay 5.9 percent.

III. Problems Created by the High Tax Burden

While the \$2 trillion of federal taxes collected each year do fund many useful and desirable programs, they also create an array of damaging side effects on the nation's economy. The most obvious impact, of course, is that individuals lose control of earnings sent to Washington, and as a result may be short of funds needed to finance their own family's food, housing, or health care needs.

The actual transfer of resources from individuals to the government through taxation is far from frictionless. A tax dollar extracted from an individual or a business ends up costing the private economy much more than just one dollar. This is the case for two main reasons.

First, tax design, collection, and enforcement is costly and requires many highly skilled experts who would otherwise be producing useful goods and services for consumption. In addition to the IRS's 100,000 employees, every business in America must employ tax accountants, bookkeepers, and lawyers to tabulate and collect the required taxes. In turn, they hire tens of thousands of outside accountants and lawyers to figure out how much is owed, devise plans to minimize next year's tax bill, and do battle in the tax courts. For example, U.S. businesses spend roughly \$5 billion each year in tax consulting fees to the Big Five accounting firms, let alone fees paid to smaller accounting firms, law firms, and other consultants. One estimate placed the total cost of tax compliance for U.S. businesses at \$150 billion.³³

The Office of Management and Budget estimates that individuals and businesses will spend over 6 billion hours (3 million person-years) filling out tax forms this year, including hours spent record-keeping and learning the tax rules.³⁴ The tax code has gotten so complicated that more than half of U.S. families now use tax preparation firms to make sure they comply with the complex rules. These firms, such as H&R Block and Jackson Hewitt, have seen their

³³Tax Foundation *Special Brief* by Arthur Hall, March 1996.

³⁴Office of Management and Budget, *Information Collection Budget of the United States Government*, fiscal year 1999.

businesses soar. H&R Block's 1999 revenues from tax operations of \$1.3 billion are up 30 percent in the past two years.

A second, larger burden to the economy than the actual tax collection costs are the incentive and disincentive effects created by the tax code on individual and business behavior. High marginal tax rates in the personal income tax code dissuade individuals from extra work effort, saving for retirement, or taking risks to start and grow businesses.

The highly complex corporate income tax system has a wide-ranging impact on how American businesses structure themselves and conduct their operations. Business decisions such as how much new machinery should be purchased, where new facilities should be located, how employees should be compensated, how many workers should be hired, and what type of pension plan to offer, are all affected by tax rules. The result is that billions of dollars of economic resources are being moved around in response to tax rules, and not being allocated to uses that maximize economic growth.

In summary, larger tax burdens mean that more skilled people are engaged in zero-sum work, and that more economic decisions are made with regard to tax considerations, rather than individual choice and maximum efficiency. While taxes are required to fund the necessary functions of government, a simplified tax system can minimize these negative side effects. At the heart of tax reform ideas, such as the flat tax and the national retail sales tax, is the goal of minimizing distortions and waste in the current system.

But before the country moves towards a major tax reform, the federal tax system can be updated and improved with some smaller reforms. The next section briefly summarizes some first steps towards a new tax system for the 21st century.

IV. First Steps to a Simpler and More Efficient Tax System

Reduce income taxes on savings and investment. America's income tax system is widely recognized to create a bias against savings and investment. Because savings and investment are crucial to sustaining strong economic growth, reforms should be enacted to reduce this distortion.

A main source of the problem is that earnings from corporate investments are taxed at both the corporate level and the individual level. Corporate profits generated by investments in machines and equipment first incur a 35 percent corporate income tax.³⁵ Then a portion of earnings are distributed to individual shareholders in the form of dividends, which are subject to ordinary income tax rates of up to 39.6 percent (plus state and local income taxes). If corporations retain after-tax profits, company valuation will increase as share prices rise. Ultimately shareholders will pay tax on the rising share prices when they realize capital gains, or may pay the estate tax on the fair market value of their shares when they die, at a top rate of 55 percent.

Consider a corporation that earns \$1 per share, pays 35 cents in corporate income tax and distributes the remaining 65 cents. Individual shareholders in the 39.6 percent tax bracket will end up with just 39 cents from the original \$1 in earnings. In this case, the effective marginal tax rate on the \$1 of earnings is 61 percent. Even taxpayers in the 15 percent bracket confront an effective tax rate of 45 percent on their corporate earnings, leaving them with only 55 cents of each dollar earned by their corporate assets. The effect is to reduce the return on equity investment, which may reduce the pool of capital available for business investment, and may bias businesses toward debt financing, since interest is a deductible expense at the corporate level.

While many other industrial countries have a higher overall level of taxes than the United States, most nonetheless have income tax systems that contain provisions to reduce the double-tax burden on corporate equity. The double layer of tax may be reduced by lowering the tax on dividends and capital gains at the individual level, or allowing businesses to deduct dividends at the corporate level.

Other aspects of the income tax system are also investment-unfriendly for U.S. businesses seeking to compete in the global

³⁵Moreover, to the extent that depreciation schedules do not allow the equipment to be fully expensed, the initial investment is also subject to additional tax.

economy. For example, the rapid obsolescence of new technologies is not fully reflected in tax depreciation rules. Semiconductor and printed circuit board manufacturing equipment must be written off over five years, but often becomes obsolete in three. A number of other industrial countries have more competitive depreciation treatment for technology equipment.³⁶

In summary, through multiple tax layers, high marginal rates, and uncompetitive depreciation rules, the income tax system creates disincentives to savings and investment. The benefits of reducing these burdens would include greater efficiency, reduced business debt levels, greater capital formation, and faster economic growth.

Reduce the marriage penalty. Substantial concern has been expressed in recent years regarding features of the income tax code which create “marriage penalties.” These occur because the tax code does not treat a married couple as equal partners in earning the couple’s total income.

Marriage penalties are mainly caused by the breakpoints between tax brackets for married taxpayers (which are not twice the breakpoints for single taxpayers), and the standard deduction for married taxpayers (which is not twice that for single taxpayers). In 2000, the standard deduction is \$4,400 for singles, but only \$7,350 for married couples. Similarly, the 28 percent tax rate bracket begins at \$26,250 for singles, but only \$43,850 for married couples. At the top end of the income spectrum, marriage penalties become severe. This is because the income breakpoint for the 39.6 percent rate is the same for singles as for married couples. A straightforward way to reduce marriage penalties is to make the standard deduction and the tax breakpoints for married couples twice the amounts for singles.³⁷

Make health insurance deductible for individuals. Health care insurance is an important component of employee compensation

³⁶Testimony by the American Council for Capital Formation before the Senate Budget Committee, January 20, 1999. The Treasury Department is conducting an extensive study of depreciation periods and methods, which will be completed later this year.

³⁷This has been proposed in the Marriage Tax Relief Act of 2000, which has been passed by the Senate Finance Committee and awaits action by the full Senate.

for most workers. There are two main reasons why employers and employees benefit from inclusion of health insurance in compensation packages: lower costs as the result of economies of group purchase, and employer tax advantages. As a result, about two-thirds of non-elderly adults receive health insurance through group plans offered by their employers.

When employees receive health insurance benefits as part of their compensation package, the benefits are generally not taxed at the employer or employee level. By contrast, families and individuals purchasing health insurance directly must generally do so with after-tax earnings.³⁸ This difference in tax treatment makes the direct purchase of health insurance more costly, creating an unfair bias against families not receiving benefits through work.

This unequal treatment is a historical relic dating back to World War II. At the time, employers provided health insurance as a means to escape wage controls. Because health insurance was not counted as a wage increase, it enabled employers to raise total compensation and attract additional workers. The rule distorts personal decision making and reduces the competitiveness of the health insurance industry. In today's world, the rule is indefensible. Legislation making the direct purchase of health insurance fully deductible for all families should be adopted. Provisions in the Taxpayer Relief and Relief Act of 1999 would have accomplished this, but President Clinton vetoed the act.

Repeal the Alternative Minimum Tax. Congress adopted the Alternative Minimum Tax (AMT) to ensure that high-income taxpayers would pay their fair share of taxes. Unfortunately, this goal was accomplished at a very high cost in terms of tax complexity because the AMT essentially requires taxpayers to perform additional calculations under a second tax system parallel to the regular income tax.

³⁸However, taxpayers who itemize can deduct some medical expenses, but only to the extent that their total medical expenses exceed 7.5 percent of adjusted gross income. Self-employed individuals can currently deduct 60 percent of their family's expenses for health insurance; this will rise to 100 percent in 2003.

Today, tax statistics show the AMT is unneeded because higher-income families pay a very high average tax burden even before AMT is considered. IRS figures show that in 1997 families with incomes over \$200,000 (who represent just 1.5 percent of tax filing families) paid 37.1 percent of all income taxes before AMT. The AMT only very slightly increased the tax share of these families to 37.3 percent. But this slight increase in burden creates high complexity costs for taxpayers, and high administrative expenses for the IRS. The IRS National Taxpayer Advocate and other tax experts recommend that this unnecessary tax be repealed, or at least reformed.³⁹

While the tax was originally aimed only at high-income Americans, flaws in its design mean that rising numbers of middle-income taxpayers must also deal with the AMT. In particular, AMT exemption amounts, phase-out thresholds, and the top tax rate threshold are not indexed for inflation, so as incomes grow more families become subject to this tax. Even if they do not owe AMT, more and more taxpayers must perform calculations to see if they are liable for it, above and beyond their regular tax amount. Taxpayers hit by this add-on tax are projected to jump from about 1 million today to about 9 million by 2009.⁴⁰

Repeal the Social Security earnings test. Americans in their sixties are increasingly healthy and energetic and not ready for retirement. Unfortunately, current Social Security rules discourage them from continuing to work. The minimum age to begin receiving Social Security retirement benefits is 62. The Social Security “earnings test” reduces benefits for retirees age 62 to 69 who have earnings from work above fairly low earnings thresholds. While these rules are not part of the tax system, they effectively act like a high marginal tax rate on work effort for retirees. The earnings test should be repealed to eliminate this perverse incentive which discriminates against the industrious elderly.

³⁹Internal Revenue Service, National Taxpayer Advocate, *Annual Report to Congress FY 1999*.

⁴⁰U.S. Congress, Joint Committee on Taxation, report JCX-39-99, June 22, 1999.

In 2000, individuals age 62 to 64 lose \$1 of benefits for every \$2 they earn above \$10,080 a year. Those age 65 to 69 lose \$1 of benefits for every \$3 they earn above \$17,000 a year. Like other workers, older workers are also subject to payroll and income taxes on earnings.

The combined effect of lost Social Security benefits plus payroll and income taxes means that, above the threshold, persons age 65 to 69 keep only \$41 for every \$100 they earn if they have decided to take Social Security benefits during those years. This effectively creates a marginal tax rate of 59 percent.⁴¹ Such high marginal tax rates are hard to justify. The economy suffers because it is deprived of the knowledge and skills of productive workers. The elderly are harmed because the law discourages them from providing for themselves and, as a result they become more dependent on government.

Today, most Social Security recipients do not work. But many would like to, and this policy discourages them from doing so. As the health of older Americans continues to improve, the harmful side effects of the current Social Security earnings test will worsen. As we write this, a bill to remove the earnings test for persons 65 and older (H.R. 5) has passed the House of Representatives and the Senate. However, the bill would not remove the earnings test for persons under age 65.

⁴¹Suppose that a Social Security recipient age 65 to 69 earns an additional \$107.65 in pre-tax wages above the earnings threshold. Payroll taxes take \$15.30, income taxes are \$15 in the 15 percent bracket, and Social Security benefits are reduced \$33.33. The effective, combined marginal rate is $\$63.33 \div \$107.65 = 0.59$, or 59 percent.

7. ECONOMICS, TRADE DEFICITS, AND PAYING OFF THE NATIONAL DEBT

Sound economic policy requires sound thinking. Two issues that are currently attracting considerable attention are trade deficits and the possible elimination of the federal government's public debt. Economic analysis provides considerable insight into both issues.

I. Is the Trade Deficit a Problem?

During the last 25 years, the United States has persistently run large trade deficits. There is a natural tendency to believe that a trade deficit is bad for an economy. This is understandable: the word "deficit" suggests things like excessive spending relative to income, bank overdrafts, indebtedness, and a future day of reckoning. A trade deficit, however, is not like this. A trade deficit occurs when a nation's imports exceed its exports. Many times, this occurs because a nation is growing more rapidly than its trading partners. Rapid domestic growth stimulates imports, while slow growth abroad weakens demand for a nation's exports. This combination often causes a trade deficit.

Trade deficits may also occur when investment opportunities at home are attractive relative to those available abroad. Trade deficits are the flip side of net inflows of capital. With floating exchange rates, market forces will bring American purchases of goods, services, and assets from foreigners into balance with sales of these items to foreigners. This means that

$$\text{Exports} + \text{Net Foreign Investment} = \text{Imports}^{42}$$

Therefore, when foreigners invest heavily in a country--when there is the net inflow of capital--a trade deficit (current-account deficit) will occur.

⁴²This formula omits investment income and unilateral transfers, which are small in the case of the United States.

During the last two decades, the United States has grown faster than many of its trading partners. At the same time, investment opportunities have been highly attractive in the United States. This combination has undergirded the trade deficits of the last two decades. Why do many people think the trade deficits are bad? Would we have been better off if the U.S. had grown more slowly or if the environment for investment in the United States had been less attractive? These questions answer themselves. Recent trade deficits reflect the strength of the U.S. economy, not its weakness.

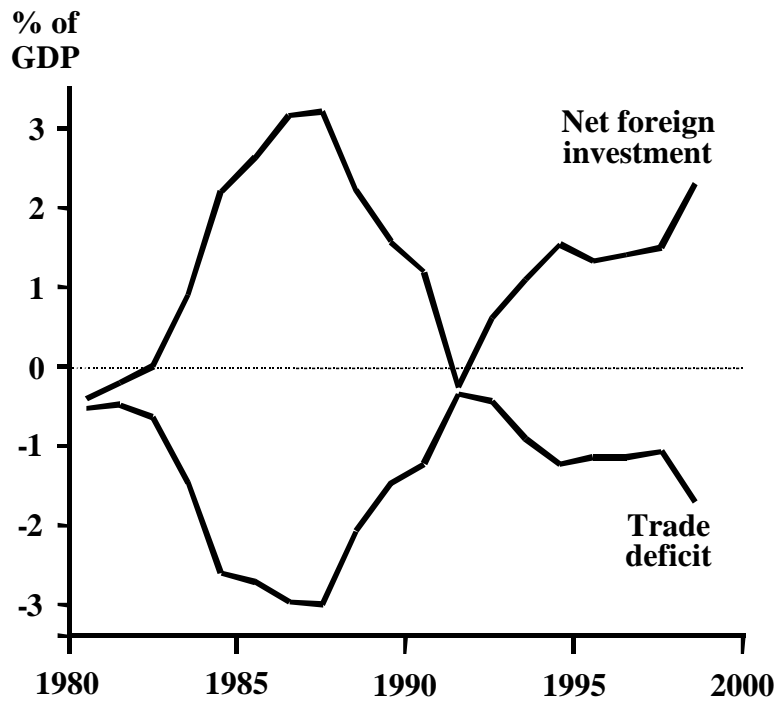
Exhibit 14 illustrates that net foreign investment (net inflow of capital) and the trade deficit are almost mirror images. When net foreign investment increases, the demand for the dollar rises in the foreign exchange market, causing it to appreciate. In turn, the appreciation of the dollar stimulates imports relative to exports, causing a trade deficit. Just the opposite happens when there is an outflow of capital: the dollar depreciates, exports are stimulated relative to imports, and the trade balance shifts toward a surplus.

Doesn't a trade deficit mean greater indebtedness to foreigners? Not necessarily. Much of the foreign investment involves the purchase of stocks and physical assets like buildings and business assets. Americans benefit because they are able to sell these assets to foreigners at more attractive prices than would otherwise be possible. Foreign investments of this type do not increase American indebtedness to foreigners. Some foreign investments are in the form of loans or the purchase of bonds, which mean lower interest rates for Americans. If the investments are sound, they will generate a future income stream that is more than sufficient to repay the loans. Even in this case, the loans are helpful to the U.S. economy.

Critics of trade often argue that trade deficits mean loss of jobs. Once the link between the inflow of capital and trade deficits is recognized, the error of this view is obvious. The inflow of capital that must accompany a trade deficit will lead to lower interest rates and a higher level of investment. Any loss of jobs accompanying the excess of the imports relative to exports will be offset by higher employment due to the lower interest rates and more investment. The U.S. experience during the Great Expansion illustrates this. Even though imports grew more rapidly than exports and trade deficits

Exhibit 14: Relationship Between the Trade Deficit and Net Foreign Investment

Net foreign investment (NFI) and the trade deficit are closely linked. When NFI changes, so does the trade deficit.



Sources: *Economic Report of the President*, 2000, table b-22; Haver Analytics.

Note: For underlying data, see Appendix, table 7.

were sizeable throughout much of the period, total employment increased by 35 million from 1983 to 1999 and the unemployment rate fell to a 30-year low (see Exhibits 1 and 3 above). Simply put, the protectionist view that trade deficits reduce employment is fallacious. Neither economic theory nor empirical evidence provide support for this position.

Can a country continue to run trade deficits? Perhaps surprisingly, the answer is “yes.” Remember that trade deficits reflect the net inflow of capital. The inflow can and will continue as long as investors find the U.S. economy more attractive than other economies. Put another way, foreigners will be happy to supply investment capital to the U.S. economy as long as they can earn competitive returns. In the case of debt financing, as long as the net income generated by the investment is large enough to cover the borrowing costs, there is no reason why the process cannot continue indefinitely. The historical evidence is consistent with this view. The U.S. experienced trade deficits and capital inflows year after year from 1820 to 1870. During that period, investment opportunities in the New World were more attractive than those in Europe, so Europeans were quite willing to continue financing undertakings in the New World.

A trade deficit is quite different from a business loss or even the budget deficit of a government. No legal entity is responsible for the trade deficit.⁴³ It is not something that one party owes to another; it is merely the sum of the buying and selling decisions of millions of people. Suppose an American retailer purchases \$500,000 of shoes from a British manufacturer. In turn, the British firm uses the funds to buy stocks or bonds issued by an American corporation. These transactions will increase the size of the trade deficit. But why is there any reason for concern? They reflect the voluntary choices of individuals that will both reap the benefits and bear the costs. This is also true for a nation’s trade deficit.

II. Should the Federal Debt Be Fully Paid Off?

At the end of 1999, the federal debt was \$5.7 trillion. Of this amount, \$2.2 trillion was held by federal agencies and trust funds (primarily the Social Security Administration) and another \$500

⁴³ In his typical satirical manner, the late Herbert Stein put it this way: “The trade deficit does not belong to any individual or institution. It is a pure statistical aggregate, like the number of eggs laid in the U.S. or the number of bald-headed men living here.” Herbert Stein, “Leave the Trade Deficit Alone,” *Wall Street Journal*, March 11, 1987.

billion was held by Federal Reserve Banks. Thus, the amount of debt that the federal government owes to someone other than itself is only \$3 trillion.

Eliminating or at least greatly reducing the federal debt has become a generally accepted goal across the political spectrum. The attractiveness of paying off the national debt is certainly understandable. However, there are also reasons to exercise caution.

There is an “optimal amount of debt” for both businesses and governments. Just as the optimal amount is often positive for a strong healthy business, it may also be positive for the federal government. There are several reasons why the optimal federal debt is unlikely to be zero. First, U.S. Treasury securities play an important role in our financial markets. Treasury securities, particularly those that are indexed for inflation, provide households, businesses, pension funds, and financial institutions with a secure, highly liquid asset that makes it easier for them to deal with an uncertain future. The interest rate on these securities also provides a benchmark for the evaluation of other, riskier assets. Furthermore, if the federal government repays the debt by levying higher taxes than would otherwise exist, private households and businesses will have to borrow more than would otherwise be the case. In essence, this substitutes riskier, high-interest debt for more secure, low-interest debt. On balance, it is not obvious that the substitution will reduce overall interest costs.

Second, the Federal Reserve manages the money supply through the purchase and sale of U.S. securities in the open market. If Treasury securities were unavailable, the Fed would have to buy and sell a large amount of securities issued by private firms, which would give the Fed an opportunity to play favorites and subject the Fed to political pressure regarding the companies whose securities it purchases.

Third, the U.S. dollar is a “reserve currency.” Central banks and other monetary authorities around the globe currently hold more than \$600 billion of U.S. Treasury securities as reserve assets. If the national debt were paid off and the securities were unavailable to foreigners, the dollar would be less attractive as a worldwide currency. With time, the reduction in the worldwide demand for the

dollar could erode its position as the world's leading currency and make financial markets in dollars less extensive. That might make it more costly for Americans to engage in international transactions.

Finally, we must not forget that the national debt is a relatively small portion of the federal government's unfunded liabilities. Currently, the unfunded liabilities of the Social Security system are estimated to be between \$5 trillion and \$11 trillion; those of the Medicare program are projected at almost \$10 trillion. These liabilities are far greater than the outstanding federal debt. Thus, restructuring these two programs in a manner that will both improve their performance and solvency is far more important to the future of American taxpayers than paying off the debt.

8. CONCLUSION

During the last two decades, the United States has been prosperous because we have had relatively open markets, monetary policy has focused on price stability, and federal government spending has fallen modestly as a share of GDP. This prescription has worked around the world. If the United States continues to adopt sound policies consistent with strong growth, the Great Expansion can continue. In this regard, the following are important.

Social Security, health care, and education

- Adopt Social Security reforms that would allow individuals to channel a portion of their payroll tax into Personal Savings Accounts. Begin moving the system from the pay-as-you-go approach to a personal savings and investment approach.
- Reform Medicare by placing greater reliance on Medical Savings Accounts and less reliance on third-party payments. This would increase incentives for consumers and suppliers to economize.
- Expand choice in education and make it possible for parents, particularly those with low incomes, to escape failing schools and choose the schools most suitable for their children.

Trade

- Avoid giving the World Trade Organization (WTO) responsibility for environmental and labor standards, which are already handled by other organizations and would dilute the WTO's focus.
- Expand the North American Free Trade Agreement (NAFTA) and other open market and free trade initiatives.
- Unilaterally phase out quotas and tariffs over 10 to 15 years.

Domestic and international monetary policy

- Continue to focus the Federal Reserve on price stability. Establish price stability by law as the main long-term goal of the Federal Reserve.
- Encourage official dollarization in interested countries.

- Encourage countries to adopt fixed exchange rates (as dollarization would provide) or fluctuating rates, and avoid pegged rates, which have been at the center of many currency crises.
- Reform the International Monetary Fund, using as a basis some of the recommendations of the International Financial Advisory Commission appointed by the Congress.

Taxes

- Reduce or eliminate the marriage penalty.
- Make health insurance fully deductible for individuals so that direct purchase of health insurance is on an equal footing with purchase through an employer.
- Repeal the Alternative Minimum Tax, which imposes a high burden of paperwork and generates little additional revenue.
- Repeal the Social Security earnings test, as Congress has recently done for persons age 65 to 69, but not persons age 62 to 64.
- End multiple taxation that discourages savings and investment, such as the double taxation of corporate profits.
- Shorten depreciation periods to reflect the rapid pace of technological change in an increasing number of industries.
- Resist big new spending initiatives that will obligate taxpayers for large sums in the future.

This staff report was prepared by James Gwartney, Chief Economist to the Chairman, and James Carter, Chris Edwards, Angela Ritzert, Kurt Schuler, Charles D. Skipton, Robert Stein, Lawrence Whitman, and Victor Wolski. Contact James Gwartney (202-224-2989) with questions or comments.

APPENDIX

Table 1: Real Federal Spending per Person

Year	Federal government spending (FY) ----- <i>Billions of current dollars</i> -----			GDP deflator	Current population
	Total	Defense	Non-defense	1999=100	millions
1960	92.2	48.1	44.1	21.5	180.6
1961	97.7	49.6	48.1	21.7	183.6
1962	106.8	52.3	54.5	22.0	186.5
1963	111.3	53.4	57.9	22.2	189.2
1964	118.5	54.8	63.8	22.6	191.8
1965	118.2	50.6	67.6	23.0	194.2
1966	134.5	58.1	76.4	23.5	196.5
1967	157.5	71.4	86.0	24.3	198.7
1968	178.1	81.9	96.2	25.2	200.7
1969	183.6	82.5	101.1	26.4	202.6
1970	195.6	81.7	114.0	27.8	205.0
1971	210.2	78.9	131.3	29.3	207.6
1972	230.7	79.2	151.5	30.6	209.8
1973	245.7	76.7	169.0	32.2	211.9
1974	269.4	79.3	190.0	34.7	213.8
1975	332.3	86.5	245.8	38.1	215.9
1976	371.8	89.6	282.2	40.6	218.0
1977	409.2	97.2	312.0	43.1	220.2
1978	458.7	104.5	354.3	46.1	222.5
1979	504.0	116.3	387.7	49.7	225.0
1980	590.9	134.0	457.0	54.0	227.6
1981	678.2	157.5	520.7	59.1	229.9
1982	745.8	185.3	560.4	63.2	232.1
1983	808.4	209.9	598.5	66.0	234.2
1984	851.9	227.4	624.5	68.5	236.3
1985	946.4	252.7	693.7	70.7	238.4
1986	990.5	273.4	717.1	72.4	240.6
1987	1,004.1	282.0	722.1	74.3	242.8
1988	1,064.5	290.4	774.1	76.7	245.0
1989	1,143.7	303.6	840.1	79.7	247.3
1990	1,253.2	299.3	953.8	82.7	249.9
1991	1,324.4	273.3	1,051.1	85.8	252.6
1992	1,381.7	298.4	1,083.3	87.7	255.3
1993	1,409.4	291.1	1,118.3	90.0	258.0
1994	1,461.7	281.6	1,180.1	92.0	260.5
1995	1,515.7	272.1	1,243.7	94.0	263.0
1996	1,560.5	265.8	1,294.8	95.8	265.4
1997	1,601.2	270.5	1,330.7	97.4	267.9
1998	1,652.6	268.5	1,384.1	98.7	270.5
1999	1,703.0	274.9	1,428.2	100.0	273.1

Sources: Haver Analytics; *Economic Report of the President*, 2000, tables b-1, b-3, b-80, and b-82.

Note: FY = fiscal year.

Real Federal Spending per Person *(continued)*

Federal government spending (FY)						
Year	----- Billions of 1999 dollars -----			----- Per person in 1999 dollars -----		
	Total	Defense	Non-defense	Total	Defense	Non-defense
1960	429.7	224.4	205.4	2,379	1,242	1,137
1961	450.3	228.5	221.7	2,452	1,245	1,208
1962	485.7	238.0	247.7	2,605	1,276	1,328
1963	500.7	240.2	260.5	2,647	1,270	1,377
1964	525.4	242.7	282.7	2,739	1,265	1,474
1965	515.1	220.5	294.5	2,652	1,135	1,516
1966	571.7	247.0	324.8	2,909	1,257	1,653
1967	648.8	294.2	354.5	3,266	1,481	1,785
1968	705.7	324.6	381.1	3,517	1,617	1,899
1969	694.9	312.2	382.7	3,429	1,540	1,889
1970	703.0	293.5	409.5	3,430	1,432	1,998
1971	717.2	269.2	448.1	3,455	1,297	2,159
1972	753.4	258.6	494.8	3,590	1,232	2,358
1973	763.6	238.3	525.3	3,604	1,125	2,479
1974	776.0	228.6	547.4	3,630	1,069	2,560
1975	871.5	226.9	644.6	4,037	1,051	2,986
1976	916.0	220.8	695.2	4,202	1,013	3,189
1977	948.5	225.4	723.1	4,307	1,024	3,284
1978	995.8	226.8	768.9	4,475	1,019	3,456
1979	1014.8	234.2	780.6	4,510	1,041	3,469
1980	1095.2	248.3	846.9	4,811	1,091	3,720
1981	1147.0	266.4	880.6	4,989	1,159	3,830
1982	1180.1	293.2	886.9	5,084	1,263	3,821
1983	1224.8	318.0	906.7	5,229	1,358	3,871
1984	1244.1	332.1	912.0	5,265	1,405	3,859
1985	1338.5	357.5	981.1	5,614	1,499	4,115
1986	1368.2	377.6	990.6	5,687	1,570	4,117
1987	1351.4	379.5	971.8	5,567	1,563	4,003
1988	1387.9	378.6	1009.3	5,665	1,545	4,120
1989	1435.5	381.0	1054.5	5,805	1,541	4,264
1990	1515.3	361.9	1153.3	6,064	1,449	4,616
1991	1544.3	318.7	1225.6	6,114	1,262	4,853
1992	1574.8	340.1	1234.8	6,169	1,332	4,837
1993	1566.6	323.5	1243.1	6,072	1,254	4,818
1994	1588.4	306.0	1282.4	6,097	1,175	4,922
1995	1613.0	289.5	1323.5	6,134	1,101	5,033
1996	1629.2	277.4	1351.7	6,138	1,045	5,093
1997	1643.8	277.7	1366.1	6,135	1,036	5,098
1998	1674.9	272.1	1402.9	6,192	1,006	5,186
1999	1703.0	274.9	1428.2	6,236	1,006	5,229

Table 2: Civilian Labor Force

Year	<i>----- millions -----</i>			<i>---- share of total ----</i>	
	age 16-34	age 35-54	Total	age 16-34	age 35-54
1960	25.9	31.1	69.6	37.2%	44.7%
1961	26.2	31.5	70.5	37.2%	44.7%
1962	26.0	31.7	70.6	36.8%	44.9%
1963	26.7	32.1	71.8	37.1%	44.7%
1964	27.4	32.4	73.1	37.5%	44.3%
1965	28.4	32.6	74.5	38.1%	43.8%
1966	29.4	32.7	75.8	38.8%	43.2%
1967	30.6	32.9	77.3	39.5%	42.5%
1968	31.6	33.0	78.7	40.2%	41.9%
1969	33.2	33.2	80.7	41.1%	41.1%
1970	34.9	33.4	82.8	42.1%	40.3%
1971	36.5	33.3	84.4	43.3%	39.5%
1972	39.1	33.4	87.0	45.0%	38.3%
1973	41.7	33.5	89.4	46.7%	37.4%
1974	43.8	33.9	92.0	47.7%	36.9%
1975	45.5	34.0	93.8	48.5%	36.2%
1976	47.5	34.3	96.2	49.4%	35.7%
1977	49.7	34.8	99.0	50.2%	35.2%
1978	51.7	35.7	102.3	50.6%	34.9%
1979	53.3	36.6	105.0	50.8%	34.9%
1980	54.5	37.4	106.9	51.0%	34.9%
1981	55.5	38.2	108.7	51.1%	35.1%
1982	55.8	39.3	110.2	50.6%	35.7%
1983	56.1	40.5	111.6	50.3%	36.3%
1984	56.7	41.9	113.5	49.9%	36.9%
1985	57.2	43.4	115.5	49.5%	37.6%
1986	58.0	45.0	117.8	49.2%	38.2%
1987	58.2	46.7	119.9	48.6%	38.9%
1988	58.0	48.5	121.7	47.7%	39.9%
1989	58.0	50.5	123.8	46.8%	40.8%
1990	58.4	52.4	125.8	46.4%	41.6%
1991	57.3	54.1	126.3	45.4%	42.9%
1992	57.0	56.1	128.1	44.5%	43.8%
1993	56.3	57.9	129.2	43.6%	44.8%
1994	56.0	59.5	131.1	42.7%	45.4%
1995	55.7	61.0	132.3	42.1%	46.1%
1996	55.0	63.0	133.9	41.1%	47.0%
1997	54.8	64.9	136.3	40.2%	47.6%
1998	54.7	65.9	137.7	39.7%	47.9%
1999	54.4	67.3	139.4	39.0%	48.3%

Source: Haver Analytics.

Table 3: National Health Care Expenditures (NHE)

Year	----- Billions of dollars -----				----- Share of NHE -----		
	Total NHE	Out-of-pocket payments	Private health insurance	Public funds	Out-of-pocket payments	Private health insurance	Public funds
1960	26.9	13.1	5.9	6.6	48.7%	21.9%	24.8%
1961	28.8	13.4	6.6	7.3	46.5%	23.1%	25.4%
1962	31.3	14.2	7.4	8.0	45.5%	23.6%	25.5%
1963	34.1	15.5	8.0	8.7	45.6%	23.5%	25.6%
1964	37.6	17.3	8.9	9.4	45.8%	23.8%	24.9%
1965	41.1	18.5	10.0	10.3	45.1%	24.4%	25.0%
1966	45.3	18.8	10.3	13.7	41.6%	22.9%	30.2%
1967	51.0	18.8	10.7	19.0	36.9%	20.9%	37.3%
1968	57.7	20.8	12.2	21.8	36.0%	21.1%	37.8%
1969	64.8	22.7	13.8	24.5	35.1%	21.4%	37.9%
1970	73.2	24.9	16.3	27.7	34.0%	22.2%	37.8%
1971	81.0	26.4	18.6	31.2	32.6%	22.9%	38.5%
1972	90.9	29.0	21.3	35.1	31.9%	23.4%	38.6%
1973	100.8	32.0	23.9	39.3	31.7%	23.7%	39.0%
1974	114.3	34.8	26.8	46.6	30.5%	23.5%	40.8%
1975	130.7	38.1	31.3	55.0	29.1%	23.9%	42.1%
1976	149.9	41.9	37.9	62.4	28.0%	25.3%	41.7%
1977	170.4	46.4	45.9	70.2	27.2%	26.9%	41.2%
1978	190.6	49.7	52.5	79.6	26.1%	27.6%	41.7%
1979	215.2	54.3	60.9	90.1	25.2%	28.3%	41.9%
1980	247.3	60.3	69.8	104.8	24.4%	28.2%	42.4%
1981	286.9	68.5	82.2	121.2	23.9%	28.6%	42.2%
1982	323.0	75.4	95.4	134.6	23.4%	29.5%	41.7%
1983	355.3	82.3	106.2	147.5	23.2%	29.9%	41.5%
1984	390.1	90.9	119.2	160.1	23.3%	30.6%	41.1%
1985	428.7	100.7	132.8	174.2	23.5%	31.0%	40.6%
1986	461.2	108.1	140.6	189.8	23.4%	30.5%	41.2%
1987	500.5	116.1	152.4	207.2	23.2%	30.5%	41.4%
1988	560.4	127.5	178.1	226.1	22.7%	31.8%	40.4%
1989	623.5	133.2	208.5	252.1	21.4%	33.4%	40.4%
1990	699.4	145.0	239.6	283.2	20.7%	34.3%	40.5%
1991	766.8	153.3	261.7	317.9	20.0%	34.1%	41.5%
1992	836.5	161.8	285.5	353.0	19.3%	34.1%	42.2%
1993	898.5	167.1	306.8	385.3	18.6%	34.1%	42.9%
1994	947.7	168.5	315.1	422.8	17.8%	33.2%	44.6%
1995	993.7	171.0	324.3	455.2	17.2%	32.6%	45.8%
1996	1,042.5	178.1	337.1	481.4	17.1%	32.3%	46.2%
1997	1,092.4	187.6	348.0	507.1	17.2%	31.9%	46.4%

Source: Health Care Financing Administration Web site, <http://www.hcfa.gov>.

Note: There remains a small portion of third-party financing, comprised principally of charitable contributions.

Table 4: Health Care Price Indexes

Year	CPI (1966=100)	--- Raw index ---		-- Index relative to CPI --	
		Medical care	Drugs and supplies	Medical care	Drugs and supplies
1966	100.0	100.0	100.0	100.0	100.0
1967	103.1	107.2	98.1	104.0	95.2
1968	107.4	113.7	96.4	105.8	89.8
1969	113.3	121.3	97.7	107.1	86.2
1970	119.8	129.3	99.4	108.0	83.0
1971	125.0	137.3	99.4	109.8	79.5
1972	129.0	141.8	99.0	109.9	76.7
1973	137.0	147.5	98.7	107.7	72.1
1974	152.2	161.2	101.0	106.0	66.4
1975	166.0	180.6	107.3	108.8	64.6
1976	175.6	197.7	113.0	112.6	64.3
1977	187.0	216.7	119.9	115.9	64.1
1978	201.2	235.0	129.1	116.8	64.2
1979	224.1	256.7	139.2	114.5	62.1
1980	254.3	284.8	152.0	112.0	59.8
1981	280.6	315.2	169.4	112.4	60.4
1982	297.8	351.7	189.1	118.1	63.5
1983	307.4	382.5	209.9	124.4	68.3
1984	320.7	406.1	230.0	126.6	71.7
1985	332.1	431.6	251.8	129.9	75.8
1986	338.3	463.9	273.4	137.1	80.8
1987	350.6	494.7	295.2	141.1	84.2
1988	365.1	527.0	318.7	144.3	87.3
1989	382.7	567.7	346.3	148.3	90.5
1990	403.4	619.0	380.9	153.5	94.4
1991	420.4	673.0	418.7	160.1	99.6
1992	433.0	722.8	450.1	166.9	103.9
1993	446.0	765.8	467.5	171.7	104.8
1994	457.4	802.3	483.4	175.4	105.7
1995	470.4	838.4	492.7	178.2	104.7
1996	484.3	867.7	509.2	179.2	105.2
1997	495.4	892.0	522.6	180.1	105.5

Source: Haver Analytics.

Table 5: Real Education Spending and Student Performance

End of school year	Public school K-12 students (millions)	Total government expenditures for elementary and secondary education			Avg SAT of students entering college
		Billions of		1999 \$ per pupil	
		current \$	1999 \$		
1970	51.3	28.4	122.0	\$2,381	1049
1971	51.3	33.1	136.2	\$2,657	1045
1972	50.7	35.4	141.2	\$2,783	1039
1973	50.4	40.9	153.6	\$3,044	1029
1974	50.1	44.6	150.8	\$3,012	1026
1975	49.8	48.2	149.3	\$2,998	1010
1976	49.5	52.0	152.3	\$3,079	1006
1977	48.7	57.1	157.1	\$3,224	1003
1978	47.6	61.7	157.8	\$3,312	1001
1979	46.7	70.4	161.6	\$3,464	998
1980	46.2	72.8	147.3	\$3,187	994
1981	45.5	81.0	148.5	\$3,262	994
1982	45.2	86.8	149.9	\$3,320	997
1983	45.0	95.7	160.2	\$3,562	997
1984	44.9	103.2	165.6	\$3,687	1001
1985	45.0	112.1	173.7	\$3,861	1009
1986	45.2	118.1	179.6	\$3,974	1009
1987	45.5	127.2	186.7	\$4,103	1008
1988	45.4	136.7	192.6	\$4,240	1006
1989	45.9	148.1	199.1	\$4,338	1006
1990	46.4	160.4	204.6	\$4,405	1001
1991	47.2	172.2	210.8	\$4,461	999
1992	48.2	192.5	228.7	\$4,745	1001
1993	48.9	207.4	239.3	\$4,889	1003
1994	49.7	223.6	251.5	\$5,060	1003
1995	50.5	234.7	256.7	\$5,080	1010
1996	51.4	246.0	261.4	\$5,087	1013

Sources: Dept. of Education, National Center for Education Statistics, *Digest of Education Statistics*, 1998 and earlier editions; College Board Web site, <http://www.collegeboard.org>; Haver Analytics.

Table 6: Trade Openness Index (average 1980-97)

	Country	Index	Country	Index	Country	Index					
1	Hong Kong	9.9	26	Venezuela	6.5	50	Kenya	5.0	74	Dominican Rep	4.1
2	Singapore	9.8	27	Thailand	6.4	51	Tunisia	5.0	75	Central Afr Rep	4.0
3	Belgium	9.0	28	Japan	6.4	52	Cote d'Ivoire	5.0	76	Trinidad Tobago	4.0
4	Panama	8.8	29	South Korea	6.4	53	Gabon	4.9	77	Bahamas	3.8
5	Luxembourg	8.5	30	France	6.3	54	Paraguay	4.9	78	El Salvador	3.7
6	Germany	8.5	31	Chile	6.2	55	China	4.8	79	Pakistan	3.7
7	United Kingdom	8.4	32	South Africa	6.2	56	Sri Lanka	4.8	80	Egypt	3.7
8	United States	8.4	33	Jordan	6.2	57	Dem Rep Congo	4.8	81	Nepal	3.6
9	Netherlands	8.4	34	Israel	6.1	58	Ecuador	4.7	82	Nicaragua	3.4
10	Switzerland	8.1	35	Indonesia	6.0	59	Zambia	4.6	83	India	3.3
11	Malaysia	7.9	36	Botswana	6.0	60	Turkey	4.6	84	Brazil	3.3
12	Canada	7.7	37	Philippines	6.0	61	Cyprus	4.6	85	Tanzania	3.1
13	Sweden	7.7	38	Fiji	5.9	62	Cameroon	4.6	86	Algeria	3.0
14	Ireland	7.5	39	Rep of Congo	5.7	63	Hungary	4.5	87	Madagascar	3.0
15	Norway	7.4	40	Bolivia	5.5	64	Colombia	4.5	88	Nigeria	2.9
16	New Zealand	7.4	41	Greece	5.5	65	Honduras	4.4	89	Argentina	2.8
17	Italy	7.3	42	Jamaica	5.5	66	Belize	4.4	90	Ghana	2.8
18	Taiwan	7.1	43	Malta	5.4	67	Zimbabwe	4.4	91	Syria	2.4
19	Spain	7.1	44	Mali	5.4	68	Guatemala	4.3	92	Uganda	2.4
20	Australia	7.1	45	Iceland	5.3	69	Senegal	4.3	93	Iran	2.0
21	Denmark	7.1	46	Mexico	5.3	70	Barbados	4.2	94	Burundi	1.4
22	Uruguay	6.9	47	Morocco	5.3	71	Malawi	4.2	95	Sierra Leone	1.4
23	Austria	6.9	48	Costa Rica	5.1	72	Niger	4.2	96	Bangladesh	0.6
24	Portugal	6.7	49	Mauritius	5.0	73	Peru	4.2	97	Myanmar	0.2
25	Finland	6.5									

Table 7: Individual Income Tax Shares

<i>Federal income tax share by percentiles</i>					
Year	Top 1%	Top 5%	Top 10%	Next 40%	Bottom 50%
1980	19.1%	36.8%	49.3%	43.7%	7.0%
1981	17.6%	35.1%	48.0%	44.6%	7.5%
1982	19.0%	36.1%	48.6%	44.1%	7.3%
1983	20.3%	37.3%	49.7%	43.1%	7.2%
1984	21.1%	38.0%	50.6%	42.1%	7.4%
1985	21.8%	38.8%	51.5%	41.4%	7.2%
1986	25.7%	42.6%	54.7%	38.9%	6.5%
1987	24.8%	43.3%	55.6%	38.3%	6.1%
1988	27.6%	45.6%	57.3%	37.0%	5.7%
1989	25.2%	43.9%	55.8%	38.4%	5.8%
1990	25.1%	43.6%	55.4%	38.8%	5.8%
1991	24.8%	43.4%	55.8%	38.7%	5.5%
1992	27.5%	45.9%	58.0%	36.9%	5.1%
1993	29.0%	47.4%	59.2%	36.0%	4.8%
1994	28.9%	47.5%	59.4%	35.8%	4.8%
1995	30.3%	48.9%	60.7%	34.6%	4.6%
1996	32.3%	51.0%	62.5%	33.2%	4.3%
1997	33.2%	51.9%	63.2%	32.5%	4.3%

Source: Internal Revenue Service.

Table 8: Trade Deficit and Net Foreign Investment

Year	GDP	Trade deficit	Net foreign investment	Trade deficit	Net foreign investment
	----- billions of dollars -----			----- as a share of GDP -----	
1980	2795.6	-14.9	11.4	-0.5%	0.4%
1981	3131.4	-15.0	6.3	-0.5%	0.2%
1982	3259.2	-20.6	-0.2	-0.6%	0.0%
1983	3535.0	-51.7	-32.0	-1.5%	-0.9%
1984	3932.8	-102.0	-87.0	-2.6%	-2.2%
1985	4213.0	-114.2	-110.9	-2.7%	-2.6%
1986	4452.9	-131.9	-140.6	-3.0%	-3.2%
1987	4742.5	-142.3	-152.0	-3.0%	-3.2%
1988	5108.3	-106.3	-113.2	-2.1%	-2.2%
1989	5489.1	-80.7	-86.7	-1.5%	-1.6%
1990	5803.3	-71.5	-69.2	-1.2%	-1.2%
1991	5986.2	-20.7	14.9	-0.3%	0.2%
1992	6319.0	-27.8	-38.7	-0.4%	-0.6%
1993	6642.3	-60.5	-72.9	-0.9%	-1.1%
1994	7054.3	-87.1	-108.3	-1.2%	-1.5%
1995	7400.6	-84.3	-98.0	-1.1%	-1.3%
1996	7813.2	-89.0	-110.7	-1.1%	-1.4%
1997	8300.7	-88.3	-123.7	-1.1%	-1.5%
1998	8760.0	-149.55	-201.5	-1.7%	-2.3%

Source: Haver Analytics; *Economic Report of the President*, 2000, table b-22.