

**THE 1997 ECONOMIC REPORT OF THE
PRESIDENT: ECONOMIC AND
BUDGET OUTLOOK**

HEARING

before the

**JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES**

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Monday, February 10, 1997

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 2:10 p.m., in Room 2359, Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Present: Representatives Saxton and Maloney and Senators Bingaman, Sessions, and Sarbanes.

Staff Present: Christopher Frenze, Robert Keleher, Mary Hewitt, Juanita Morgan, Colleen Healy, Roni Singleton, Pat Ruggles, Bill Spriggs, and Amy Pardo.

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

Representative Saxton. Good afternoon, everyone. It gives me great pleasure to welcome the Council of Economic Advisers Chairman, Joseph Stiglitz, before the Joint Economic Committee today. As sister organizations established under the same statute, we deal with many of the same issues. I hope you will accept my expression of best wishes, as we understand that you are moving on to the World Bank. Congratulations.

Mr. Stiglitz. Thank you.

Representative Saxton. The economic history of the United States is one of cyclical swings in economic activity, and recent history is no exception. The economic expansion that began in 1991 is now almost six years old. This cyclical upswing has been associated with a moderate rate of economic growth and expansion of employment, a lower unemployment rate and improvement in a number of other cyclical indicators. Though the pace of economic growth during this expansion is below average for postwar economic expansions, the long-term slowdown in trend labor force growth may be part of the explanation for this. However, productivity and wage growth has been relatively weak.

We politicians in Washington have our own way of addressing cyclical movements in the economy. By now everyone knows the drill: The party in the White House claims that the typical upward movement in the business cycle is due to its policies, while those in the other camp, now my camp, claim the expansion is some sort of statistical illusion or, even worse, is about to come to some grim and disastrous end. All this political posturing proceeds despite the fact that in the near term in Washington, whether in the Executive or Legislative Branch, we can have only a modest impact on the economy under most circumstances.

However, especially when tax rates are cut deeply from very high levels, as was the case in 1964 and 1981, one can expect significant positive results in the near term. But in most cases, in the great majority of cases, our \$8 trillion economy dwarfs the effects of the laws we pass in the short and medium term. Over the longer term, of course, our tax and spending decisions can and do have significant impact on economic growth.

It is the policies of the Federal Reserve that mostly affect the economy in the short run. By lowering inflationary expectations, Federal Reserve policy produced lower interest rates in 1991, 1992 and 1993, and produced a sound and stable foundation for the expansion. Under normal circumstances, the influence of Federal Reserve policy dominates the effects of fiscal policy in the near term. It is in the longer term that the weight of our fiscal policies from the Congress and the Administration can make a cumulative difference.

The business cycle expansion does not belong to Washington politicians in either party. Let's give credit where credit is due, to the many millions of hard-working American citizens outside of this city. The workers, entrepreneurs, and farmers across the country know it is they, not Washington, D.C., that are making the economy grow. They deserve the credit for economic expansion, and all the posturing in Washington cannot take it away from them. The American people know that the tax increase in 1993 has about as much to do with the current cyclical upswing as the tax increase in 1990 offered by Bush. The 1990 Bush tax increase is not the reason the economy turned around in 1991, any more than the 1993 tax increase determines current economic conditions.

Obviously, a growing economy makes addressing economic policy easier for us in government. Just as a recession pushes up the budget deficit, an upswing holds down Federal spending and boosts Federal revenues. Employment rises and unemployment falls, making implementation of policy such as welfare reform easier. There is also less pressure

from desperate industries for bailouts and subsidies. Without distraction from problems caused by recession, a mature expansion is a good time to address long-term structural issues, such as reducing barriers to savings, investment, long-term productivity, and economic growth. The relatively low economic growth rates of roughly 2 percent projected by the Administration and Congressional Budget Office into the foreseeable future are not all that encouraging. We need to closely examine our current tax code and identify the ways it undermines incentives for savings, investment, and long-term economic growth.

I would like to conclude by suggesting that the Administration's current approach to economic policy in general and tax policy in particular seems rather narrow and depends heavily on specifically targeted measures. In recent weeks, news articles in *The New York Times*, *The Washington Post*, and other major publications have quoted many economists and policy analysts from across the political spectrum raising very serious doubts about the efficacy of our employment tax credit and narrowly targeted junior college tax credit in particular. I would like to turn to the economic issues raised by these proposals during the question-and-answer period.

Once again, Dr. Stiglitz, thank you for being with us, and at this point, I will turn to our colleagues.

Senator Bingaman.

[The prepared statement of Mr. Saxton and accompanying chart appear in the Submissions for the Record.]

OPENING STATEMENT OF SENATOR

JEFF BINGAMAN, RANKING MINORITY MEMBER

Senator Bingaman. Thank you very much. Thank you, Mr. Chairman. I welcome the chance to hear Dr. Stiglitz in, as he said, his swan song of testimony before the Congress before he moves on to the World Bank. But I agree with the general thrust of what you said, Mr. Chairman, which is that there is much that goes on in the economy which we do not directly impact. But I do think that the policies and legislation that are passed ultimately have a very substantial effect on the economy, and I think, clearly, as any politician knows, if the economy is bad, you get blamed for it. So when it is good, you should take credit even though probably the blame is not justified and much of the credit may not be either.

So I do want to ask, Dr. Stiglitz—I agree with the basic conclusion, which is what you are going to give us, that the economy is very strong.

I do want to ask about how those macroeconomic factors are being translated into the lives of the people that I represent. Particularly, I am concerned with the trend which, I believe is still there, toward more and more people losing their healthcare coverage, toward fewer and fewer people having pension coverage, as a percentage of our work force. Those are concerns that I have, and I would be interested in any thoughts that you have got as to whether those trends are in fact accurate and, if so, what we can do about it.

I would also be interested in any thoughts that you have about the trade imbalance that seems to have become chronic in the last couple of decades—we have an enormous trade deficit with the rest of the world—and how that trade deficit in particular affects the mix of jobs in this country and our ability to create high-wage jobs. Those are the issues that I want to inquire about after your testimony.

Thank you very much for being here.

Representative Saxton. Senator?

OPENING STATEMENT OF SENATOR JEFF SESSIONS

Senator Sessions. Thank you very much, Mr. Chairman. I appreciate your remarks and am delighted to be a part of this panel's discussion. This is a fascinating subject that is so important to millions and millions of Americans.

I think our economy is good in a lot of different ways. In Alabama, the unemployment rate is pretty good. Some companies tell me, as I travel the State, they are having a hard time finding employees, and that is a good sign. But I also know that we have to admit that not everything is good, and that the rate of growth this decade has not been at the level that we would like it to be. And, in particular, family income is not where it ought to be.

I was looking at some numbers from Alabama that point this out. Over the last two decades, family income in Alabama for the average family of four, according to the Census Bureau, when the economy grew by 3 percent or more, they gained, on average, \$1,000 dollars in income a year; when the economy grew by less than 3 percent or more, they lost, on average, \$1,000 dollars a year. Your figures indicate that every decade since the 1930s has at least six years of growth over 3 percent, except for this decade which has only one year of growth over 3 percent. Because of that, we haven't had the kind of income increases for families that all of us would like to see.

I am also a strong believer in tax relief for families, and I think that is certainly one way to get an immediate infusion of income, including a \$500 tax credit per-child for working families. So, Mr. Chairman, those are my thoughts and I look forward to participating with you.

Representative Saxton. Thank you.

Mrs. Maloney.

OPENING STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY

Representative Maloney. Thank you very much. I join the Chairman and Ranking Member in thanking you for your services and wishing you well in your new assignment. It is always a pleasure to hear from you, especially when you bring good news on the performance of the economy over the past year, and indeed over the past four years. And the past four years have seen a combination of low unemployment, low inflation, along with a steady growth in output, the so-called misery index, the sum of inflation and unemployment rates is the lowest it is been in three decades.

Today's unemployment rate is just 5.4 percent, a level lower than many economists had thought was consistent with reasonable price stability; and yet inflation over the past four years has averaged only 2.8 percent. That is the lowest average inflation rate for any Administration since John F. Kennedy's.

Gross domestic product, our basic measure of national output, has grown at a steady pace with average growth of 2.5 percent over the past year. Growth in the fourth-quarter was a spectacular 4.7 percent, and I would like to understand why we had such a large increase then.

And this growth and output has been matched by a growth in the labor force. More than 11 million new jobs have been created over the past four years. Today, more than 56 percent of adult women in the United States are employed, the highest proportion we have recorded. And in spite of the minimum wage increase that some predicted would cost jobs, youth employment remains high by historic standards.

All of this is indeed good news, and I look forward to your comments on how we can continue with a expanded economy and your recipe for continued growth.

Representative Saxton. Thank you.

Dr. Stiglitz.

**STATEMENT OF DR. JOSEPH E. STIGLITZ, CHAIRMAN,
PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS**

Dr. Stiglitz. Thank you. I am honored to be speaking before your Committee to present the *Economic Report of the President* and the Report of the Council of Economic Advisers.

As you know, the *Economic Report of the President* is submitted to Congress each year in fulfillment of the requirement imposed by the Employment Act of 1946. This landmark legislation enunciated for the first time the Federal Government's responsibility for management of the economy, assigning it the responsibility to "promote maximum employment, production, and purchasing power." Those are the words that were used in the Act. In this, the 51st year since that Act, I am pleased to report that the state of the Nation's economy is excellent. In many respects, the economy is as strong as it has been in three decades.

As we look at the economy today, we see enormous strengths: The investments of the past few years, both physical and human, should put us in good stead for the future. The strong competitive pressures should continue to be a force for innovation and increased efficiency. In 1992, the national unemployment rate averaged 7.5 percent; over the past four years the unemployment rate has come down to 5.4 percent. Not only has the American economy created more than 11 million new jobs: but those jobs are disproportionately good jobs; more than two-thirds of them are industry-occupational categories paying above median wages.

We have not seen any of the imbalances that have typically characterized the economy at this stage of expansion—no inflation, no weaknesses in the overall financial sector, no real estate excesses, no inventory overhang. Indeed, consumer confidence remains strong, the ratio of net worth to disposable income is as high as it has been in three decades, real wages and incomes are growing, and there is little evidence of incipient inflationary pressures.

Not only has the economy grown rapidly and sustainably, but the fruits of that growth have begun to be shared more equitably. Between 1993 and 1995, the most recent year for which data are available, not only did the incomes of every quintile of the income distribution increase, but also the largest percentage increase was seen by the poorest in American society.

I hope you have the charts from the written testimony that I submitted, and I will refer to a few of those charts, not in the order in which they are presented.

In Chart 16 you see the fact that every quintile in the population has had an increase and that the largest increase has been in the first quintile, the bottom quintile, in the population.

In the remainder of my oral presentation, I will briefly cover three topics: the reasons for this remarkable performance, the challenges that lie ahead, and the underlying economic philosophy that has both informed the policies that we have undertaken and should continue to guide us in addressing our future challenges.

Since 1993 this Administration has developed a comprehensive agenda that has contributed to the Nation's current economic health and strength. There are four key elements of this agenda.

First, reducing the deficit. The Administration's most important economic policy accomplishment has been a substantial reduction in the Federal budget deficit. Since the 1992 fiscal year the deficit has been cut by 63 percent from \$290 billion in 1992 to \$107 billion in fiscal year 1996. And that you will see in Chart 2.

The dramatic decline in the deficit over the past four years is the result of many factors. By far the most important are the fiscal policy changes adopted in the Omnibus Budget Reconciliation Act of 1993 and the stronger economic performance to which it contributed. Without this deficit reduction, the Federal debt today would be half a trillion dollars higher than the \$3.7 trillion currently held by the public. It is hard to imagine that the rapid expansion of investment and exports could have survived the resulting environment of higher interest rates and lower national savings.

Second, opening markets at home. This has involved an aggressive policy of reforming regulatory structures in key sectors of the economy, including telecommunications, electricity, and banking. In reforming electricity and telecommunications regulation, the Administration's belief was that the proper regulatory structure would enhance competition and thus lead to valuable new services and lower prices.

Recent financial reforms have provided greater incentives for competition and innovation, in ways that have reduced the overall cost of regulation to both the government and banking sector itself while preserving and enhancing the safety and soundness of the Nation's banks.

On the environmental front, the Administration has shown that regulatory policies that recognize the importance of incentives can be cheaper and more effective than traditional regulatory controls. The full import of these and other regulatory changes will not be felt for years to come.

Third, an aggressive effort to increase exports through opening markets abroad. Two major trade agreements, the North American Free Trade Agreement and the Uruguay Round accord of the General Agreement on Tariffs and Trade, which established the World Trade Organization, were enacted during the President's first term. As already noted, U.S. exports have boomed, especially in those areas where trade agreements have been reached.

And, finally, we have restored confidence in economic policymaking. Polls show that more Americans rated the conduct of economic policy favorably in November 1996 than at any time in the previous decade. This vote of confidence was the result of number of factors. First, the government was putting into practice an economic philosophy that not only seemed to be working but also was in accord with the country's basic values. The initiatives outlined above, from getting the deficit under control to securing the long overdue passage of a new telecommunications bill, were proof that this philosophy could work. Also the public differences between the Federal Reserve and the Executive Branch that had sometimes characterized earlier administrations were replaced with a respect for the central bank's independence.

Although I could go on at greater length about the economic achievements of the last fewer years and the policies that contributed to them, I think the more important contribution made by the *Economic Report of the President* is to produce and disseminate the ideas and analysis that are an important input into the process of designing better policies for the future. In my remaining time today I would like to outline four of the major challenges that we still face and suggest some of the policies that will contribute towards solving them.

First, the economic challenges of an aging population. Earlier I discussed the tremendous steps taken over the past four years to reduce the deficit. As important as deficit reduction has been, there is general recognition that it will only have been a temporary palliative if we do not solve the long-term challenges associated with the aging of the population. Chart 10 shows that the projected Federal expenditures under current policy for Social Security, Medicare, and Medicaid all are expected to grow substantially over the coming decades. The third chapter of the *Economic Report* describes the dimensions of these problems and also analyzes the consequences of opposed alternative solutions.

The objective of the discussion in that chapter is not to provide answers but rather to reframe the questions, to advance the public policy

debate that should accompany any serious changes of these essential public programs. In looking for a solution to our coming financial problems, we need to be mindful of the contributions that our entitlement programs have made in increasing economic security among the aged and reducing poverty, to the point where today poverty among the elderly has reached the lowest level since the data began to be collected over four years ago. The President said in the State of the Union, "We must agree to a bipartisan process to preserve Social Security."

Proposals that have been made for Social Security contain different elements. We need to keep in mind that programs that from an economic perspective look quite different can have similar effects on, for example, national savings or the rate of return to Social Security contributions, but different impacts on transaction costs and risk distribution.

In the case of Medicare and long-term care within the Medicaid program, Chapter 3 of the *Report* pays considerable attention to two sets of economic issues, incentive effects and adverse selection, that should play an important role in any meaningful discussion of proposals for reform.

Secondly, the increase of inequality and persistence of policy. Americans of all incomes participated in the economic growth of the 1950s and 1960s. But in the decades that followed not only was overall growth slower, but these shrunken gains were reaped disproportionately by those at the top of the income distribution, which you can see in Chart 13. You can see that the vast proportion of the gains that occurred from 79 to 95 were in the upper quintile.

As already noted, some evidence suggests that this trend may have begun to reverse itself in the past few years. Chapter 5 of the report discusses trends in inequality and shows that an important contributing factor is the increasing wage gap between educated and uneducated workers.

Another major problem is the persistence in some areas of pockets of poverty. The nationwide poverty rate has hovered between 10 and 15 percent for the past 30 years, but the burdens of poverty are distributed very unevenly throughout American society. Both short-run and long-run policies are needed to help reduce income inequality and poverty further.

In the short run, the earned income tax credit, EITC, can help raise the incomes of workers with low earnings. In 1995, almost 3.3 million people were lifted out of poverty by the EITC. The recent increase in minimum wage will further enhance the poverty-reducing power of the

EITC. Ultimately, however, transfer payments can only mitigate the consequences of the market.

To make lasting changes in relative income trends we need to influence the returns to different types of workers. This can be accomplished by providing greater access to education and training programs, programs that help create a more uniform, high-skilled work force.

Third, displaced workers. Joseph Schumpeter, one of the 20th Century's greatest economists, described capitalism as a process of creative destruction. New industries constantly come into existence as old industries are destroyed. There is some debate whether the pace of change today is such that individuals are more likely to lose their jobs than before.

Chart 11 shows that, by one measure, the rate of job loss has fallen. But even if job dislocation is no greater than it has been in the recent past, it is still hard on workers and their families.

Government can help individuals in making job transitions in a variety of ways. The unemployment insurance system, improved portability of pensions and health insurance, and proposed reforms to our re-employment and training services all help ease the transition between jobs. Improved access to education will also provide benefits over the long-term.

Fourth, international challenges. The continuing globalization of the world economy—the shrinking of economic and intellectual distances through reduced transport costs and improved telecommunications—has forced us to redesign our policies and our ways of thinking about them in fundamental ways.

The *Report* makes the case that economic competition differs fundamentally from the kind of competition that characterized the Cold War. First, economic competition rests on an underlying cooperative structure of fair rules, as embodied in the World Trade Organization and the General Agreement on Tariffs and Trade before it.

Second, and perhaps more importantly, international economic relations are clearly positive-sum. Trade promotes the living standards of all participants by allowing us to focus on those areas in which we are relatively productive.

In order to consolidate and extend the gains of the trade policies of the last four years, however, it is more important for us to have a guiding principle to justify and evaluate our international economic role. Chapter 7 of the *Economic Report* suggests that we think of the goal of

international relations as the provision of international public goods. Just as governments need to provide national defense, protect the environment and help finance basic scientific research, so international arrangements are needed for the provision of international economic cooperation, peace and order, the environment and basic research. These are all areas in which international cooperation can provide benefits to the United States, while also benefitting other countries.

I have described four of the major challenges the United States still faces. Instead of ignoring or lamenting these challenges, the nation must embrace them, transforming problems into opportunities. We can do this only if we continue to pursue a coherent economic agenda. That economic agenda has been informed by an economic philosophy, which seeks to delineate what is and should be the role of government in economic affairs, what is and should be its core mission.

Indeed, much of this year's *Economic Report of the President* is an attempt to describe what will perhaps be viewed as the Clinton Administration's most enduring contribution, the formulation and implementation of an innovative economic philosophy. In the past, two opposing visions of the American economy have vied for dominance. To put it starkly, one is a Panglossian view of an America of vigorous, self-sufficient individuals; the other of a world in which government is primarily responsible for our well-being.

Over the past four years, this Administration has promoted a third vision, one that synthesizes and transcends these two polar world views. This vision puts individuals at its center, but it emphasizes that individuals live within and draw strength from communities.

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

The answer to this question will change as our economy changes, and hence this is a question which must be asked and re-asked again. I have illustrated how the Clinton Administration has tried to answer this

question over the past four years and how it will seek to answer the question in response to the challenges we face during the coming years.

This Administration has already accomplished much of the policies of the last four years. Over the next four years, the Administration will continue to build on those policies, holding fast to its vision of the government's role in the economy as the basis for an agenda to promote growth, opportunity and responsibility.

Thank you.

Representative Saxton. Dr. Stiglitz, thank you very much for a very thoughtful statement.

Let me just begin with a compliment to the Administration. Over the past several years, one of the subject issue areas that the Joint Economic Committee has dealt with is the effect of the size of government on our economy; and, as you correctly pointed out in closing your statement, one of the questions we must constantly ask ourselves is what is it the government can do to help the economy perform better. I would suggest that, on the margins, there are lots of things that we can do, not the least of which is reflected in the report entitled: *Shrinking the Size of Government*.

As a matter of fact, we agree and we think that the appropriate size for government might be somewhere between 18 and 19 percent of GDP; and of course today it is somewhere around 22 percent. So perhaps together, over a period of time, we can work together from wherever we are to affect the correct course with regard to that subject of shrinking the size of government.

Of course, serious questions have been raised about the budget submission in a number of quarters, including recent articles in *The Washington Post*; and I would like to raise a few questions myself. But first let me just say to the Members of the Committee and to anyone who is interested, it has been my stated intent to run this Committee and to proceed forward on as nonpartisan and bipartisan an agenda as possible.

Having said that, it doesn't mean that we won't disagree about issues; and I think that is healthy and that is good. I think this is one place where, in the absence of a partisan tone, we can discuss some of these issues. I would just like to begin by raising some questions which others have had, and which I think are good questions.

In your statement, Dr. Stiglitz, on page 2—and if I may just quote from it—it says, “the dramatic decline in the deficit over the past four years is a result of many factors. By far the most important are the fiscal

policy changes adopted in the Omnibus Budget Reconciliation Act of 1993 and the stronger economic performance to which it contributed.”

My memory serves to tell me that one of the major ingredients of the Budget Reconciliation Act of 1993, which passed in the middle part of August, was a rather substantial tax increase; and of course that was intended to be helpful, in the minds of the people who drafted it, to reducing the deficit.

I am also mindful that there are those on Capitol Hill—and I would certainly include myself in that group—who believe that tax increases aren't always as helpful as they might appear to be in accomplishing the goals that seem the most obvious.

In Bob Woodward's book, *The Agenda*, according to him there was at least some discussion in the White House along those lines. President Clinton was very doubtful, apparently, according to Bob Woodward's book, that the size of the tax increase might be, quote, “too harsh”; and at least some of his political advisors were uncomfortable with the Administration's argument in favor of the budget proposal in 1993 because they knew that growth of the economy and jobs was going to occur anyway, not necessarily because of the 1993 tax increase.

Now, the tax increase is credited, apparently in your statement, for giving the Federal Reserve the ability to keep down interest rates and effect the stabilization of interest rates. Because of the Budget Reconciliation Bill of 1993, and because of the consequent stabilization of interest rates, that helped to promote economic growth. Am I phrasing that about correctly?

Dr. Stiglitz. That is right.

Representative Saxton. Research shows at the same time, however, that long-term interest rates were about 8.5 percent in 1991, fell to 7.6 percent in 1992, and to 6.6 percent in 1993. And I would just say at this point that the Budget Reconciliation Act of 1993 passed in August, about six weeks prior to the end of the fiscal year, so I don't think the Budget Reconciliation Act had really anything much to do with interest rates in 1993. Then, following the Budget Reconciliation Act, interest rates actually went up again.

So I am curious about this assertion that the tax increase went to stabilize interest rates, which history shows were already on their way down but went back up after the act passed; and somehow this had a positive effect on the economy. Would you like to explain that?

Dr. Stiglitz. Sure. Let me first say, beginning with the first set of issues that you raised, which is one of the concerns that always when you

raise tax rates is what will be the impact on tax revenues. That was part of the debate that was going on.

There were some people like Marty Feldstein, who had been Chairman of CEA under President Reagan, who said raising the tax rates on this upper income group would have perverse effects, people would start working less; and, as a result of that, rather than reducing the deficit you would increase the deficit because the reduction in their labor supply would be so great that revenues would actually go down.

So that was an issue that we wanted to look at. We felt fairly confident that what we called the labor supply, the response of workers, would be sufficiently small of people at the upper end of the economic distribution, that in fact the revenues would go up substantially.

The data that has come in so far strongly supports our view, that in fact if you look at the most recent data that has been available, 1994 I think it was, both the—the tax revenues and incomes (reported incomes, and people usually don't report more income than they actually earn) of people in the upper 10 percentile, which is the upper bracket, went up by 9 percent. So that, in fact, revenues did come in substantial amounts as a result of this increase in tax rates.

So that the main concern—the concern on the other side, people like Feldstein—did not seem to be borne out. In fact, this was a measure that did work to reduce the deficit. So that is the first point.

Secondly, because it reduced the deficit, it meant that the government had to go to the bond market and borrow less than it otherwise would have had to borrow; and as it goes to the bond market and borrows more, that does drive interest rates up.

The third point that you raise—and a word that we use in the economics profession—is that this government borrowing crowds out private investment. The third point that you raised has to do with the timing, and that is actually an issue that we dealt with in the *Economic Report of the President* in 1994, and we have a chart where we show this.

One of the things that has happened increasingly in markets is that people become more sophisticated and they have become more forward looking. So that the big event that helped bring down interest rates is when the Administration came forward with a deficit reduction package; and as each step along the way, when it became clear that it was going to be signed or that it was going to be passed, that helped bring it down. So that you don't date the impact from the date of actual passage, but it can have anticipatory effects; and in this case it seems—this what is called rational expectation theory seems to have been born out.

Representative Saxton. I may be confused. I don't think so. Interest rates were already going down at the beginning of this economic recovery. Again, long-term bonds were at 8.5 percent in 1991, at 7.6 percent in 1992; and, prior to the passage of OBRA 93, we were at 6.6 percent; and in 1994 rates went back up. So explain to me how OBRA made interest rates go down, when it appears to me they went up.

Dr. Stiglitz. The way you have to pose the question is there are lots of forces going on in the economy at any point in time. You have to ask what we call the counterfactual. What would have happened if the government were in the business of borrowing another half-trillion dollars on the bond market?

It is just simple elementary economics, demand and supply. If you added in this amount of demand for funds on the bond market, it would have pushed up long-term interest rates.

You know, the government comes in—this is not a little amount. You know, this is not your borrowing money or my borrowing money. This is half a trillion dollars. That adds up to a lot of pressure on the bond market. So the demand curves and supply curves for funds are bouncing all over the place. They are going up and down, affected by a whole variety of factors, international and domestic.

What you have to ask is the question, what would have happened, given all those other factors that are going on, if we had put on in the last four years another half trillion dollars of borrowing? I don't think you would find many people who would say a half trillion dollars of borrowing would have had an enormous effect on interest rates.

Representative Saxton. But you don't deny they went up in 1994?

Dr. Stiglitz. The numbers speak for themselves.

As I said, the issue is, what would they have been otherwise? As you go into an economic recovery, one of the factors is that—you know, one of the things that was wonderful about this recovery was that it was not fed by artificial gimmicks like a tax-induced increase in real estate investment that led to imbalances in real estate that we had to live off for a long time. It was based on solid investment in productive capital goods. But those firms, as they were investing in capital goods, had to go to the market; and they had to borrow.

Representative Saxton. But you are saying you agree that they were going down, and when we passed OBRA they went back up. To fairly quote you, you say they would have gone up more.

Dr. Stiglitz. They would have gone up more had we not passed that deficit reduction act. We would have been in the market with another half trillion dollars of borrowing.

Representative Saxton. So the statement that the market stabilized because OBRA was passed and interest rates went down must be qualified by saying, well, they went down relative to what they would have been otherwise. Is that what you are saying?

Dr. Stiglitz. Yes. Let me put it this way—in a different way.

I think actually there is more to it than that. Because if you look at Chart 2 what you see is what was happening to the deficit in the pre-OBRA estimate. That showed the deficit as soaring up. Markets, when they see something like that, when they see the government requiring more and more borrowing, they lose confidence in the political process as being able to address the kinds of key issues. They would have seen increased demands on the financial markets. That would have set off a tendency going in the other direction.

So one way of looking at it is that had there not been confidence that we were going to address the problem and that was generated by OBRA 93 that really did bring down—and you can see that solid line, how it brought it down already from what it would have been otherwise. That is really what made an enormous difference, in my judgment, on business confidence.

Representative Saxton. All right. Let me turn to one other subject, and then I will pass the wand over to Senator Bingaman.

Deficit reduction is obviously very important. We all agree on that. It is a question of how we get to where we would like to be. You will agree with me, I hope, that the deficit was in decline in 1993. Actually, the deficit in 1993 was \$35 billion below what it was in 1992?

Dr. Stiglitz. This chart shows the deficit. In 1993, had it not been for OBRA, it would have been scheduled to go up.

Representative Saxton. Now OBRA, again, was passed in the middle of August, six weeks before the end of the fiscal year; correct?

Dr. Stiglitz. Yes.

Representative Saxton. So you are not saying that the passing of OBRA had anything to do with the \$35 billion reduction in the deficit from 1992 to 1993.

Dr. Stiglitz. No.

Representative Saxton. No.

Thank you.

Now in light of—

Senator Bingaman. —confusion about the fiscal years we are talking about here. OBRA was passed six weeks before the end of fiscal year—

Dr. Stiglitz. 1993.

Senator Bingaman. 1993.

Dr. Stiglitz. Yes, because—

Representative Saxton. We were not on time. Surprise, surprise.

Now, if we could suppose that we had gotten ourselves on a track of deficit reduction, was there some evidence that we had done so because we reduced the deficit by \$35 billion during that fiscal year? If one projects ahead to the current year, we would be about the same place in terms of deficit reduction if we had continued what we were on the track doing then, and we wouldn't have had a tax increase. What do you suppose—

Dr. Stiglitz. I guess I don't understand what it means to be on the track. We have what—these are the kinds of numbers that were produced by CBO and based on the kinds of budgets that were, the 1992 budgets, the Bush budgets. They do a multi-year forecasts; and that tells you where they are going.

So policies were put into place that subtracted from the baseline expenditures and that added to the baseline revenues. That was what OBRA 93 was about. OBRA 93 was a change from the baseline of this half trillion dollars.

Representative Saxton. Now look, we know and I think you and I both agree on certain principles; and one of the principles that we agree on is that when the economy goes into a recession, it is likely that our deficit will increase; yes?

Dr. Stiglitz. That is right.

Representative Saxton. And when the economy does well, as it is today, it is likely that our deficit will be reduced.

The economy began to do well in 1991 and continued to do well in 1992, and the principle that you and I just discussed was beginning to take place: The economy was growing and the deficit was being reduced.

So isn't it fair for one to ask, weren't we already on the path to deficit reduction with a growing economy and that increasing taxes didn't necessarily have as much to do, as the Administration would like us to think it did, with deficit reduction?

Dr. Stiglitz. No, with all due respect. The fact is, economists have a standard way of looking at that, which is called the full employment deficit. The fact is that OBRA 93 reduced the full employment deficit in a marked way. So when we do our calculations we take precisely that kind of thing account.

In fact, what you can see in Chart 6 is our calculation based on CBO numbers. We look at what is called the standardized employment or the full employment deficit. What you see is that, as a percentage of GDP, the change in the standardized deficit—these are the taking into account the level of employment—and these show the marked deductions that occurred in 1994, 1995 and 1996 and also shows that things were going the other way in 1991, 1992.

So this is taking into account exactly the full effect that you described just in the economy to take account of those changes in the level of employment.

Representative Saxton. Let me just conclude with this one last question. Apparently, you would like us to agree that deficit reduction took place, as your statement points out, because of the Reconciliation Act and the tax increase, et cetera. Do you deny that the growing economy and resulting growing revenues—do you deny that that is part of the deficit reduction that we have seen?

Dr. Stiglitz. Sure. As I say, what we think is that the policies that we put into place helped the economy recover faster than it otherwise would have recovered, helped stimulate the economy and, in particular, helped create the composition of demand with investment and export growth. But clearly that growth process by itself helps improve the fiscal situation of the economy. OBRA 93, though, was vital in getting us, as these charts show, in doing more than would have happened simply from a recovery to full employment.

Representative Saxton. Thank you.

Senator Bingaman.

Senator Bingaman. Thank you very much.

Let me ask about the last of your charts, Chart 16, where it shows real household income growth by quintile 1993 to 1995. How do you explain the substantial increase in the average annual percentage change in the first quintile there? Is that because of the earned-income tax credit?

Dr. Stiglitz. No, these numbers are calculated before the earned-income tax credit was included. If you include that, it would be even more dramatic. The earned-income tax credit has made its own

contribution substantially to reducing poverty and improving the people at the bottom.

Senator Bingaman. How would you explain then the difference between Chart 13, which shows that between 1979 and 1995, most of the income growth has been generated for the top quintile, and Chart 16, which shows that in the last three years, 1993 to 1995, most of the benefit went to the first quintile?

Dr. Stiglitz. As you point out, these are dramatic changes. Part of it is typical of a business cycle in an economic recovery. One of the reasons why it is so important to keep the economy running at full employment is that some of the people who get hurt most in an economic downturn, or when the economy is operating at less than full employment, are people at the bottom end of income distribution. They are the people that lose jobs first. As you recover, they do better.

Senator Bingaman. So this is more of a reflection of a fact we were pulling in a slump, we were in a recovery?

Dr. Stiglitz. One of the points we point out in the *Economic Report of the President* is this change is more than can be accounted for by that. Part of it is due to that, but part of it is it is more than that. We do not know fully what explains it.

Part of the reason for the increase in inequality that occurred was the increase in wage differentials between college graduates and high school graduates, and that increased enormously over that preceding 15 years. That increase has now seemed to have been moderated and slightly reversed. That would help people relatively at the bottom. But, again, we don't know whether that is a long-term trend or at this point something that just happened over the last two years.

A lesson from this is one of hope, that maybe the long-term trends have been reversed, but one of vigilance, that two years' data is not a basis for confidence at this point.

Senator Bingaman. The real household income that you are referring to here in this chart does not include fringe benefits like health care coverage?

Dr. Stiglitz. That is right.

Senator Bingaman. When we started the hearing, I mentioned my concern that at least from the anecdotal information I have received, there still are more people losing their health care coverage now than used to have it. Is that accurate? Has there been anything to change that trend?

Dr. Stiglitz. Well, let me say I think both the concerns you raised, both about health care and about pensions, are concerns that I share, and I think they are shared by people in the Administration. One of the reasons why we have this initiative to cover people who are unemployed and extend coverage to them as part of the unemployment insurance, when they lose their job, is it is a particularly difficult time to lose their job and income, but they also lose their health insurance, because we have a system in which health insurance is typically provided through your employer. So just when you can afford it least, you lose your health insurance. So we have tried to put in a provision that is directed at that issue exactly.

The other thing that actually is something that the CEA has been pushing strongly is pension simplification in legislation that got passed last August. There was an important provision for pension simplification which should have the effect of encouraging more small businesses and other businesses as well to provide pension plans for their employees.

One of the reasons that our research suggested there was a decline in pension coverage was that the transaction costs that are associated with pensions had gotten out of hand, and that is why we pushed very strongly for this pension simplification law.

Senator Bingaman. Let me ask about the trade situation. You have said several times, and I agree with you, we have done a fairly good job of promoting exports relative to previous periods. And the President the other night in his State of the Union said we are now exporting more than at any point in history. The unfortunate fact is we are also importing more than at any point in history and the amount we are importing has grown faster than the amount that we are exporting has grown.

I am concerned, I guess, that the strong dollar, which Secretary Rubin finally spoke of this last Friday or this weekend, has had and is having the effect of reversing any gains that we may see, as a result of export promotion policies by the Administration. If you let the dollar get to a level where it is uneconomical for people to buy our goods and it is very economical for us to buy their goods, you exacerbate the situation, resulting in job creation overseas and job loss here. I would be interested in your thoughts about what can be done to bring the deficit more into line, what the importance of the strong dollar is to that.

Dr. Stiglitz. First, let me agree with you that our export performance has been very impressive. Exports are up one-third over the last four years. For an advanced industrial economy to have that kind of increase in exports is really very impressive.

Secondly, let me reiterate an economist's position, but I think it is correct, which is that trade is a win-win situation, where both parties gain from it.

As we increase our exports and increase our trade more generally, we are able to redeploy our resources into areas that are of comparative advantages, where jobs in goods producing industries supported by exports pay 13 to 16 percent higher than other jobs, so we move resources from areas where they are less productive to more productive areas. It is one of the main methods by which we can increase our living standard today.

One hundred years ago, we increased our living standard by moving to the frontier, from agriculture to manufacturing, because manufacturing had a higher productivity than agriculture. That frontier is over. We only have 3 percent of our population involved now in agriculture and the new frontier, in my view, is this export frontier.

So this is a very important part of our program over the long run for America's increase in living standards.

The third point is the subject that actually we talk a great deal, at great length in the *Economic Report of the President*, is this issue of what is happening to our deficit and the relationship to the dollar.

One of the things that you have to keep in mind is that there is a lot of attention always focused on our exchange rate with the yen or exchange rate with the mark. But, in fact, we have a very broadly diversified trading portfolio. We trade with lots and lots of countries. It is one of our strengths, and it means if there is problems in any one country, we have lots of other countries to continue to export to.

If you look at the trade—weighted exchange rate, weighted by the amount we trade with different countries, that rate has only changed by 6 percent since mid-1995. So there hasn't been this dramatic change that you see in a couple of our exchange rates.

Secondly, from the point of view of economics, the trade deficit is mainly related to the balance between our investment and our savings. And in the mid-1980s, what happened was our deficit grew because our savings went down because we had huge fiscal deficits. Fiscal deficits became very large, so national savings went down and that is why we ran a trade deficit, and trade deficits soared. As a percentage of GDP, our trade deficits are nowhere near as bad as they were a decade ago.

But our trade deficits are not coming from of low savings, but they are coming from high investment. What happened is there is a gap

between savings and investment not caused by savings going down, but caused by investment going up.

When investment goes up, that is a very different kind of deficit than when savings decreased, because when investment goes up, what that means is that we are borrowing from abroad to make productive investments that will increase the productivity of America in the future. People will not be borrowing funds to invest if they didn't think the returns more than paid the interest they would have to pay. So the overall strength of the American economy is actually being enhanced.

Senator Bingaman. You are saying the larger the trade deficit, the better off we are?

Dr. Stiglitz. No. I am saying the larger investment, the better off we are. It would be great if we could get our savings up.

One of the reasons I talked before about attacking some of the problems that I did and problems of aging, is because I think it would be good to get our national savings up. But the trade deficit is always related to the gap between savings and investment. I don't want our investment to come down, I want our savings to go up.

Senator Bingaman. I will quit after this, Mr. Chairman, but I have had difficulty understanding this for some time. I am always told that exports are a good thing and we are very proud of our increased exports because that means every time we export another \$1 billion, that creates 20,000 to 25,000 jobs in the country. That represents 20,000 to 25,000 jobs that are producing that \$1 billion worth of goods.

I have always thought if that is true, then every time we incur a \$1 billion worth of trade deficit, we lose 20,000 to 25,000 jobs. Is that wrong?

Dr. Stiglitz. Well, let me put it like this: In the *Economic Report of the President*, we do try to reframe the question to put it in ways we think are the right ways of thinking about it. What we think of is when the economy is reaching full employment, which is where we are now, the issue isn't so much about creating jobs.

The issue is what kinds of jobs. We are redeploying resources. The economy is basically at full employment. If we create one million new jobs in one sector, the monetary authorities are likely to respond to adjusting in such a way that the level of unemployment is going to be kept at the level they think of as a non-inflationary level. So what trade is about is redeploying resources from areas that are less productive to areas that are more productive.

Senator Bingaman. Unfortunately, in our case, it has resulted in redeploying resources out of manufacturing into other sectors, into the service sector.

Dr. Stiglitz. But some of the service sectors are sectors like computer services, financial service sectors, these are high-productivity sectors. This is one of the confusions that gave rise to this image in the United States of this job creation, everybody said it was in the service sector, isn't that bad? The image was of hamburger flippers.

When we look in detail where it was we are creating jobs, yes, they are in the service sector, but they weren't the hamburger flippers. They are computer programmers, financial services, and other high-wage paying service sector jobs.

So the answer is just like, as I said before, we move from agriculture to manufacturing, as the economy goes through the next continuing evolution, we are going to go out of manufacturing into the service sector. We hope we will go into the high-productivity service sector of areas of research and innovation, that will continue to provide the basis of increasing living standards for Americans.

Senator Bingaman. Thank you very much, Mr. Chairman.

Representative Saxton. Senator Sessions.

Senator Sessions. Thank you very much.

On the matter of growth during this past year, I was in a campaign mode and traveled to Alabama and took the opportunity to stop at a lot of businesses in our State. It was really impressive to see the efforts they have made to increase productivity and how even in rural Alabama, you will find small plants shipping all over the world. That is indeed good.

I think that we have got to be sure that we make sure we give credit where it is due. It is due to those managers and those business owners who are working daily to think of creative and better ways. We can provide policies that facilitate them in that effort, and that is something good. But I am real impressed with many of the things that are happening out there in the private sector.

I also have a sense that the government sector is not as productive. When I took over as Attorney General,—two years ago, we faced a serious crisis, and I had to lay off one-third of the employees. We reorganized and worked hard and increased the actual output of that law office with those employees.

When we are dealing with how to improve the productivity of this Nation, we ought to leave resources in the hands of that vibrant private

sector and be less committed to putting them into the less-productive government sector.

Could you comment on that philosophy?

Dr. Stiglitz. Well, I agree, as I said in my remarks, the core of our economy is the private sector, and that is in fact one of the things we have commented repeatedly on, that one of the things that distinguishes this economic expansion is the rate of increase in the private sector jobs. In fact, if you look in terms of rate of increase of private sector demand, it has been stronger in the last four years than essentially in any other comparable period.

That doesn't mean that there is not an important role for government. Government, as I said, has a very important role in complementing, facilitating the private sector, not only in exports, but in a whole variety of areas.

One of the things that all of us talk about in the big expansion in the private sector is the Internet. That was started by a government-funded research program. The government did the right thing basically in starting it off, and then the private sector took the idea and further designed it.

This is not new. In 1842, the Federal Government started the telegraph, the first telegraph line between Baltimore and Washington funded by the Federal Government. Then it also didn't go out and build up the whole thing, but it demonstrated, we call it, they didn't use the words, pre-commercial test of the viability of it, and once it was shown it could work, the private sector picked it up.

There are a whole host of areas in which I think there are essential complementary: R&D, education, and infrastructure. If you don't have roads, people are not going to be able to deliver their goods. You have to have a good infrastructure. I could go on with the whole list.

So the first important point I want to emphasize is there is real complementary between the two. It is not either/or, it is finding the right balance and right complementary.

The second point, I agree with you, we have to work more to increase the efficiency of the public sector. There have been great strides in the increased efficiency of the public sector. As a percentage of the public labor force, the public sector is smaller than at any time since before the New Deal in the early 1930s, and yet we produce a lot more.

We do a lot more. We have a whole set of programs, Social Security, Medicare, we didn't have in 1931 and 1932. To do all that with a smaller labor force, relative to the size of the population means, in

effect, we become more productive. People don't recognize this, but there are a variety of ways.

It is hard to measure productivity in the kinds of activities we government employees are engaged in, but I think we have become more productive, and I can give you examples. Like the Social Security Administration in its computerization effort, its phone answering service—

Senator Sessions. If it were a private business running Social Security, it would be less, I assure you.

Dr. Stiglitz. I am not sure of that. In fact, one of the remarkable things is the low transaction cost involved in Social Security.

Senator Sessions. I think one of the things the Chairman was suggesting was that he was here during an effort to get control of our government and make it more productive, and was making progress in that. When you raise taxes, it reduces the pressure on us to make those tough choices and confront problems.

I would not have laid off as many people in my office if I had had any other choice. I hated to do that. But it worked, because I had to do it. You have to push government. I just want to make that point to you.

You mentioned Social Security and some of the options being discussed in that regard. I have a question in which I am somewhat interested. How do you feel, what kind of impact, pros and cons, do you see to the securities market by increased investment in Social Security Funds?

What are the advantages and dangers of that?

Dr. Stiglitz. Well, that is one of the issues that we do discuss in the *Economic Report of the President*. It is one of the issues that was discussed, for instance, by the Quadrennial Advisory Council on Social Security.

The interest in this particular proposal I think is primarily generated by the fact that over historical record, returns on equities have been substantially higher than returns on government securities, and investing them in higher-return assets means there are more funds, both for increasing the overall strength of the Social Security Trust Fund and providing returns.

The downside that those who are critics of this kind of proposal worry about is the additional risk. They say well, yes, historical record is that they have yielded higher returns, but what if?

Senator Sessions. Has the President taken a position on that?

Dr. Stiglitz. No.

Senator Sessions. Just to touch a bit on the issue I raised Friday, the Department of Labor statistics reported to this committee, and we discussed the problem with household income. I notice you have some numbers that show some increases in household income. But when I asked the Department of Labor official, if household income shows some growth, even in recent months, he said it remained flat.

As far as over a decade or more, you would admit, would you not, that the average income for working families is not where we want it to be and that we need more growth in that area?

Dr. Stiglitz. Yes. I think it is easy to agree.

Senator Sessions. Would you agree also that the Department of Labor official said the other day, Friday, that the income is flat for families?

Dr. Stiglitz. Well, no, that I am not quite sure, because the data we show in Chart 16, which is from the Department of Commerce, shows very clearly that from 1993 to 1995 there were real increases, the average was 2.7 percent, but there were real increases in every quintile. Those are using the CPI.

If there were an upward bias in the CPI measurement of, say, even 0.5 percentage point, that would mean rather than a 2.7, it would be 3.2 real increase in household income, which is actually a fairly robust increase in income.

Would I like to see a higher increase? Yes, obviously I would.

Senator Sessions. One of the things that was curious to me, is that average wages went up one cent per hour. That is the kind of level that we wish could be higher.

Dr. Stiglitz. That particular series shows a lot of month-to-month variation. Real wages have been going up. In fact, the way we characterize it, we are in this golden zone where real wages are going up, wages are going up faster than prices, but not so fast as to put real pressure on inflation. This is where we want them to be. We want wages to be up faster than prices, real wages growth, but in line with productivity. We would like productivity to go up at a more rapid rate, but real wages have been going up significantly.

Senator Sessions. Thank you, Mr. Chairman. That is all I have.

I just think that we have had some good things going on out there. When you go out and meet with the average business facility in this

country, they are doing remarkable things. If we maintain the right kind of structure for them, they will be very competitive in the world market.

Dr. Stiglitz. I agree.

Representative Saxton. Senator Sessions, thank you very much.

Mrs. Maloney.

Representative Maloney. Dr. Stiglitz, more women are in the labor force now than ever before. Why do you think we are seeing this increase in female employment?

Obviously, there are more opportunities for women, but are there other factors at work? We are at a record employment level, we heard at our last hearing for women, 56 percent.

Dr. Stiglitz. That is right. Participation rates are increasing significantly. I think that probably economists would emphasize the fact that discrimination has been reduced and opportunities have been increased. Education levels have increased significantly over the last 20 or 25 years. So it is not only in the job market, but you have to push it back one stage into education, in educational opportunities, and even back further in elementary and high school.

There are programs that try to make women more aware of a broader range of job opportunities and try to get them more interested in science and mathematics so they don't always go into the kinds of areas they had been traditionally shunted into.

Representative Maloney. Even though average family earnings have risen over the past 10 or 15 years, the number of earners it takes to generate the earnings have risen, too. So when we have a family where both the wife and the husband work, the expenses rise likewise, particularly for child care.

What steps do you think we need to take or what steps has the Administration proposed to take in light of the increased costs to a double wage-earner household? And in particular could you comment on the role of the Administration's proposed \$500 Family Tax Credit in this connection?

Dr. Stiglitz. Well, I think that it is clear that one of the purposes of the \$500 Tax Credit is to pay attention to the special problems that people with children face as they enter the labor force. They have to bear the cost of child care.

There is also the Child Care Tax Credit.

Representative Maloney. That is very small.

Dr. Stiglitz. It is \$480 for a child. If you add that to the \$500, that is \$1,000 almost per child.

Representative Maloney. Still, the cost of child care is really tremendous. Oftentimes women making even large salaries cannot work because the cost of child care is even higher.

I would like to know your thoughts on whether or not it would make sense to make the existing dependent tax deduction refundable so that families can have some help with this very necessary expense, even if the family must spend more for day care than the amount they owe in taxes?

Dr. Stiglitz. Well, I think you have to always balance—there are a lot of good objectives of tax provisions that you might want to pursue. We live in a period of extreme financial stringency. And I think one, as I said before, one of the reasons that our economy I think is so strong, is because we have been relentless in our pursuit of deficit reduction. One of the things we did last year as we were thinking about initiatives for the campaign, is every time we came up with a new initiative, we asked how do we finance it?

The answer is there are some merits in a proposal like that, but you have to ask how would you finance it? What would you cut out? What would you replace this program with?

Representative Maloney. Women workers still earn quite a bit less than male workers. Ten years ago it was, roughly, 50 cents on the dollar. Now it is, roughly, 70 cents on the dollar. Do you see women making gains so it becomes a level playing field, or do you think women will continue to make considerably less than men?

Dr. Stiglitz. One of the key issues here is you need to look at the new entrants into the labor force. I think the evidence is that the new entrants into the labor force face less discrimination than the older entrants. New entrants are also entering into occupations that are more representative.

There is not only less wage discrimination, but there is in fact some evidence it has been very widely addressed. If you look at a woman in the same job, they tend to get comparable wages.

The problem has been more with job discrimination and what is called the glass ceiling. There was a report that came out about a year and a half ago on the glass ceiling. Those are the areas we have to work on more now. I think some of the kinds of differences you mentioned reflect difference in occupational choices and educational levels.

Representative Maloney. Even in occupational choices, a lot of times there is still a disparity.

Dr. Stiglitz. Yes. That has something to do, like I say, with things like the glass ceiling, which I think remain important barriers.

Representative Maloney. To follow up on the glass ceiling, many reports show there is a glass ceiling. Only 10 percent of the population in Congress are women. Less than 1 percent become CEOs. Does the Administration have any policies to address the issue of the glass ceiling?

Dr. Stiglitz. Well, the Administration has consistently, in terms of its role it played in its own appointment policy, has pursued a very aggressive policy and I think been very successful in succeeding in its own house of making sure that there is, you know, a large number of women.

Representative Maloney. That is true in appointments. I know you are going to be followed by a competent woman. But policies out at large.

Dr. Stiglitz. I think these demonstration effects are very important. What they have shown is they can recruit good women. It is not a question of—it is affirmative action, I would say, in the best sense. They went out and they sought. The women they found have been fully as qualified as any man, but they went out and sought, and they succeeded. I think by demonstrating you can do this, I think it has a role model effect that can be very important.

Representative Maloney. Pension coverage is declining for workers in general. What can we do to encourage companies to offer pension coverage for their workers? Are there any administration proposals in that area?

Dr. Stiglitz. Yes. This is what I referred to in answer to Senator Bingaman's question. I think one of the things we did do is the initiative of pension simplification. One of the barriers to firms, particularly small businesses providing barriers, was the high transaction costs. The pension simplification that was enacted last August should dramatically reduce those transaction costs and increase coverage, particularly by small businesses. I think there is more to be done in that area of simplification.

Representative Maloney. In addition to simplification, would you advocate or believe in tax credits possibly to encourage small businesses to expand pension coverage?

Dr. Stiglitz. At this juncture I would like to see whether the tax incentives we currently provide, which are substantial, because money you put into a pension plan has significant tax deferral benefits, I would like to see whether the simplification would by itself succeed in getting more pension coverage, which I think it will.

Representative Maloney. Our GDP has grown at a steady pace, which is always good news, but in the fourth quarter it was 4.7 percent, quite a large jump compared to the average growth of 2.5 percent over the past year.

What do you attribute that to, and what can we do to help to grow our economy? Why did we have such a big jump in the fourth quarter?

Dr. Stiglitz. There are always going to be some quarter-to-quarter variations in the economy.

Representative Maloney. That is a large one though.

Dr. Stiglitz. Yes, and it is the last quarter under—well, I am Chair of the CEA, so I am pleased I will be going out on a high point. It would be nice if it turned out to be even higher in the next quarter, but I would not count on that level being sustained.

There are going to be inevitably quarter-to-quarter variations. I think the issue you raise is how do we increase the steady state potential GDP as we go forward, and that is basically the kind of growth agenda that I talked about in my remarks, that basically you have to increase investment, and that is related to continuing to have deficit reduction.

You have to have your increasing investment in human capital, in our education programs, and you have to increase efforts to increase efficiency, and that has a four-part agenda: One, increasing support for R&D, which I think is terribly important. You call it knowledge infrastructure, something that has not been given enough attention; secondly, increasing competition domestically, because I think competition is really a spur to innovation; third, by continuing to increase our export markets, because these are really opportunities for us to take advantage of our comparative advantages and have been a real source of economic growth; and, finally, continuing to increase efficiency in the public sector, which is the part of the economy which is under our purview.

So I think if we keep at these, there is no magic bullet or simple formula that says, "Do this." There are people that would like to pretend there is a magic bullet. I don't think there are magic bullets like that. I think you need a broad-based agenda—I know it says long—but a

broad-based agenda, and keep on all these elements, and over time productivity will increase and growth will increase.

Representative Maloney. We have had a relatively long period of economic expansion. Can we anticipate more expansion? Are we going to see a downturn? What do you predict will be happening in our economy?

Dr. Stiglitz. I see a continuing expansion in the economy, and in terms of the short run, in the coming year, when we look at the structure of the economy, we don't see any imbalances. Inflation is low, as I mentioned. There is no inventory overhang.

In the last year's *Economic Report of the President*, we asked the question that is very similar to the question that you asked, which is do expansions end of old age? The answer that in our analysis was very clear, the answer to that is no. The probability of an expansion ending is basically a constant probability per month. There is no higher probability of an expansion ending after five years or after three years or after six years.

Expansions tend to end not because of old age, but because of usually some form of economic mismanagement. The major source contributing to an economic downturn is a marked increase in inflation and, as a result of that, the Fed stepping on the brakes and bringing the economy down in a very marked way.

A second, far less important, but still important, source is inventory overhangs, where large inventory builds up, and then firms cut back on their inventory investment, and that brings the economy down. We don't see any of those factors current at the present time.

Representative Maloney. Just back to your talk on the inflation, with the Fed, do you think since we have had sort of a continued low inflation that they should loosen up on their interest rates a little bit or not?

Dr. Stiglitz. We don't comment on Fed policy. I think the fact is that the economy has been performing actually admirably in every dimension.

Representative Maloney. Is zero inflation achievable?

Dr. Stiglitz. We actually have a discussion—

Representative Maloney. Or would we even want to attain that?

Dr. Stiglitz. We have a discussion of that issue in the *Economic Report of the President*, Chapter 2, where we point out that at times in the past there have been high costs associated with inflation. There are large

costs associated with inflation when inflation gets to a high number, over 12 or 15 percent. Two things we point out. One is that at the low and stable levels of inflation that we have been at and what we currently are at, it is very hard to identify any significant costs associated with inflation. Secondly, we cite one study that argues quite persuasively there are significant costs to the economy in terms of output of trying to push it too close to zero inflation.

Representative Maloney. At our last Committee meeting, we had a discussion on the proposal from the Fed for a commission to study the CPI. Some people are stating, the Boskin Commission and others, that it isn't accurate enough and possibly should be looked at. What are your feelings on that?

Dr. Stiglitz. Again, we have a discussion of the issue.

Representative Maloney. I hadn't gotten your book until today.

Dr. Stiglitz. It is a big book to read, especially in the morning.

We do have a discussion of the biases in the CPI and the Advisory Commission to study the Consumer Price Index (the so-called Boskin Commission). What we do in there is discuss the various sources of the bias, and it is not just one bias, there are a series of basically five different sources of bias.

The underlying—when you look at these various sources, there are several of those in which there is widespread consensus among the economics profession both that the biases are there, and about the magnitude of those biases, and about how we might go about addressing those biases.

There are other biases that they identify where there is more controversy about the magnitude and about the best way of addressing them.

Representative Maloney. Well, the debate of the day is the balanced budget amendment, and I would like to ask, I am sure you probably wrote about it in here, too, but what are your feelings on the constitutional balanced budget amendment?

Dr. Stiglitz. I think the balanced budget amendment would be a big mistake. The reason from an economist's point of view is very simple: It would eliminate the automatic stabilizers that play a very important role in stabilizing the economy. The result of this, our analysis suggests that as a result of decoupling or unplugging the automatic stabilizers, when the economy goes into a downturn, the level of unemployment

would probably be between 1 and 1-1/2 percent higher than under the current regime. That is a high price to pay.

Representative Maloney. Thank you very much.

Representative Saxton. Dr. Stiglitz, let me go back to this matter of interest rates for just a minute. Let me tell you why. I have always believed that as a general principle, if government were to want to do something to spur economic growth, that something that would encourage savings and investment might be the order of the day and, therefore, both John Kennedy and, perhaps for different reasons, Ronald Reagan believed that in order to get economic growth and create the kind of economy that all Americans would like to see, that their policies reflected a different philosophy of tax cuts.

When taxes were increased in 1993, I have to say that I was pleasantly surprised that we began to see some economic growth, which is what we have been talking about today, and we would all like to see more of.

I am just having trouble understanding it, and I am having more trouble understanding it now than I did when I walked in the room, because the explanation that the Administration gave was that the tax increases created a stability in the financial markets which provided for a decrease in interest rates, and the Fed responded accordingly.

I remember, as a matter of fact, when long-term rates were on their way up a few years ago, and the Fed was trying to hold short-term rates down, and that caused some other problems. But by and large, beginning in late 1990 until 1993, it is a matter of fact interest rates were dropping. That wasn't because of a tax increase. Something else may have been providing for stability in the market, unless it was George Bush's tax increase, and that could have been.

But then in 1993, what you described as a slight increase—and I suppose everything is relative, and I am just looking for a way to understand this. When Bill Clinton's subsequent explanation of his tax increase was "I increased taxes too much," when that went into effect, interest rates didn't go up a little bit, interest rates went all the way back up within a year to the point where they had been. It looks like on that chart, I have got a smaller copy here in front of me, which makes it a little easier for me to look at, but it looks like they went back up where they had been in 1991. It is a rather steep increase.

So I don't understand the explanation for economic growth declining when rates went up when we increased taxes—excuse me, when they increased taxes. I don't take credit for that. That is not my thing.

Maybe you can try once more to help me understand how that is a decrease in interest rates. I heard you say before that they didn't go up as much as they otherwise could have. I don't think anybody can prove that. So help me out.

Dr. Stiglitz. Okay. Let me first try to address the first set of issues that you raised, which is the role of tax cuts in trying to stimulate economic growth and productivity.

There are basically, as I said before, three pillars of economic growth: Investment in physical capital, investment in human resources, and improvements in technology and efficiency in a broader sense.

If you look at what happened after the 1981 tax increase, and you ask the following question: Was there a change in the trend rate of increase of productivity? You have to be careful because there are cyclical patterns to changes in productivity, so if you pick out particular years, you can get distorted numbers. You have to look at the trend, taking out the cyclical fluctuations. And the answer is no, that tax cut did not have any effect. It continued going on at the rate of roughly 1.0, 1.1 percent. That has been the characteristic since 1973.

If you look at it from a microeconomic perspective, that is not surprising. The two underlying issues are did it have any effect on savings? No. In fact, national savings went down, because it created a huge increase in the government's deficit, and that brings down national savings. And did it have any effect on labor force participation? If you look at the trend line, actually labor force participation went down even more than that.

Representative Saxton. Did I hear you say the tax decrease stimulated the deficit or created the deficit? Did I just hear you say that?

Dr. Stiglitz. What I said was the conjunction of things that happened, yes, you did, that the deficit increased after the tax cut of 1981.

Representative Saxton. I have this real neat chart back in my office that shows the rate of increase in spending, and it shows the rate of increase in spending just went way beyond the increased revenues that we got from growth in the economy, or whatever.

Dr. Stiglitz. You shouldn't isolate any one particular policy, but had they not cut the taxes, the cut in taxes did reduce revenues, and that reduction of revenues—you ask just what happened to the difference between revenues and expenditure—that gap increased as a result of that tax cut. It is lower than it would otherwise have been.

So there was a deficit, and, as a result of that, the bottom line from this is that savings did not increase and productivity did not increase as a result of that tax increase. There is no evidence on that going that way.

Representative Saxton. If you will permit me to just jump back in here for just a minute, one of the previous Council of Economic Adviser reports under this Administration stated, "It is undeniable that the 1981 tax cut stimulated the economy."

Dr. Stiglitz. I have to put that in context.

Representative Saxton. That is an undeniable statement.

Dr. Stiglitz. The issue that we are asking is what was the effect of the 1981 tax cut on the trend growth of productivity? Did it make the economy over the long run grow faster than it otherwise would have? The answer is it doesn't show in the data. It doesn't have an effect on either the savings rate or on labor force participation. It did not stimulate the economy. It is not part of a growth policy. You cannot link that policy change to a growth policy change. You would not find many people that would identify it.

Representative Saxton. One of your predecessors did.

Dr. Stiglitz. Well, you will have to show me the exact analysis.

*Let me go on to the other parts of your question. The fact is that interest rates are determined by a complex of forces of demand and supply, forces that move in very volatile ways.

Now, one of the factors that affect the demand for capital is an economic expansion. When investment is going up, people feel confident about the economy, the demand for funds rise. So in an economic expansion, typically you will find other things aren't changed. Interest rates will often rise. When the economy goes into a recession, the demand for funds falls, and conversely, interest rates will fall.

When you are comparing 1991 with 1994, what you are doing is comparing an economy in recession and very little demand for funds from the private sector for investment because the economy was doing not very well. In 1994, there was a high demand for funds from the corporate investment sector because the economy was doing very strongly.

Now the issue is what would have happened in that situation in 1994 with a strong economy, high investment demand, high demand for funds from the private sector if we added to that \$200 billion of borrowing from the Federal Government? You add to any situation like that an additional demand for funds, that is going to soar the interest rates, choke off the investment and bring the economy's growth to a halt.

Representative Saxton. Thank you.

Let me ask you one more question about that , and then I will get off this thing.

In the budget that we got for this year just recently, they state flatly here on page 25—this is the statement: “Falling deficits enabled the Federal Reserve to hold short-term interest rates low in 1993.”

How can they make that claim?

In addition, the markets always reacted favorably, cutting long-term rates.

It didn't happen that way, did it?

Dr. Stiglitz. I think this is the same issue we have been talking about.

Representative Saxton. I think it is. Do you want me to repeat what I said before or say it louder or what?

I just don't know how people write this stuff when it appears to me not to be the case.

Dr. Stiglitz. Let me try to say it again, that lower deficits and the anticipation of lower deficits—it is not only the lower deficits, but the anticipation of lower deficits—will result in lower interest rates. Lower long-term interest rates, are often associated with—the word they often use—are validated by the monetary authorities in lower short-term interest rates.

Representative Saxton. Long-term rates didn't actually fall, right?

Dr. Stiglitz. Lower than they would have otherwise been.

Representative Saxton. They didn't actually fall, right? We are back in Washington. Is this a cut or not?

Dr. Stiglitz. They did fall earlier in the year, and they fell earlier in the year, particularly as it was clear that the administration was engaged, committed to a course of deficit reduction. The problems that had plagued the country for 12 years and had not been addressed, the soaring deficits, were finally going to be addressed. I think that change of economic course really did make a difference.

Representative Saxton. Let me move real quickly to another subject. You mentioned education, and the President has talked a lot about education. As a matter of fact, education is one of the vital components, I think, and we all agree we have got to do better at educating and reeducating as we move forward. The President's position

regarding proposals on education tax cuts, can we discuss that for just a moment?

Dr. Stiglitz. Sure.

Representative Saxton. I read recently *The Washington Post* article w-where they quote the Education Executive Director of the Policy Analysis for the College Board saying that the Clinton plan tips the benefits so heavily to the more advantaged in our society that I have great misgivings. I appreciate that families are struggling, but this is clearly an upper income program.

Would you respond to that?

Dr. Stiglitz. Yes. I think you have to look at this program in conjunction with other Administration programs. We are always expanding in a very significant way the Pell Grants. The intent of this was to say that it is not just people who are below this key threshold that are eligible for Pell Grants that have trouble financing their kids' education, but there are groups of people, lower middle income individuals, who are paying taxes, who don't qualify for Pell Grants, that are having a hard time. This is a tax deduction/credit that is available to these individuals to ease their burden.

Representative Saxton. So this will be part of an overall program, and there apparently is some need, perceived need at least, to help that class?

Dr. Stiglitz. That is right. You don't want to look at this in isolation of the very major expansion.

Representative Saxton. This part of the program is for the upper income folks?

Dr. Stiglitz. It is phased out at upper income. I basically call it middle as opposed to the Pell Grant, which is focused on the other part of those.

Representative Saxton. Yes.

Dr. Stiglitz. But you have to look at these together, not as independent pieces.

Representative Saxton. Okay. Let me just ask one other question, and then we will go Senator Sarbanes.

With regard to the employment tax credit, *The New York Times* quotes the Inspector General of the Labor Department, Charles Masten, as saying an earlier version of the Clinton plan known as the Targeted Jobs Tax Credit had "virtually no impact on employers' decisions to hire members of these groups, and that 92 percent of the workers hired under

the program would have been hired anyway." After conducting several audits Mr. Masten said, "I can only conclude that the tax credit is a windfall for employers since the program is inconsequential in encouraging the employment of welfare recipients it was intended to help."

Dr. Stiglitz. Those concerns of the earlier programs were extensively discussed by us as we were designing our program. There is evidence, a reexamination of the data and a consideration of a variety of different programs that Larry Katz at Harvard University conducted, and the new program that we are designing is substantially different from this old program. Design changes were made specifically to address those kinds of concerns.

Representative Saxton. Thank you.

Senator Sarbanes, would you like to have a shot at some questions here?

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator Sarbanes. If it is the appropriate time.

Representative Saxton. Go ahead.

Senator Sarbanes. Thank you very much, Mr. Chairman.

Chairman Stiglitz, welcome. It is nice to see you. As I listened to my colleague on the other side of the aisle, I am reminded a little bit of Gabriel Heatter. Most people in the room never heard of him. He was a radio correspondent during World War II. I was just a young kid. But he used to start every program, he would say, "Oh, there is bad news tonight," and then he would go from there. And I want to talk about the good news that you are bringing in with this economic report.

Now, we are at, what, 5.4 percent unemployment?

Dr. Stiglitz. That is right.

Senator Sarbanes. We haven't been down in the lower 5-point something unemployment rate since when?

Dr. Stiglitz. Except for a couple quarters, it has been basically a couple decades.

Senator Sarbanes. A couple of decades.

Now, the inflation rate is under 3 percent, right?

Dr. Stiglitz. That is right.

Senator Sarbanes. The best in what, 30 years?

Dr. Stiglitz. Something like that. That is right.

Senator Sarbanes. So the unemployment rate right now is the best in a couple of decades, given a couple of quarters that matched it earlier on, and the inflation rate is the best it has been in 30 years. We have created, what, 11 million new jobs over the last 4 years?

Dr. Stiglitz. 11.5.

Senator Sarbanes. 11.5 million jobs.

We are sort of—it is not unfair to say we are kind of the envy of the world right now in terms of how our economy is working. Would that be fair to say?

Dr. Stiglitz. That is right. I have had the pleasure in the last year to represent the United States in a couple of international meetings.

Senator Sarbanes. It is fun to go to them nowadays—

Dr. Stiglitz. It is a lot more fun.

Senator Sarbanes. —with other nations' economists.

Let me take you through a little exercise here. In 1992, the deficit was what?

Dr. Stiglitz. \$290 billion; 4.7 percent of GDP.

Senator Sarbanes. I am going to get to the percent in a minute. Let me just do the dollar terms first.

We brought the deficit down, and when I say "we," I mean the Administration and the Congress. We ran those deficits through the 1980s and into the early 1990s, and that was the Administration and the Congress. I mean, we are both at fault, although I do want to point out that the Congress every year except one voted lower budgets than either President Reagan or President Bush submitted to the Congress.

Dr. Stiglitz. I think that is an important point to emphasize, that the debate was over the composition of how the money was spent, and not over the level.

Senator Sarbanes. That is right. In fact, the congressionally enacted budgets in every year, but one, in total, were less than the budgets submitted to the Congress by either President Reagan or President Bush during their 12-year tenure.

But the deficit now has come down from \$290 billion to \$107 billion in successive stages over four years, correct?

Dr. Stiglitz. Yes.

Senator Sarbanes. Now, that represents as a percent—and this is, I think, an even more impressive performance -- as a percent of GDP, we brought the deficit down from 4.7 percent of GDP to 1.4 percent.

When were we last at 1.4 percent deficit of GDP, percent of GDP?

Dr. Stiglitz. I don't know the year, but it has been a long while.

Senator Sarbanes. Almost 25 years, I think. We are getting some assistance here, I think. I hope.

Dr. Stiglitz. In 1970, quarter-century ago.

Senator Sarbanes. Twenty-five years ago.

Dr. Stiglitz. I take it back; 1974 was 0.4 percent.

Senator Sarbanes. Okay. So the unemployment is the best in 20 years. Inflation is the best in 30 years. With the deficit as a percentage, GDP is the best in 23 years, 24 years.

Now that is just on our own standards, comparing internally against other American benchmarks. Now, let's just go outside and compare ourselves relatively with other countries now worldwide. This is G-7, deficit is a share of GDP. Now, we are at 1.4 percent right here. That is the United States. Here is Japan, 3.1; Germany, 3.5; Canada, 4.2; France, 5.0; U.K., 5.1; Italy, 7.2. By far the best performance of any of the G-7 countries, correct?

Dr. Stiglitz. Yes.

Senator Sarbanes. Now, as I understand it, the master criteria for the European Union, there are two important financial criteria they have set for joining the monetary union. And, in fact, these are called stiff standards to meet as they try to get them into a monetary union, the 15 countries of the European Union. One standard is annual budget deficit is a percent of GDP, that is what we were just looking at, where the United States is now 1.4 percent, correct?

Dr. Stiglitz. That is right.

Senator Sarbanes. The European Union has set for its countries is 3 percent, and as I read it, the only countries in the EU who are doing better than the 1.4 percent where the U.S. is right now are Denmark, Ireland, and Luxembourg. So if we were trying to meet the EU criteria, we would have easily met that criteria -- criterion and, in fact, met it so well that only 3 of the 15 countries of the European Union (EU) would have done better than us.

Now, the other standard that is set is government debt as a percentage of GDP. I understand that figure here is about 50 percent. Is that your understanding?

Dr. Stiglitz. That is right. I think it is a little higher than that but basically.

Senator Sarbanes. All right.

Now, in the EU, the only countries that are below that are France and Luxembourg and the U.K. just barely. France and the U.K. just barely, and Luxembourg. So once again, the U.S. meets that criterion of the European Community. And in fact, does better than any of the European Union countries with a couple of exceptions. So if you take both standards together, really the only country in Europe doing better than the U.S. in meeting these, what they call the tough criterion for union, is Luxembourg.

Now, it seems to me that is a pretty good performance in two dimensions. I tried to give as it were a vertical dimension, just comparing performance in the U.S. over a time period. And so we find there that just looking at U.S. performance—unemployment is the best in 20 years; inflation the best in 30 years, the deficit as a percentage of GDP the best in almost 25 years—that is the vertical comparison.

We do a horizontal comparison now with other countries and take the European Union, which I think is a fair measure, although I did include Japan in the deficit comparison figure; we are doing better than almost any of the other major industrial countries. Is that a reasonable perception of our economy?

Dr. Stiglitz. That is right.

Senator Sarbanes. Well, you know, it must be nice to be able to be the Chairman of the Council and come to the Congress with that kind of economic report.

Now, let me just pursue one other item with you. I am very much interested in the automatic fiscal stabilizers. Now, essentially that is a concept that is developed in the post-World War II period. Is that fair to say?

Dr. Stiglitz. That is right.

Senator Sarbanes. And as I understand the automatic fiscal stabilizers, in effect, what we do is when we go into an economic downturn, we automatically start running a larger deficit because we lose tax revenues from the slowdown in economic activity and we also increase our expenditures for things like unemployment insurance and other transfer payments to cushion the impact of unemployment. Is that correct?

Dr. Stiglitz. That is right.

Senator Sarbanes. Now, the consequence of the loss of revenue and the increase of expenditures is to, of course, increase the deficit. But

that increase of the deficit in an economic downturn serves to cushion the extent of the downturn and therefore helps to offset it from going deeper. Is that right?

Dr. Stiglitz. That is right, very much so.

Senator Sarbanes. Now, if we were to try to balance the budget in an economic downturn or if, in fact, we were compelled to do so because let's say there was a constitutional requirement for a balanced budget, so that as we had an economic downturn, we would either increase taxes or cut spending because we were getting this growing deficit in order to prevent it. Wouldn't the consequence of that be to drive the economy down even further?

Dr. Stiglitz. Yes. Before you came, I pointed out that our analysis suggests that the downturn of the economy would have about 1 to 1-1/2 percent higher levels of unemployment than we have currently. What is so important about the automatic stabilizers is that they go into place without any decision-maker having to look at the data, having to debate. Unlike with the monetary authorities, they don't have to debate the issue about where the economy is, where it is going. They go into place automatically without anybody having to make a judgment about where the economy is.

Senator Sarbanes. That is right. I can recall a time when Alan Greenspan said that the economy was doing all right and later it developed that months earlier the economy had, in fact, taken a downturn once we got the figures, and it hasn't been spotted by—I mean, I think Greenspan was calling it as he saw it but he just didn't see it.

Dr. Stiglitz. Yes. And that is why these automatic stabilizers are really so important. They go into place, as I state, automatically simply based on the economic performance, whether people are being laid off from jobs and based on how incomes are going and, therefore, tax collections go just automatically. And that is why you can't use monetary policies to fully offset the decoupling of the automatic stabilizers.

Senator Sarbanes. Now, let me ask you this question. I have been constantly intrigued by this chart. This chart begins in 1870 and it runs up to the present, and this is real economic growth, 1870 to 1995. And, of course, what it shows is tremendous fluctuations in the economy until we get to the post-World War II period. From here on out is the post-World War II period. Now, that is when we began to use automatic fiscal stabilizers.

Now, I don't attribute it entirely to the automatic because we have also made conscious decisions about counter-cyclical fiscal policies,

which is another dimension. But isn't it reasonable to think that the automatic fiscal stabilizers have had something to do with, in effect, truncating the fluctuations in the business cycle that we have experienced in the post-World War II period?

Look, we have hardly gone into negative growth during the post-World War II period. We still get fluctuations but we have greatly ameliorated them and we no longer get these kinds of deep recessions.

Dr. Stiglitz. Yes, that is exactly the point I would have emphasized, there is still going to be some fluctuations but they never get below 1 or 2 percent negative. You don't have the huge downturns that you had six times in the period you have illustrated there.

Senator Sarbanes. Now, if we so constrain ourselves by, say, a constitutional requirement to constantly balance the budget even in difficult economic terms, don't we run the risk of turning an economic downturn in a recession and a recession into a depression just as we were experiencing back before we started using automatic fiscal stabilizers?

Dr. Stiglitz. And that is the reason the Administration is so strongly opposed to the balance the budget amendment.

Senator Sarbanes. I think it is a very strong argument, and the argument that is made to counter is, you can get 60 votes to waive it or three-fifths votes in the House.

First of all, people may not recognize that there is a recession going on. As you just pointed out, the automatic stabilizers work without anyone having to spot what is taking place. Two, if they recognize it, they will argue about what needs to be done or whether it is really taken—I can remember with President Bush, we went through a long, difficult period trying to get him to extend the unemployment insurance.

Finally, it was done but I think late in the date.

Let me ask this final question. The Chairman has been very gracious with his time. In terms of stabilizing the economy, isn't the sooner you can pick up—well, of course the automatic stabilizers do it right away, then you may come along with additional policy—but the sooner you can counter the downturn, the less you have to do, the more likely it is you will succeed? Once it gains a downward momentum, doesn't it become more difficult to turn it around and bring it back up?

Dr. Stiglitz. I agree, and that is one of the reasons I feel automatic stabilizers are so important because they start working as soon as there is a downward movement in the economy.

Senator Sarbanes. Thank you.

Representative Saxton. Thank you, Senator.

Dr. Stiglitz, I have no further questions at this time. I would just like to thank you for coming here to be with us today and to say that we appreciate very much the job that you have done while you have been with us here in government, and I look forward to at least watching your progress as you assume your new duties with the World Bank. So thank you very much. And the hearing is adjourned.

Dr. Stiglitz. I thank you, Mr. Chairman.

[Whereupon, at 4:08 p.m., the Committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It gives me great pleasure to welcome Council of Economic Advisers (CEA) Chairman Joseph Stiglitz before the Joint Economic Committee (JEC) today. As sister organizations established under the same statute, we deal with many of the same issues. I hope you will accept my expression of best wishes as you move on to other challenges.

The economic history of the United States is one of cyclical swings in economic activity, and recent history is no exception. The economic expansion that began in 1991 is now almost six years old. This cyclical upswing has been associated with a moderate rate of economic growth, an expansion of employment, a lower unemployment rate, and improvement in a number of other cyclical indicators. Though the pace of economic growth during this expansion is below the average for postwar economic expansions, the long term slowdown in trend labor force growth may be part of the explanation for this. However, productivity and wage growth has been relatively weak.

However, we politicians in Washington have our own way of addressing cyclical movements in the economy. By now everyone knows the drill: the party in the White House claims that the typical upward movement in the business cycle is due to its policies, while those in the other camp claim the expansion is some sort of statistical illusion, or is about to end in some grim disaster. All this political posturing proceeds despite the fact that in the near term we in Washington, whether in the Executive or Legislative Branch, can have only a modest impact on the economy under most circumstances. However, especially when tax rates are cut deeply from very high levels, as in 1964 and 1981, one can expect significant positive effects to result in the near term. But in most cases, our \$8 trillion economy simply dwarfs the effects of the laws we pass in the short and medium term. Over the longer term, of course, our tax and spending decisions can and do have a significant impact on economic growth.

It is the policies of the Federal Reserve that most affect the economy in the short run. By lowering inflationary expectations, Federal Reserve policy produced lower interest rates in 1991, 1992, and 1993, and produced

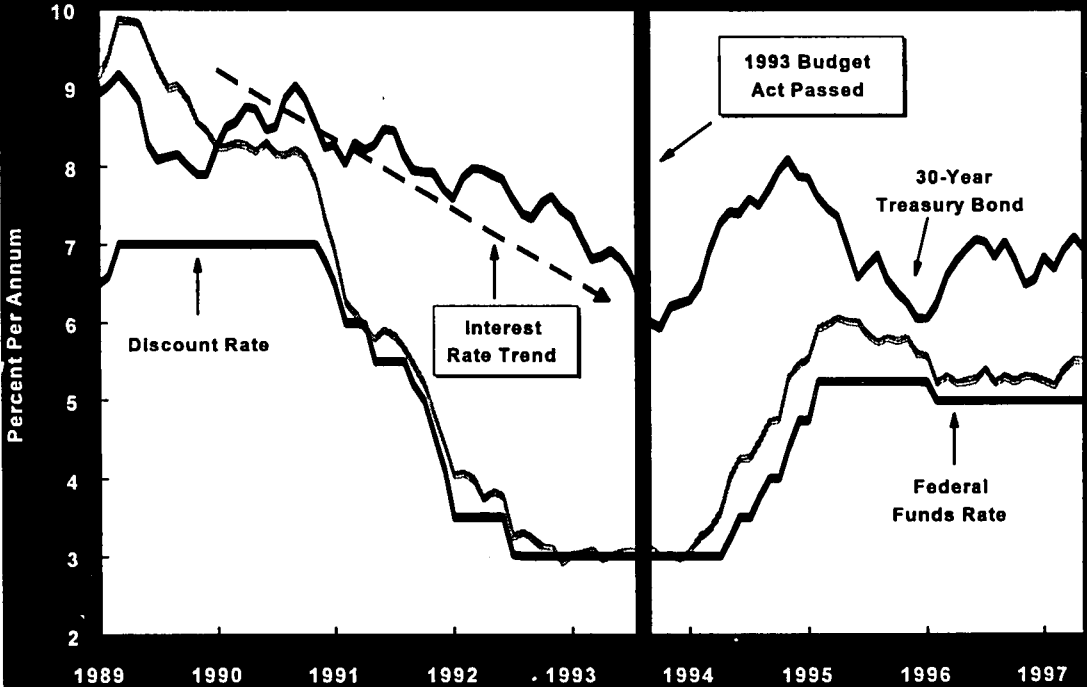
a sound and stable foundation for the expansion. Under normal circumstances the influence of Federal Reserve policy dominated the effects on fiscal policy in the near term. It is in the longer term that the weight of our fiscal policies can make a cumulative difference.

This business cycle expansion does not belong to Washington politicians in either party. Let's give credit where credit is due, to the many millions of hard-working American citizens outside of this city. The workers, entrepreneurs, and farmers, across the country know that it is they, not Washington, D.C., that are making the economy grow. They deserve the credit for the economic expansion, and all the posturing in Washington cannot take it away from them. The American people know that the tax increase of 1993 has as much to do with the current cyclical upswing as the tax increase of 1990 offered by the Bush Administration. The 1990 Bush tax increase is not the reason the economy turned around in 1991, any more than the 1993 tax increase determines current economic conditions.

Obviously a growing economy makes addressing economic policy issues easier for government. Just as a recession pushed up the budget deficit, an upswing hold down federal spending and boosts federal revenues. Employment rises and unemployment falls, making implementation of policies such as welfare reform easier. There is also less pressure from desperate industries for bail outs and subsidies. Without distraction from problems caused by recession, a mature expansion is a good time to address long-term structural issues, such as reducing barriers to saving, investment, and long-term productivity and economic growth. The relatively low economic growth rates of roughly 2 percent projected by the Administration and CBO into the foreseeable future are not very encouraging. We need to closely examine our current tax code and identify the ways it undermines incentives for savings, investment, and long-term economic growth.

I would like to conclude by suggesting the Administration's current approach to economic policy, in general, and tax policy, in particular, seems rather narrow and depends heavily on specifically targeted measures. In recent weeks, new articles in *The New York Times*, *The Washington Post*, and other major publications have quoted many economists and policy analysts from across the political spectrum raising very serious doubts about the efficacy of the employment tax credit and narrowly targeted junior college tax credit especially. I'd like to turn to the economic issues raised by these proposals during the question period.

Interest Rates



Source: Federal Reserve Bank of St. Louis.

Written Testimony for the Joint Economic Committee of Congress

Dr. Joseph E. Stiglitz
 Chairman, President's Council of Economic Advisers
 Monday, February 10th, 1997

My testimony has three parts. The first part discusses, rather broadly, the economic achievements of the past four years and analyzes the role that the policies of the Clinton Administration have played in producing this outcome. The second part of my testimony goes into more detail about the current state of the economy and our forecast for the upcoming years. The third part goes through the *Economic Report of the President* chapter by chapter, highlighting what I think are some of the more important contributions we make to the analysis of economic policy.

THE ECONOMIC RECORD OF THE LAST FOUR YEARS

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

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

Economic growth has been strong and sustainable. The economic expansion has been marked by a healthy balance among the components of demand. Private, not public, demand has been the engine of growth. The Administration's initiative to reinvent government has slowed the growth of the public sector. Private sector demand, by contrast, has grown at a 3.3 percent annual rate since the beginning of this Administration, up from 2.4 percent over the previous 12 years. It is particularly heartening to note that investment and exports have led the expansion. Investment is booming: real spending on producers' durable equipment has grown a stunning 10 percent per year since 1993. Not only has investment been a strong component of demand for the past 4 years, but the new structures and equipment that it represents will remain part of the Nation's capital stock, promoting growth and productivity for years to come. The strongest component of growth has been exports, which have increased by 8 percent per year since this Administration took office.

Just as important as today's conjuncture of growth, unemployment, and inflation is the question of whether the economy can continue to grow, with low unemployment and stable

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

Not only has the economy grown rapidly and sustainably, but the fruits of that growth have begun to be shared more equitably. In 1995, the most recent year for which data are available, the poverty rate fell from 14.5 percent to 13.8 percent the largest one-year drop since 1984. Poverty rates for elderly and for black Americans reached their lowest levels since these data began to be collected in 1959. Not only have the incomes of *every* quintile of the income distribution increased, but the largest percentage increase has been seen by the poorest in American society. Median real household income rose 2.7 percent in 1995 and more if, as some believe, the CPI has been overstating actual inflation. The fifth chapter of the *Report* provides more details on trends in household income and the factors that may account for the recent decrease in inequality, which appears to be larger than the normal cyclical improvement.

THE REASONS

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

Reducing the Deficit

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

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

Lower spending and increased revenues resulting from OBRA93 and subsequent legislation were responsible for more than \$100 billion of deficit reduction in the fiscal year that

ended in September 1996. The remaining budget savings are due to a combination of higher-than-expected tax revenues and lower-than-expected spending, which resulted from the stronger economy and a variety of technical factors unrelated to legislative changes. Many of these economic and technical factors are also the product, although less directly, of the Administration's policies including the policy of deficit reduction itself. Even though the Administration felt confident that its policies would significantly improve the economy, it continued to use conservative forecasts for budgetary purposes: growth in every year of this Administration has turned out to exceed these budgetary forecasts.

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

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

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

Opening Markets at Home

Another cornerstone of the Administration's economic strategy has been an aggressive policy of reforming regulatory structures in key sectors of the economy, including telecommunications, electricity, and banking. In reforming electricity and telecommunications regulation, the Administration's belief was that the proper regulatory structure would enhance competition, which would lead to valuable new services and lower prices. Recent financial reforms have provided greater incentives for competition and innovation, in ways that have reduced the overall cost of regulation to both the government and the banking sector itself while preserving and enhancing the safety and soundness of the Nation's banks. On the environmental front, the Administration has shown that regulatory policies that recognize the importance of incentives can be both cheaper and more effective than traditional regulatory controls. Tradable

permits for sulfur dioxide emissions are a prime example. The full import of these and other regulatory changes will not be felt for years to come.

Opening Markets Abroad

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

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

As already noted, U.S. exports have boomed, especially in those areas where trade agreements have been reached. Increased trade allows the United States and its trading partners to exploit comparative advantage. These gains from trade are reflected in the fact that wages in jobs supported by goods exports are 13 to 16 percent higher than the national average.

Restoring Confidence in Economic Policymaking

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

Not only was the substance of economic policy viewed as a success; so was the process of policy development. The establishment of a National Economic Council (NEC) to oversee that process ensured that the economy would get the same attention within the White House that foreign affairs had gotten since the National Security Council was established nearly 50 years

earlier. The NEC has effectively coordinated the inputs of the many Federal agencies, to ensure that the President receives the best options and advice, without setting agency against agency in wasteful internal turf battles. Also, the public differences between the Federal Reserve and the executive branch that had sometimes characterized earlier Administrations were replaced with respect for the central bank's independence.

RECENT ECONOMIC TRENDS AND THE FORECAST

OVERVIEW OF 1996

During the past year, the economy has been stronger than expected. Last February, the Administration projected that real GDP to grow 2.2 percent over the four quarters of 1996, and in July we revised up our forecast to 2.6 percent. This revision was not nearly optimistic enough: with last Friday's release, we now know that real GDP grew 3.4 percent over the four quarters of 1996.

But the road has not been smooth. Chart 3 shows that real growth was weak in the fourth quarter of 1995, and then recovered slightly in the first quarter of 1996. Several transitory factors account for that sluggishness: the two partial Federal government shutdowns in the fall of 1995 and the following winter, unusually severe weather in January, and a strike in March at General Motors. Much of the strong growth in the second quarter was directly traceable to the rebound from these factors.

Growth in the third quarter then slowed once again to a 2.1 percent annual rate as the consumer appeared to withdraw from the fray. A strong rebound in consumption, and a surprisingly large jump in exports, however, led to very strong growth of 4.7 percent at an annual rate in the fourth quarter.

As shown in Chart 4, price inflation measured by the total CPI--the solid line--edged up last year. But all of the increase is attributable to an acceleration in food and energy prices. Excluding these volatile components, the core CPI--shown by the dotted line in this Chart--moved down from 3.0 percent in 1995 to 2.6 percent for the 12 months ending in December 1996. This deceleration was somewhat surprising since the unemployment rate--shown in Chart 5--has been below 6 percent for more than 2 years. And as a result of the strong pace of activity so far this year, unemployment has hovered around 5.3 percent in recent months. Friday's employment report provided further evidence of a robust labor market with an additional 271,000 jobs and the unemployment steady at 5.4 percent. I discuss the reason the economy has been able to operate at higher levels of capacity later in this testimony, and Chapter 2 of the *Economic Report* contains a thorough analysis of this issue.

We have had strong growth despite fiscal policy that has been very restrictive--as shown in Chart 6. This chart shows that the standardized--employment deficit as a share of potential GDP--a standard indicator of our fiscal position--has fallen for four years in a row. Although the economic recovery has helped reduce the deficit, this chart shows that it has fallen substantially even when the level of activity is held constant. This fiscal restraint is likely to persist for a few more years as the President and the Congress are both committed to balancing the budget by 2002.

INCOME- AND PRODUCT-SIDE MEASURES OF OUTPUT

In reviewing the last year or so, I would like to raise an issue that relates not to the health of the economy but to measurement. (This issue is treated in greater detail in Chapter 2 of the *Report*.) Our measure of total real output derived from the spending side of the National Accounts (that is real GDP) has grown at a 2.1 percent annual rate over the two years ending in the third quarter of 1996. It is puzzling that precisely the same concept—called GDI for gross domestic income and measured on the income side—grew substantially faster—at a 3.1 percent annual rate over that period (we do not have GDI for the fourth quarter yet).

The issue has important implications for our assessment of productivity growth. Over these same 2 years, productivity grew at a 1.6 percent annual rate when measured on the income side (which had been the official procedure through last February), but only at a 0.3 percent annual rate when measured on the product side. The truth probably lies somewhere in between. But I am partial to the income-side estimates because of this year's revenue surprise. Tax collections this past April were well above projections. But even if one were to split the difference and say that the truth was halfway in between, then productivity growth over the past year has not differed from the 1.1 percent growth seen since 1973.

HOUSEHOLD SPENDING

Let me now move from the past to the future, and focus more closely on the details of the economic outlook. I will begin with consumer spending. Consumption expenditures grew 2.7 percent in 1996. And almost all of the signs indicate that consumption will continue to be a leading contributor to the ongoing expansion.

The fundamentals for consumer spending remain very positive. Employment growth has been excellent and incomes are rising fast. The stock market boom has also contributed to a big run-up in wealth. As Chart 7 shows, the ratio of net worth to disposable income is now the highest it has been since the 1960s. Consumer confidence, measured by the Conference Board, rose to its highest level this decade in January. Consumer sentiment, measured by the University of Michigan, is also high.

The general soundness of the household sector is affirmed by the market for new homes. Housing starts have remained at a high level all through this year—despite a significant rise in the mortgage rate. December starts were off, but much of the decline attributable to heavy rainfall in the West. The recent decline in mortgage rates should continue to support housing starts.

The only sign of consumer distress is the recent rise in delinquency rates on consumer loans. But I believe that the rise in delinquencies says more about banking practices than about the financial health of the average consumer. A section on the Financial Condition of Households in Chapter 2 of the *Report* treats this subject extensively. In brief, over the past several years, banks have mailed unsolicited credit cards in much larger numbers. Many of these people may not have been financially qualified, and fell behind in their payments. For residential mortgages, the other major type of household loan, delinquency rates have declined recently and are near their lowest level in almost two decades. For the consumer, any concerns with liabilities are overshadowed by rapid growth of assets.

BUSINESS SECTOR

As it has been over most of the expansion, private fixed investment was a bright spot in 1996. Investment in producers' durable equipment was particularly robust, growing almost 10 percent over the course of the year--with computer investment being especially strong. The decline in the fourth quarter was due almost entirely to the auto strikes and a drop in business purchases of autos. The high-tech components of business investment, which are so crucial for future growth, continued to grow at a steady pace.

The long-term demand for business structures seems to be gaining in health; investment in nonresidential structures made an unusually large contribution to the extraordinary growth in the fourth quarter. Investment in this area is likely to continue as the market for office buildings works off a large excess supply that resulted from overbuilding during the 1980s. Finally, despite steady inventory investment, the inventory-to-sales ratio remains low. This is good news when we think about the future of this expansion.

INFLATION CONSIDERATIONS

I would like to focus now on the outlook for inflation. The unemployment rate has been below 6 percent now for more than 2 years. It fell during 1996 from 5.7 percent in January to 5.3 percent in December. As you can see from Chart 8, it is now slightly below the middle of a range that the economics profession would view as consistent with stable prices. Honesty to the tenets of statistics dictates that we should discuss the band of uncertainty about the natural rate--as well as its level. As can be seen, this band is rather wide. Despite the recent decline in unemployment, however, inflation remains stable. As a result, the economics profession is gradually revising down its estimate of the natural rate.

Some have pointed to the acceleration in wages and salaries as proof that we have reached the region of excess demand. However, wages and salaries are only one part of labor costs, and the growth of other fringe benefits, which consist mainly of health insurance and pensions, have slowed dramatically over the past few years. Most of the slowing has been in health insurance premiums. As a result, hourly compensation--as measured by the employment cost index--has increased only 3.1 percent during 1996--not much different from its rate during the previous 2 years. This pace for hourly compensation, less the 1.1 percent trend for productivity growth, implies that trend unit labor costs are increasing at a 2.0 percent annual rate. As Chart 9 shows, this is below the rate of recent price inflation, so at this point--despite the rapid decline in unemployment--labor costs are not putting any upward pressure on prices.

Now some have said that the slowing of fringe benefits costs, primarily due to health care premiums, may be temporary. So let us entertain the notion that wages and salaries are the best measure of the trend in compensation. In this case, trend unit labor costs would increase by the 3.4 percent rate of wage growth that we have seen recently, less the 1.1 percent trend rate of productivity growth that we discussed earlier--and results in a 2.3 percent estimate of the trend in unit labor costs. This differs little from 2.1 percent increase in the GDP chain price index seen over the past year. In short, wages could continue to rise at their recent rate--without putting pressure on profits.

The case against a near-term outbreak of rising inflation is even stronger. First, as already noted, slow growth in hourly benefits has been holding down labor costs and may

continue to do so. Second, corporate profits are very high. Profits as a share of GDP during the first three quarters of 1996 (fourth quarter profits are not yet available) were higher than for any three-quarter period since the 1960s. Thus, profits could be a temporary buffer preventing accelerating wages from being immediately passed through to accelerating prices. Third, our statistical agency (the BLS) is in the process of fixing some problems that have overstated inflation. These fixes have already subtracted 0.2 percentage point from the measured inflation rate--and will lower it another two-tenths during the next 2 years.

So the outlook for the coming year looks to be one of continued growth with low inflation, led by robust consumer spending.

THE ECONOMIC FORECAST

I would now like to turn to the slightly longer term outlook. Last week, the Administration released its new 6-year forecast, it is shown in the attached Table. Although we try to be as accurate as possible in making the forecast, because it is used for budgetary purposes we try to make our forecasts on the conservative side. As a result, in the first four years of the Clinton Administration real growth was always higher than expected and inflation and the deficit were consistently lower than expected.

Our forecast assumes that the President's proposal to balance the budget by the year 2002 will be enacted.

Over the next two years, real GDP is projected to rise 2.0 percent annually. Starting in 1999, the pace of growth is expected to rise to 2.3 percent annually--the Administration's estimate of the economy's potential growth rate. Our real growth assumption is very close to the consensus of Blue Chip forecasters for 1996 and 1997, and to the Congressional Budget Office's January estimate for the 1996-2002 period.

Consistent with our forecast of continued expansion near the economy's potential, we believe that inflation will remain low and stable. Last year, the rate of CPI inflation was elevated by rapid increases in food and energy prices. These prices are not expected to increase any faster than other prices over the next year, and so the rate of increase in the CPI is expected to edge lower--an average of 2.7 percent a year over the forecast horizon. The decline from current inflation also reflects the likely effects of technical adjustments to the computation of the CPI that have been announced by the Bureau of Labor Statistics.

Given the outlook for moderate inflation, we project the chain-weighted GDP price index to grow at 2.6 percent over the forecast period. Combining this with the real GDP growth figures leads us to project nominal GDP growth averaging 4.9 percent over the forecast horizon.

We project that the unemployment rate will remain low. We have revised down our long-term projections of the unemployment rate to 5.5 percent, from 5.7 percent assumed in the Mid-session Review. This reflects the increasing evidence that the unemployment rate consistent with stable inflation has moved down a little.

The combination of low inflation and the movement to a balanced budget by the year 2002 will create a very favorable environment for interest rates. Short rates are expected to fall--with the yield on 91-day Treasury Bills leveling off at 4.0 percent. We also see the 10-year rate falling to 5.1 percent over the forecast period. Thus we are projecting that the term structure will

flatten slightly to a shape that reflects the historical experience in periods of low and stable inflation.

I believe that the economic assumptions presented in this budget are sound and realistic, like the assumptions in previous budgets. And they are in line with the forecasts of the Blue Chip private forecasters and the Congressional Budget Office.

THE ECONOMIC REPORT OF THE PRESIDENT

In the third part of my testimony I am going to outline what I see as some of the most important contributions made by each of the chapters in the new *Economic Report of the President*.

CHAPTER 1: GROWTH AND OPPORTUNITY

Many of the ideas and analysis in the *Report* all center around the theme of the role of government in the new era. This theme, which is woven throughout the document, is set out in the first chapter. This chapter explicates what will perhaps be viewed as the Clinton Administration's most enduring contribution, the formulation and implementation of an innovative economic philosophy.

In the past, two opposing visions of the American economy have vied for dominance. To put it starkly, one is a Panglossian view of an America of vigorous, self-sufficient individualism, the other of a world in which government is primarily responsible for our well-being. Over the past 4 years, this Administration has promoted a third vision, one that synthesizes and transcends these two polar worldviews. This vision puts individuals at its center, but it emphasizes that individuals live within and draw strength from communities. It recognizes that many have been left behind by the changing economy and may need government assistance, but that the role for government is limited: it can and should promote opportunity, not dependence.

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

Over the years, economists have identified the various circumstances in which markets fail to produce desirable outcomes, and in which selective government intervention can complement markets. Competition may be imperfect, market participants may lack needed information, or markets may be missing. Would-be innovators and entrepreneurs may fail to capture enough of the benefits of their activity to justify their effort, or the users of resources, such as clean air and water, may escape the full costs of their use, degrading the resources for all. Although such problems may occur throughout the economy, it is important for the government to focus on those that are particularly severe. Like any successful enterprise, it must identify a core mission and pursue it.

Government's core economic mission

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

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

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

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

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

CHAPTER 2: MACROECONOMIC POLICY AND PERFORMANCE

The second chapter of the report is discussed in the second section of this testimony, "Recent economic trends and the forecast."

CHAPTER 3: ECONOMIC CHALLENGES OF AN AGING POPULATION

Earlier, I discussed the tremendous steps taken over the past 4 years to reduce the deficit. As important as deficit reduction has been, there is general recognition that it will only have been a temporary palliative if we do not solve the long-term challenges associated with the aging of

the population. Chart 10 shows the projected Federal expenditures under current policy for Social Security, Medicare, and Medicaid--all are expected to grow substantially over the coming decades. As the population ages, expenditures on Social Security are expected to grow from 4.6 percent of GDP in 1996 to roughly 6-1/2 percent in 2030, then stabilize. In the case of Medicare and Medicaid, if nothing is done to reform these programs, their outlays are projected to grow from 3.5 percent of GDP in 1996 to roughly 13 percent in 2050. Their projected growth is due not just to the aging of the population, as in the case of Social Security, but also to the expectation that the volume and intensity of medical services consumed will continue their rapid rise.

Chapter 3 of the *Economic Report of the President* describes the dimensions of the problem and also analyzes the consequences of proposed alternative solutions. There is no national consensus on long-term solutions to these challenges--witness the divided recommendations of the recent Quadrennial Advisory Council on Social Security--but I think that this chapter improves our understanding of the problem. In looking for a solution to the financial problems facing these programs, we need to be mindful of the contributions that these programs have made in increasing economic security.

Social Security

Without changing the current law in any way, Social Security can pay full benefits well into the next century. Thereafter, without any changes in the structure of the program, funding will be sufficient to cover about 70 percent of benefits 75 years from now. The President said in the State of the Union, "We must agree to a bipartisan process to preserve Social Security."

Proposals that have been made for Social Security contain different elements. We need to keep in mind that, from an economic perspective, programs that look quite different can have similar effects on, for example, national savings or on the rate of return to Social Security contributions, but different impacts on transaction costs and risk distribution.

Medicare and Medicaid

In contrast to Social Security, Medicare faces short-term as well as long-term financing challenges. Also, the long-run problems facing Medicare are not as well understood as those facing Social Security, and the possible solutions are more tentative. The sections of Chapter 3 of the *Report* on Medicare and long-term care within the Medicaid program pay considerable attention to two sets of economic issues; incentive effects and adverse selection. Incentive problems are particularly important because these programs involve a number of players (health care providers and private insurance companies in addition to tax payers and current beneficiaries). Adverse selection--sometimes referred to as cream skimming or cherry picking--creates incentives under many reimbursement schemes for providers or insurers to attempt to get low risk patients; in some cases, profits can be increased more by picking good risks than by providing services more efficiently. Some proposed reforms may exacerbate the potential for adverse selection, thus deflecting incentives in the wrong direction, while other reforms are intended either to reduce its scope or deal with its consequences. As we evaluate these alternatives, we will need to look closely not only at who is affected, but at the key economic impacts--impacts on incentives, on adverse selection, and on competition.

CHAPTER 4: THE LABOR MARKET

Chapter 4 explores the effects of changes in the economy, such as advancing technology and more competitive product markets, on the American labor market. Some have claimed that a fundamental change in the nature of employment has taken place, with expanding employment concentrated in low-paying jobs, falling wages, increasing layoffs despite a growing economy, and disappearing long-term employment. We present an empirical analysis of the best available data to determine whether these concerns are warranted.

The evidence suggests that the labor market is quite robust and that many of the claims about the deteriorating nature of jobs are exaggerated. A range of evidence points to labor market strength beyond the more common macroeconomic indicators of low unemployment and strong employment growth. Employment growth has been largely concentrated in higher paying sectors of the labor market and the rate of job loss has fallen, one measure is shown in Chart 11. Nevertheless, a few areas weakness persist: Some of the job growth has occurred in low-paying jobs. Chart 12 shows that, by a range of measures, wages have been relatively flat over the past 15 years (although this may be partially an artifact of upward bias in the CPI).

Policies have been put in place and have been proposed that should help reduce these costs. The unemployment insurance system, advance notice provisions, improved portability of pensions and health insurance, and proposed reforms to our reemployment and training services all help ease the transition between jobs. Improved access to education will also provide benefits over the long term.

CHAPTER 5: INEQUALITY AND ECONOMIC REWARDS

The Chapter 5 of the *Economic Report* discusses the rise of inequality. As I said earlier, there is some evidence that the trend of increasing inequality may have been reversed in the last few years. Before discussing this, however, it is important to understand the causes of the increase of inequality itself.

Over thirty years ago, President John F. Kennedy commented that “a rising tide lifts all the boats.” Indeed, the events of the decade preceding his Presidency and the decade following it supported this statement. The tremendous economic growth I discussed earlier brought increasing incomes for all families, including the poor. Income inequality fell dramatically. Evidence since the late 1970s, however, suggests that not all boats are necessarily lifted by a rising tide. Chart 13 shows how dramatically the situation changed: during the 1980s and early 1990s, more than half of the households saw their real incomes fall. If the CPI were biased upward there would not be as many losers in *absolute* terms. The *relative* picture that the richer the group the greater the gains would, however, be unchanged. Another metric for measuring the increasing inequality is the Gini coefficient which has been risen steadily since 1968 (see Chart 14).

What has caused this increased dispersion in household incomes? At least half of the increased inequality comes from increasing labor earnings inequality for men. Much of the trend in earnings inequality is the result of rising premiums earned by some classes of workers, especially the well-educated and high-skilled. The returns to education grew tremendously during the 1980s and early 1990s, as shown in Chart 15. In 1980, a male college graduate earned

one-third more than his counterpart with only a high school education. In 1993 the college premium had grown to more than 70 percent.

There are a number of explanations for this dramatic increase in the returns to college. We can rule out changes in the supply of workers: with large increases in the college-educated workforce, supply effects should have decreased the premium. Instead, the most promising explanations center around increases in the demand for skilled workers. As new technologies have been integrated into the production process, firms have increased their demand for workers capable of using this technology. Evidence indicates, for instance, that workers who use a computer on their job earn significantly more than those who do not.

Skill-biased technological change can certainly account for the rise in earnings inequality *between* different groups. Interestingly, Chapter 5 shows that even more of the overall increase in earnings inequality is the result of more dispersion *within* groups that share the same education, experience, and demographic traits. Although there are a number of creative theories that can explain increased differentials among seemingly similar workers, there is little empirical evidence on this very important puzzle.

From the early 1970s through 1992 the trend of increasing income inequality was clear and pervasive. Income statistics from 1993 to 1995, the most recent year for which data are available, provide tentative evidence that this trend may have been reversed. The poverty rate fell from 15.1 percent in 1993 to 13.8 percent in 1995, marking the largest two-year reduction in poverty since 1973. And this is based on the official poverty rate which is before taxes. If we include the effects of the Earned Income Tax Credit (EITC), the reduction in the poverty rate has been even more dramatic. Incomes at all points of the distribution have increased since 1993, and the gains have been largest for low-income households (this is shown in Chart 16). This is the first time this has happened since 1973.

The reduction in inequality can also be seen in the Gini coefficient which declined by more last year than in any year since 1968, again without even taking the EITC into account. These reversals, while dramatic, do not come close to undoing the twenty years of increasing inequality. Also, it seems rash to declare definitively an end to a twenty year trend based on two years of data. This is especially the case for a complex phenomenon like inequality whose causes we do not fully understand.

Still, some explanations for the reversal suggest that we are seeing the beginning of a new trend. Part of the progress is due to good macroeconomic conditions, in particular falling unemployment. The *Report*, however, suggests that poverty and inequality have fallen by much more than would be predicted from aggregate variables alone. More tellingly, the college wage premium has begun to fall (look back at Chart 15). This has translated into a narrowing of the earnings gap between the median worker and the workers at the bottom of the distribution. If this is the consequence of the increased supply of college graduates, we can expect to see further reductions in this premium in the future.

Both short-run and long-run policies are needed to help reduce income inequality further. In the short-run, the Earned Income Tax Credit (EITC) can help raise the incomes of workers with low earnings. In 1995, almost 3.3 million people were lifted out of poverty by the EITC. The recent increase in the minimum wage will further enhance the poverty-reducing power of the EITC. Ultimately, however, transfer payments can only mitigate the consequences of the

market. To make lasting changes in inequality we need to address the distribution of incomes among workers. This can be accomplished by providing greater access to education and training programs that help create a more uniformly high-skilled workforce.

CHAPTER 6: REFINING THE ROLE OF GOVERNMENT IN THE U.S. MARKET ECONOMY

Traditionally, markets and government have been viewed as substitutes between which citizens and policy makers had to choose. However, this is a false and counterproductive dichotomy. Chapter 6 describes how markets and government can be seen as complements.

Judiciously crafted public policies can increase the role and effectiveness of market forces in the economy. Markets have tremendous and sometimes unheralded advantages in their ability to collect and distribute information regarding benefits and costs, and to base economic decisions on the efficiency with which resources are used today and in the future. Even here, government plays a role in protecting property, enforcing contracts, and deterring fraud. But insufficient competition, third-party side effects, public goods, imperfect information, and the importance of promoting equality and other social values mean that the government has an important role as well. In those roles, however, government can, should, and does exploit market forces to achieve its goals at least cost to taxpayers, consumers, and the affected industries.

The last year has featured two prominent examples of how government is promoting the reliance on markets. The Telecommunications Act of 1996 and the Federal Energy Regulatory Commission's Order No. 888 represent balanced steps toward promoting competition while providing safeguards against the exercise of monopoly power in local telephone and power distribution and, in the case of electricity, transmission as well. States are building on these initiatives to encourage the development of competition in retail electricity markets, and in facilitating interconnection arrangements that will allow new firms to compete in providing local telephone service.

Markets also complement governments goals. Trading of sulfur dioxide emissions permits has been an effective way to reduce the economic costs of improving the environment by abating air pollution. Similar methods could improve the efficiency of controlling greenhouse gases and other pollutants. Spectrum auctions have provided vast improvements in the speed and efficiency with which communications services are offered to the public—along with raising over \$22 billion for the Treasury.

Market principles are at the heart of natural resource policy reform. Currently, uses of Federally owned land, primarily in the West, are often heavily subsidized and have caused significant environmental damage. As western State economies become less dependent on resource extraction, and as the nation's interest in protecting the environment has increased, we should be reducing subsidies and turning to market mechanisms, such as transferable extraction rights, to promote more efficient and sensitive land use.

There are proper limits to the role of markets in activities traditionally left to the government. However, government and markets should be regarded as partners, not competitors, in promoting efficiency and in helping policy makers serve the public at least cost to the taxpayer.

CHAPTER 7: AMERICAN LEADERSHIP IN THE GLOBAL ECONOMY

Chapter 7 discusses the three major changes in the global economy over the past several years. The end of the Cold War has led to an increased emphasis on economics in international relations. Over a longer horizon, the increasing importance of the East and Southeast Asian economies has been shifting the center of gravity of the world economy West, towards the Pacific. And over an even longer horizon, we continue to witness the globalization of the world economy, a shrinking of economic and intellectual distances through reduced transport costs and improved telecommunications.

As always, changes in the world of ideas parallel those in the real world. For example, the rise of Asia--with growth rates that dwarf those enjoyed recently by the West--has demonstrated that development is indeed possible, and has stimulated a heated debate within the economics community about the optimal policies for spurring development. The transition to the post Cold War world has not been a smooth one, and many of the old ways of thinking persist--with military metaphors extending into the world of trade, with the trade deficit replacing the missile gap as the object of concern.

Economic competition differs fundamentally from the kind of competition that characterized the Cold War. First, economic competition rests on an underlying cooperative structure of fair rules, as embodied in the World Trade Organization and the GATT before it. Second, and perhaps more importantly, international economic relations are clearly positive-sum. Trade promotes the living standards of all participants by allowing us to focus on those areas in which we are relatively productive. For example, jobs supported by goods exports pay about 13 to 16 percent more than the average job in the United States. During the nineteenth century, a substantial part of U.S. productivity growth was caused by the shift from agriculture to industry. Today, exports are our new frontier: shifting resources into export production will be one of the most effective ways of increasing productivity over the long run.

Recent trade developments, as discussed earlier, have been excellent. Indeed, the politics of trade policy may be changing, as more and more firms in America become increasingly dependent on exports -- and visibly so. Partly because of the new export constituency, and our commitments to help those adversely affected by trade, the past four years have probably seen the most important breakthroughs in opening up markets since the establishment of the GATT in the aftermath of World War II. The establishment of the North American Free Trade Area (NAFTA), the completion of the Uruguay Round, and the new APEC and FTAA are dramatic developments.

In order to consolidate and extend these gains, however, it is more important than ever for us to have a guiding principle to justify and evaluate our international economic role. Chapter 7 of the *Economic Report* suggests that we think of a central goal of international relations as the provision of international public goods and the mitigation of externalities, concepts that have been central in thinking about the role of government at the domestic level. It has long been recognized that the market, if left alone, will tend to underproduce these goods. Just as governments need to provide national defense, protect the environment, and finance basic scientific research, so international arrangements are needed for the provision of international public goods.

Chapter 7 discusses four important categories of such goods: international economic cooperation, peace and order, the environment, and basic research. These are all areas in which international cooperation can provide benefits to the United States, while also benefitting other countries. In the case of basic research, for instance, American exports of educational services (in the form of fees paid by foreign students to American schools) rivals that of wheat. In this environment, knowledge is spilling over in every direction. If nations choose to free ride off of each other's discoveries, the entire world will be worse off for lack of research.

Economic cooperation may be the most fundamental international public good of all. Development and security are one example of spillovers from economic cooperation. All nations benefit as developing countries grow. In addition, economic development may restrain political pressures within countries, increasing international security.

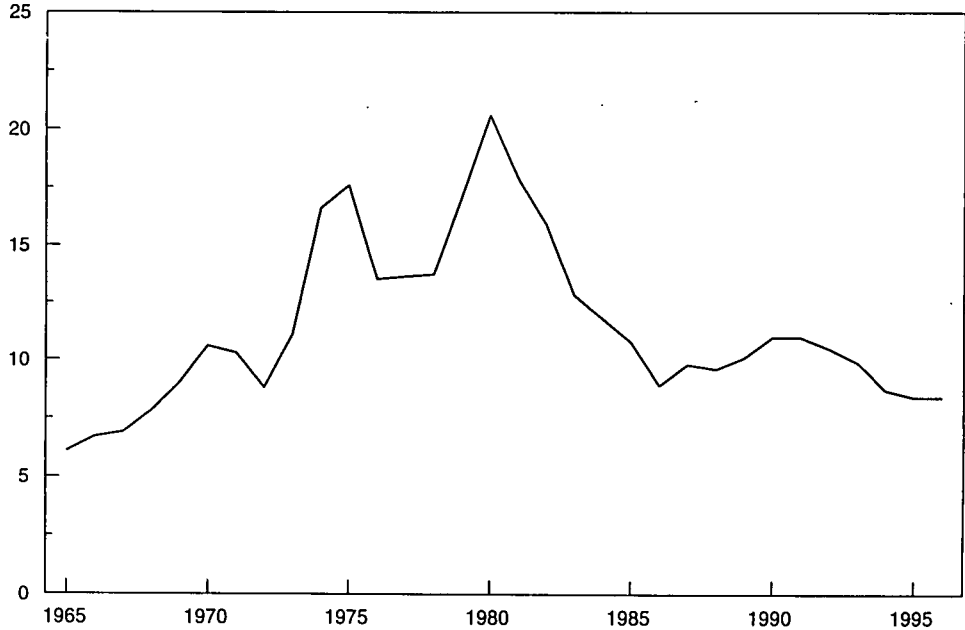
LIST OF CHARTS

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Chart 1. The "Misery Index"

The combination of a low unemployment rate and stable inflation has produced the lowest "misery index" since the 1960s.

Index points

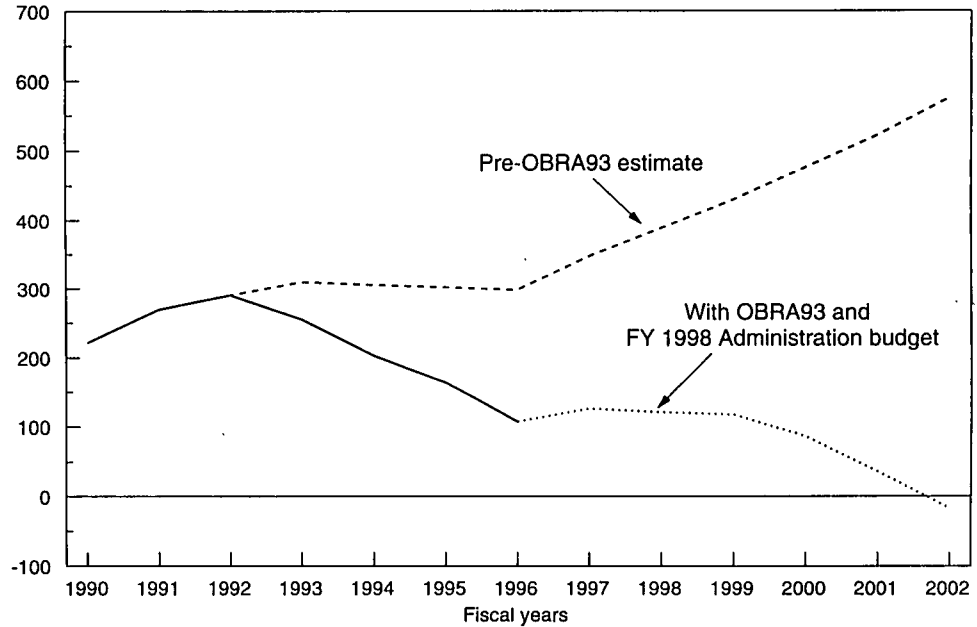


Note: The "misery index" is the sum of the unemployment rate and CPI inflation.
Source: Council of Economic Advisers based on Department of Labor data.

Chart 2. Federal Budget Deficit

Since fiscal year 1992, the Federal budget deficit has been cut by 63 percent.

Billions of current dollars

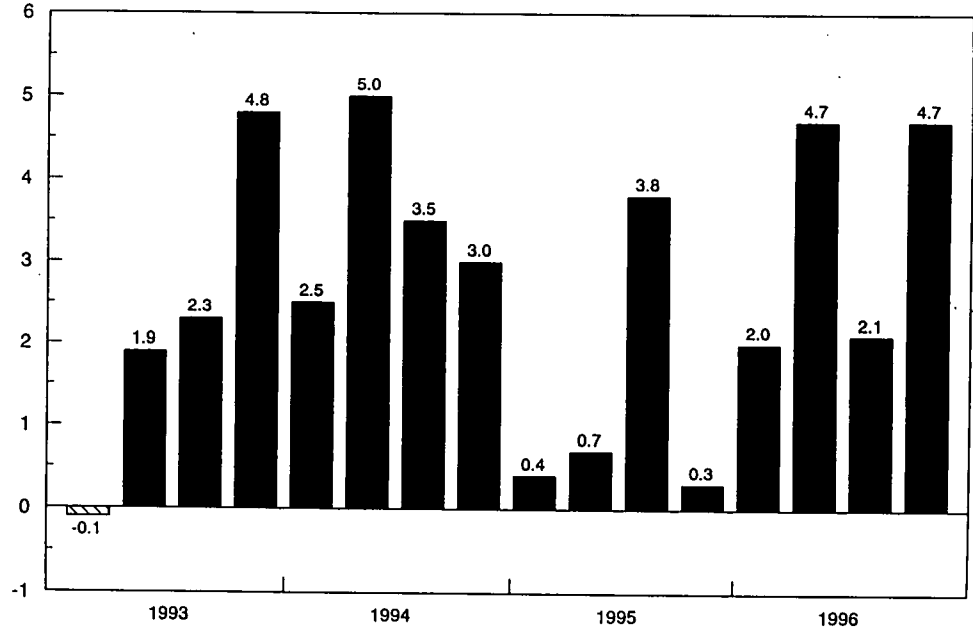


Source: Office of Management and Budget.

Chart 3. Growth in Real GDP

Despite some fluctuations from quarter to quarter, growth has been solid.

Percent change from preceding quarter

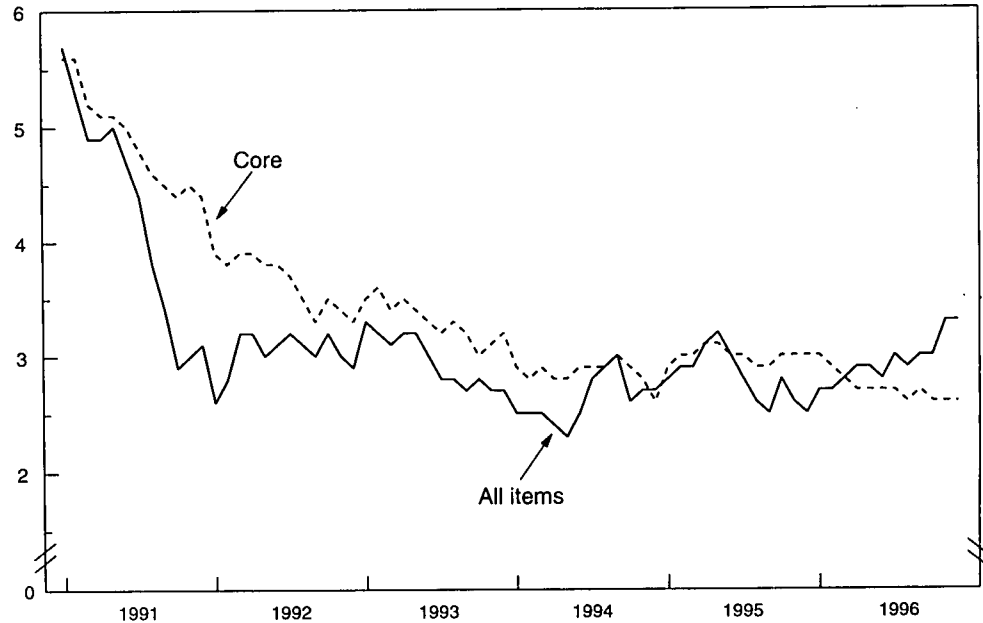


Note: Changes are at annual rates.
Source: Department of Commerce.

Chart 4. Consumer Price Inflation

Excluding the volatile food and energy components, consumer price inflation edged lower in 1996.

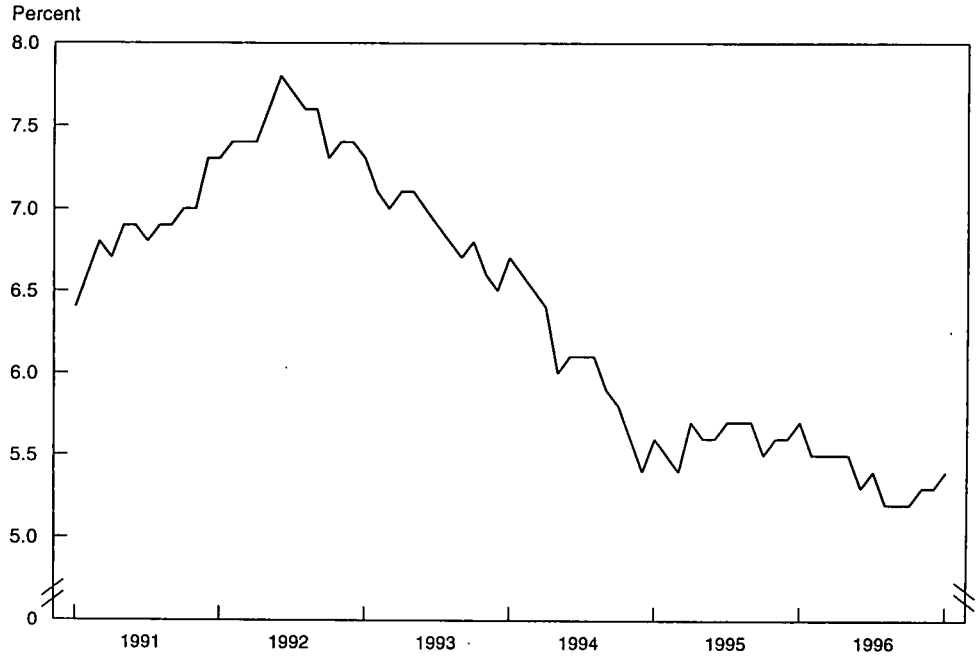
12-month percent change in CPI



Source: Department of Labor.

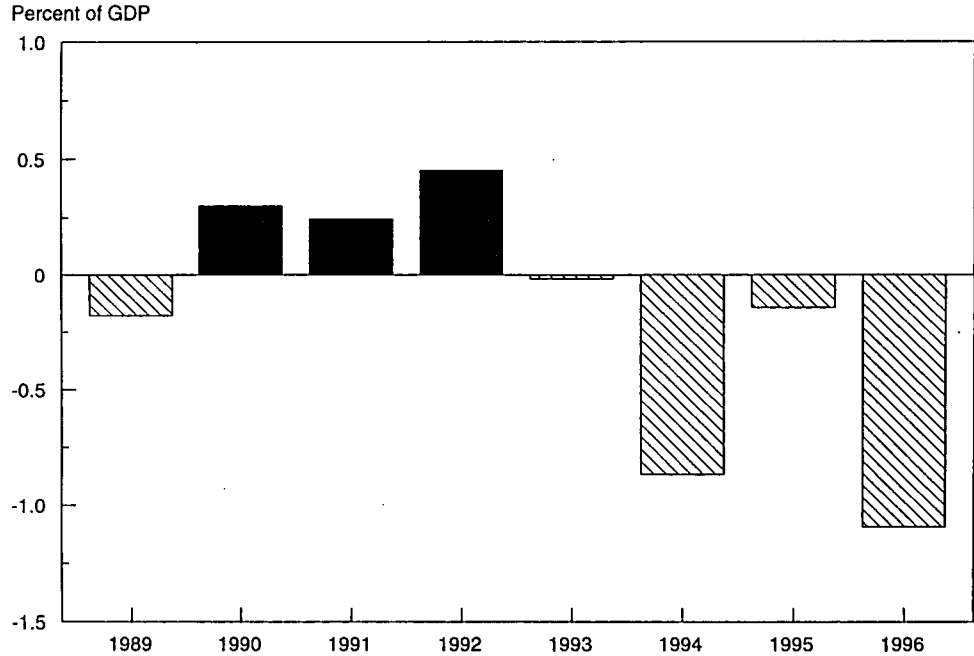
Chart 5. Civilian Unemployment Rate

Unemployment fell below 5.5 percent in the first half of 1996 and remained low.



Source: Department of Labor.

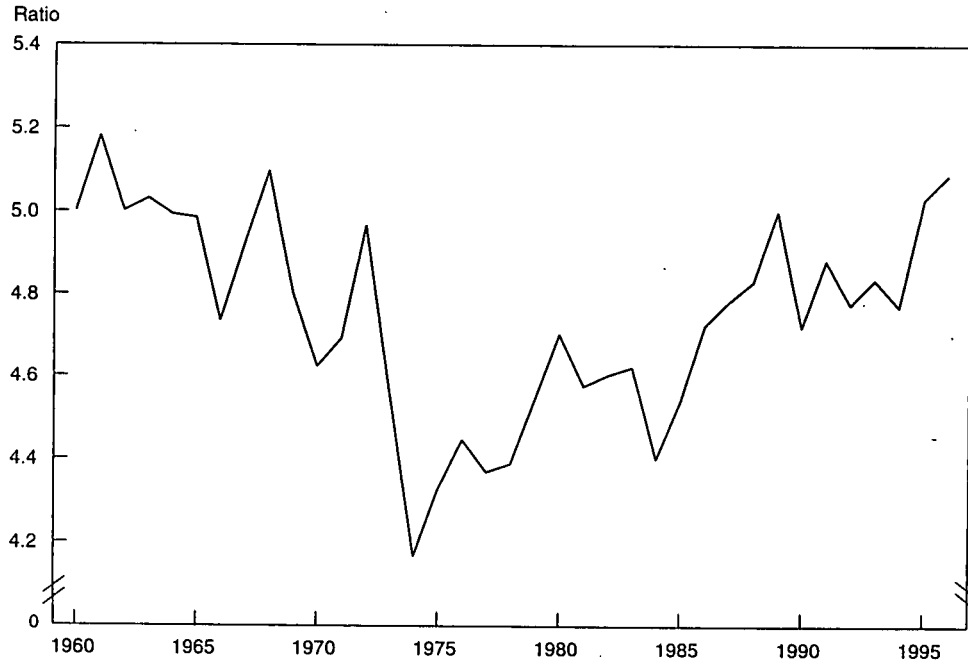
Chart 6. Change In the Standardized-Employment Balance as a Share of Potential GDP
Fiscal policy has been restrained over the past four years.



Source: Congressional Budget Office.

Chart 7. Ratio of Net Worth to Disposable Income

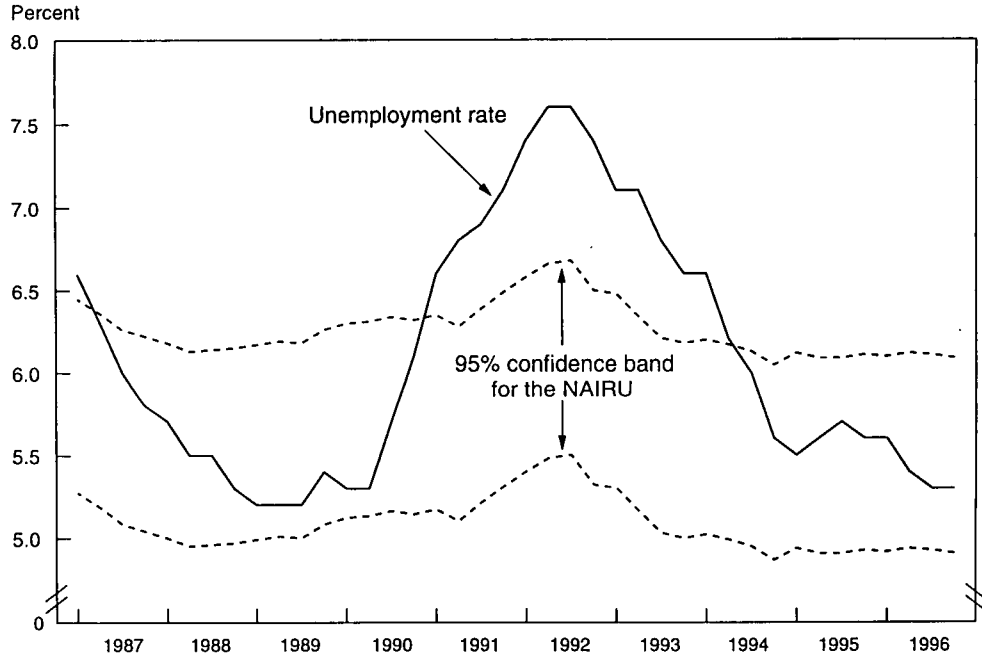
The ratio of net worth to income is at its highest level since the 1960s.



Note: Data for 1996 are for third quarter; household net worth estimated by Council of Economic Advisers. Sources: Department of Commerce and Board of Governors of the Federal Reserve System (unpublished data).

Chart 8. Unemployment and the NAIRU

For the past 3 years, the unemployment rate has been within the (wide) band of reasonable estimates of the NAIRU.

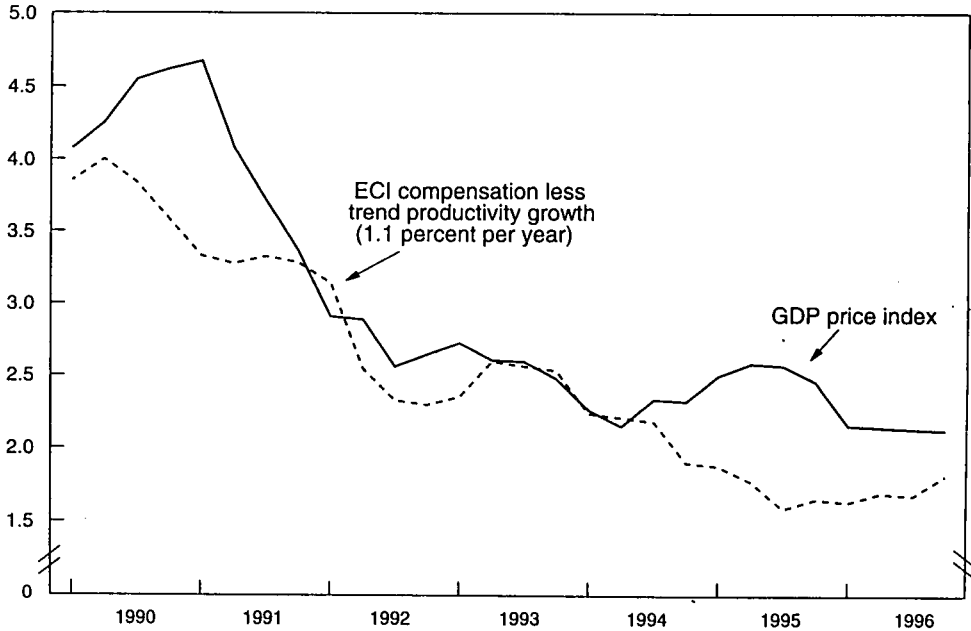


Source: Calculations based on Department of Labor data.

Chart 9. Inflation and Trend Unit Labor Costs

Inflation has been held down recently by low increases in trend unit labor costs.

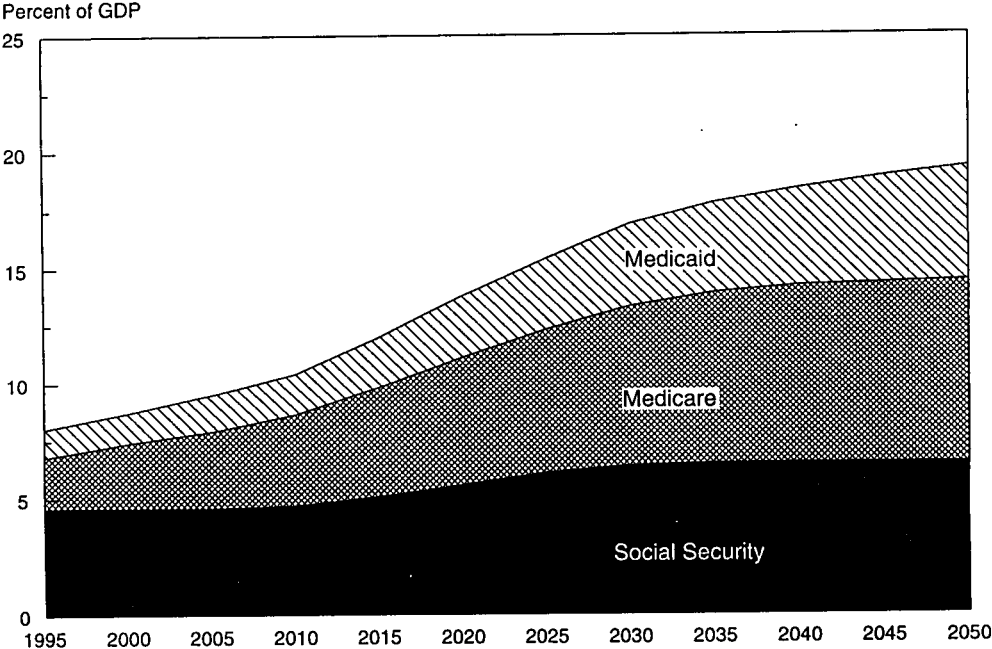
Percent change from previous year



Sources: Department of Commerce and Department of Labor.

Chart 10. Growth in Entitlement Spending

Federal expenditures on Medicare and Medicaid are projected to increase rapidly over time as a percent of GDP, with slower projected growth in Social Security spending.

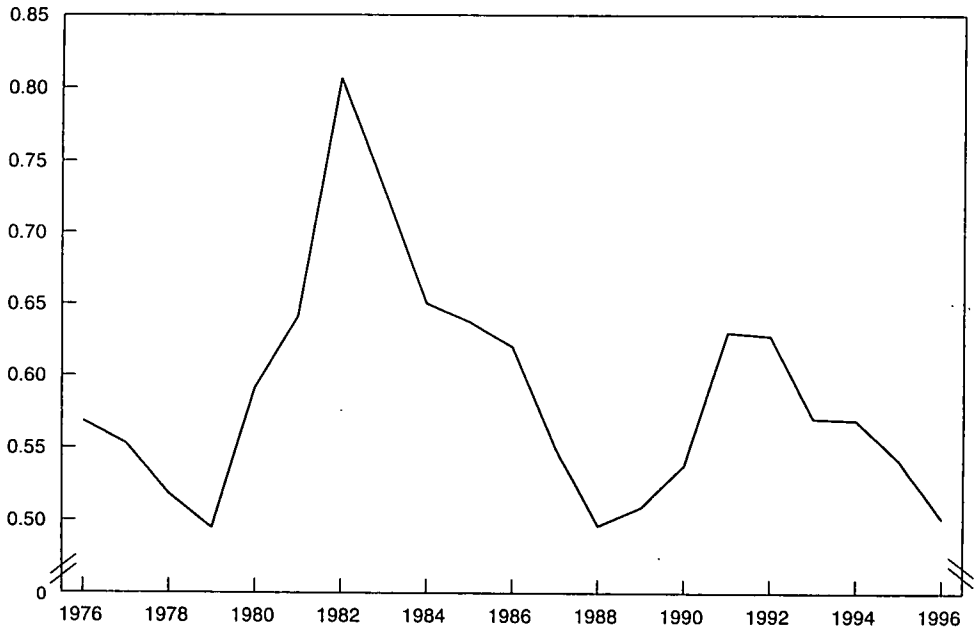


Source: Office of Management and Budget.

Chart 11. Permanent Job Losers Unemployed Less Than 5 Weeks

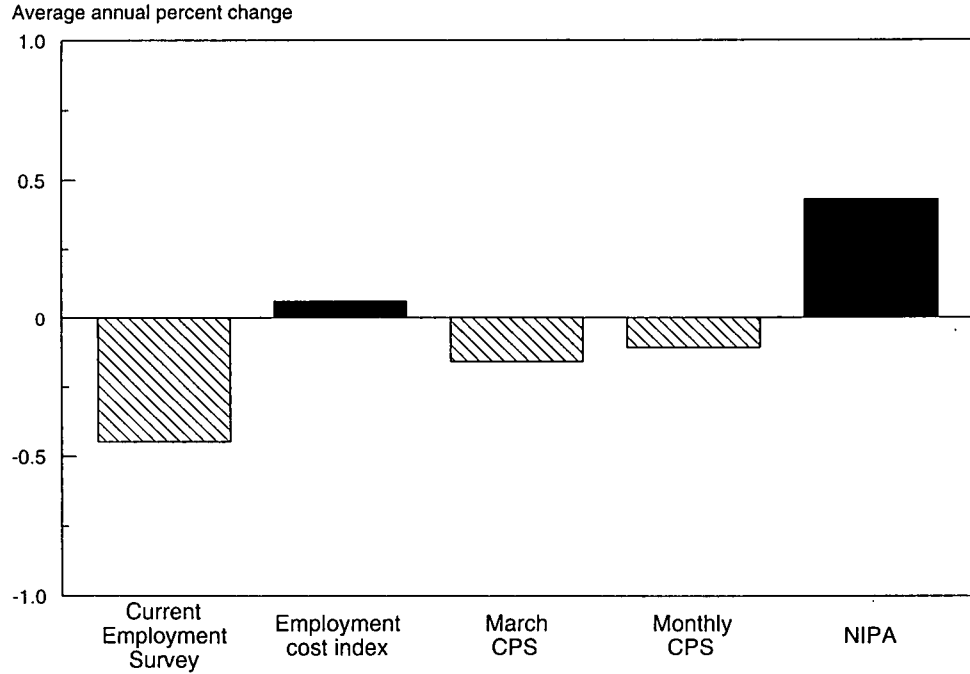
The percentage of unemployed workers who recently experienced a permanent job loss was low in the mid-1990s.

Percent of labor force



Note: Data adjusted for the Current Population Survey redesign.
Sources: Department of Labor and Council of Economic Advisers.

Chart 12. Measures of Annualized Real Wage and Earnings Growth Since 1982
Most indicators show that real wages have remained relatively flat over the past 15 years.

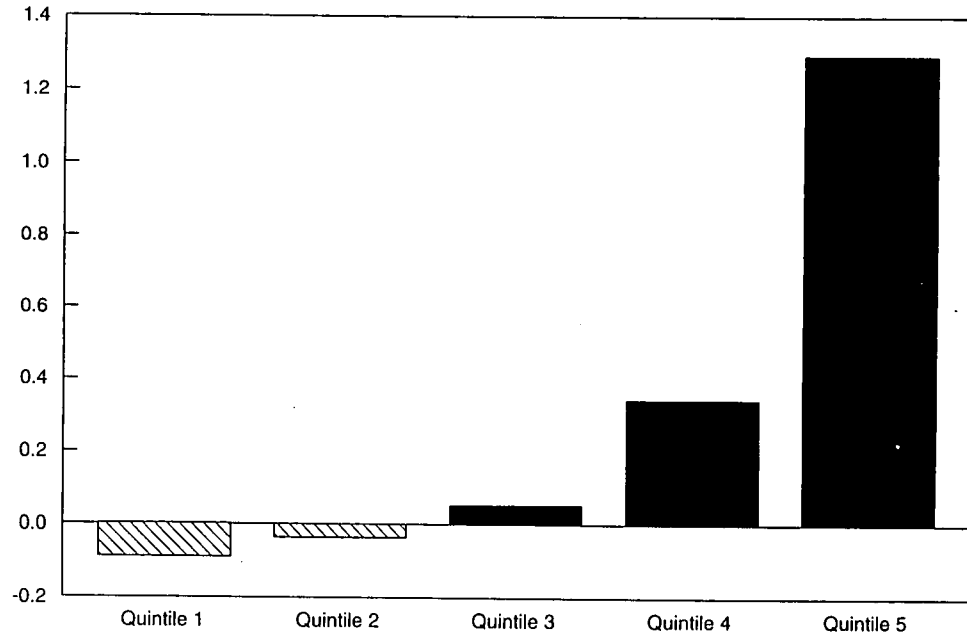


Note: Series deflated by CPI-U-X1. To the extent that the CPI-U-X1 overstates inflation, it understates gains in real wages.

Sources: Department of Commerce, Department of Labor, and Council of Economic Advisers.

Chart 13. Real Household Income Growth by Quintile from 1979 to 1995
Over the past 20 years income inequality has been growing.

Average annual percent change

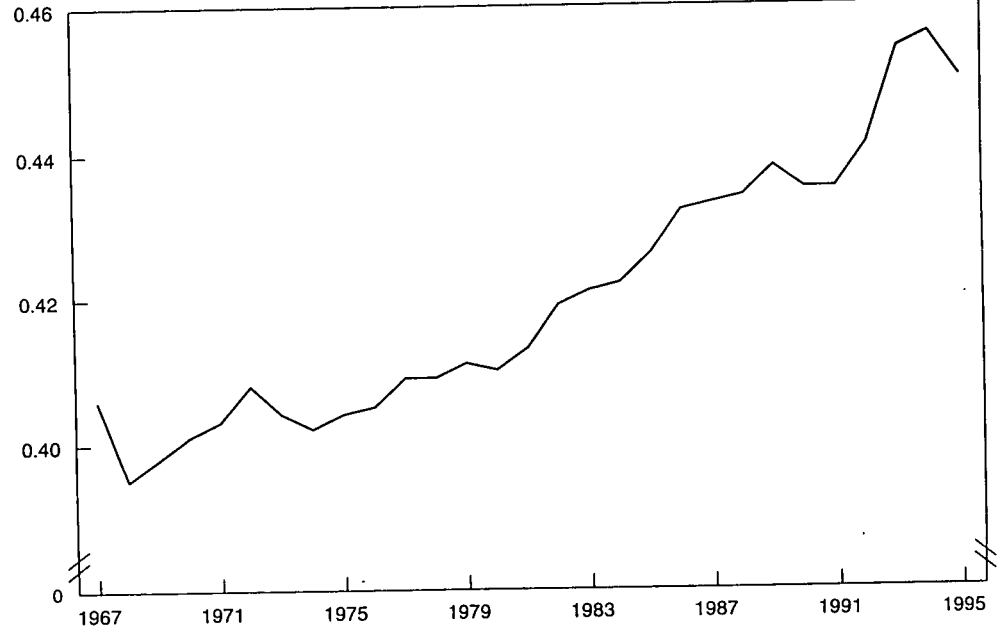


Note: Household income adjusted by CPI-U.
Source: Department of Commerce.

Chart 14. Household Income Inequality

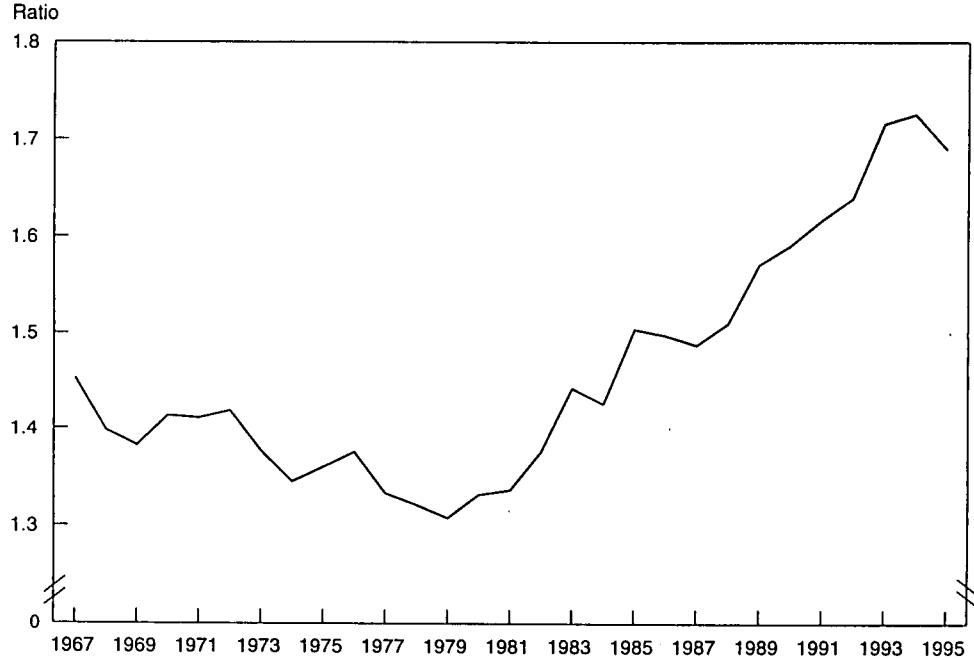
Inequality in household income has been growing since the mid-1970s.

Gini coefficient



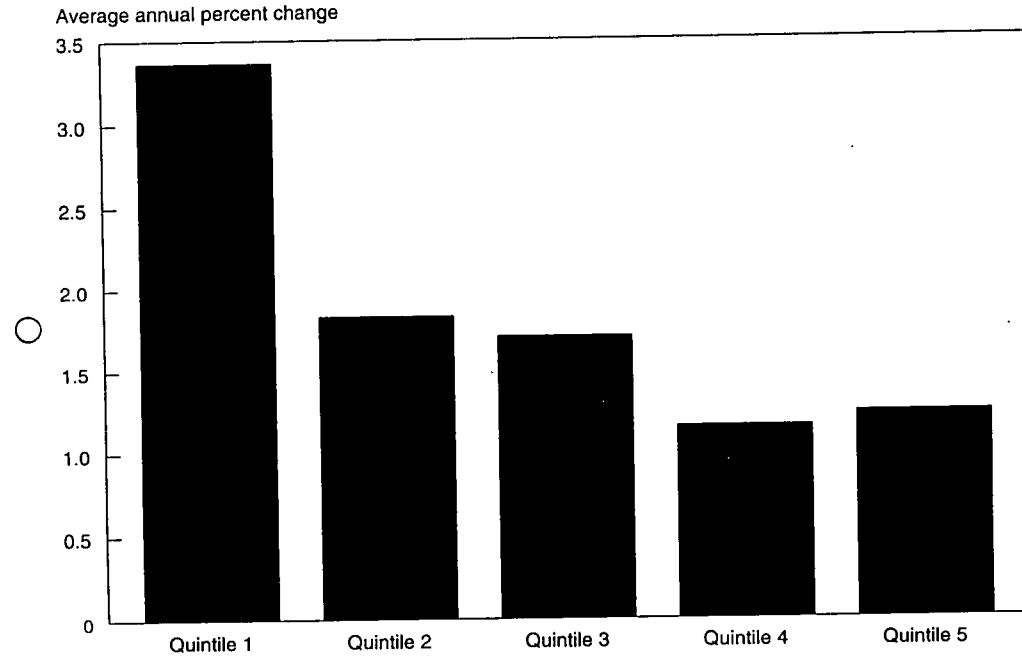
Note: Data adjusted for the Current Population Survey redesign.
Sources: Department of Commerce and Council of Economic Advisers.

Chart 15. College/High School Median Earnings Ratio for Male Full-Time, Full-Year Workers
The earnings premium associated with college attendance has risen dramatically for men since the late 1970s.



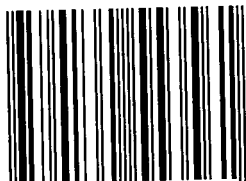
Source: Council of Economic Advisers tabulations of the March Current Population Survey.

Chart 16. Real Household Income Growth by Quintile from 1993 to 1995
Poor households experienced the largest income gains from 1993 to 1995.

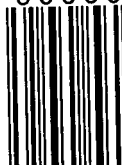


Note: Household income adjusted by CPI-U.
Source: Department of Commerce.

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