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ENSURING OUR ECONOMIC FUTURE BY PROMOTING MIDDLE-CLASS PROSPERITY

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

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ENSURING OUR ECONOMIC FUTURE BY PROMOTING MIDDLE-CLASS PROSPERITY

WEDNESDAY, JANUARY 31, 2007

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met at 9:40 a.m. in room 106 of the Dirksen Senate Office Building, the Honorable Charles E. Schumer (Chairman of the Committee) presiding.

Senators present: Bennett, Bingaman, Casey, Klobuchar, Schumer, and Webb.

Representatives present. Saxton.

Staff present: Katie Beirne, Daphne Clones Federing, Chris Frenze, Nan Gibson, Rachel Greszler, Colleen Healy, Brian Higginbotham, Katie Jones, Bob Keleher, Michael Laskawy, Zach Luck, Jeff Schlagenhauf, Chad Stone, Annabelle Tamerjan, and Adam Wilson.

Chairman Schumer. The Committee will come to order. I want to welcome both my colleagues and or guests. I have an opening statement. I know Jim Saxton has an opening statement, then we'll go right to the remarks.

If either of my colleagues would like to say something at the beginning, they're welcome to. Senator Kennedy and Vice Chair Maloney were not able to attend, but have asked to have statements put in the record, so, without objection, they will be.

[The prepared statements of Representative Maloney and Senator Kennedy appear in the Submissions for the Record on pages 39 and 40 respectively.]

Chairman Schumer. Any other statements for the record? No.

OPENING STATEMENT OF HON. CHARLES E. SCHUMER, CHAIRMAN, A U.S. SENATOR FROM NEW YORK

Chairman Schumer. Well, good morning. I'm very pleased to open the first hearing of the Joint Economic Committee in the 110th Congress.

I want to welcome Ranking Member Maloney, the Vice Chair, who couldn't be here today, and Ranking Member Mr. Saxton. Jim and I were friends in the House. We're continuing to work on a variety of legislation when I crossed the Capitol.

We're going to have a great time and a great relationship. I'm so glad you're here, Jim.

I know we're going to have some disagreements along the way, but I really do hope we'll be able to develop a shared view of the problems the American people will want us to be working on, and

look forward to working with the Minority closely, and, I dare say, neighborly, with all of you.

Now, this Committee is a Committee that's going to ask difficult questions, challenge our assumptions, and seek to define our Nation's economic challenges, using the best minds in the Nation as our witnesses for much of the next 2 years.

Our hearings are going to focus on two things that are related: One is just the changing nature of the economy. We live in a totally different world, economically, than we did even 20 years ago.

Technology has revolutionized everything: The way we live; the way we work; the way we buy; the way we sell. Globalization is now a word that everyone uses, but it has enormous, enormous effects.

But it's not just globalization that's affected our lives. We're living longer. Technology has made dramatic advances, and, as we live longer, there are the issues of 30 years of leisure at the end of a life, getting married later, having kids in different ways; everything is changing before our eyes.

It's a revolutionary period, in a certain sense—peaceful, but revolutionary, and our hearings are going to focus on that.

There's going to be a particular emphasis in these 2 years, on the middle class. That's because I believe that the middle class is the engine of the American economy. When they do well, America does well; when the middle class is anxious, America is anxious.

If we want to expand or reform aid to the poor, we can only do so, if the middle class feels that they are prosperous, moving ahead, and secure.

If we want to expand trade, because we believe it grows the economy, we can only do so, if the middle class feels that they will benefit as much from our national growth as those at the very top.

This hearing couldn't come at a better time, because on all of those measures, the middle class feels a little bit shaky. They're not struggling to get by, but they are struggling to get ahead, and if you look at the poll results, while people think they're doing OK right now—and we'll hear from our distinguished witnesses about this—they're much more worried about the future and their children's future, than they were, even 2 or 3 years ago.

They are unsure of their footing in an economy and a world that is about change, technology and even disruption. They feel they are alone to navigate the contours of change, and that government isn't really helping them where they need it.

They see the economic fortunes of different groups in our economy, growing apart, not together. They're rightfully worried that this gap will grow into an unbridgeable chasm.

We all know the statistics; we went through the most prolonged job slump since the 1930s, after the 2001 recession.

Productivity continued the strong trend that began in the mid-90s, much of it technology-driven, but real wages stagnated as the benefit of economic growth showed up in the bottom lines of companies and in executive salaries, but not in the paychecks of most workers.

But the middle class doesn't need statistics to tell them that they're on shaky ground. American families know they can't work any harder than they already do, and that for the last 6 years, they

have mostly run in place, as new expenses and new troubles hit them: Paying for the cost of education, particularly college; longer life; the number of people who help support their parents is greater and greater and greater.

And so we know that the anxiety of the middle class is not just perceived, but real. This morning, President Bush will give a State of the Economy Address in my home State of New York, and he'll try to make the case to the American public, that our economy is strong and everyone is benefiting.

The President will surely point to today's news that economic growth picked up in the Fourth Quarter, and a key measure of wages, showed some real growth, as well.

No one is happier than we are that we had a nice quarter, but if you spend time out in middle class America, if you descend from the 30,000-foot level to the communities of Main Street, you know that all is not well with the middle class.

The basic success and aspirations of middle class life—raising a family, buying a home, paying for college, saving for retirement, and health care—are becoming intimidating hurdles for average, ordinary people.

So the President is right when he says that a future of hope and prosperity in this country begins with a growing economy, but he could not be more wrong when he says that all Americans have benefited from economic growth over the past several years.

The fact is that the middle class has never been so unsure of its footing, since I came to Congress in 1980. I believe we need a new direction to promote an economic growth for all Americans in the 21st century.

We need a new map, because technology has changed our world. How do we address income inequality? How do we address trade? How do we address longer life? How do we change our health care, our education systems, to meet the new global challenges that we face?

We need to throw away the old map that has been favoring those with influence and wealth and leaving the middle class behind. Our economic fortunes need to grow together, not apart.

I said that the JEC would seek advice from the best of the best, and that's what we have to offer for our first hearing.

Bob Rubin and Larry Summers presided over a period that was quite different from today. When they were Secretaries of the Treasury, not only was there growth, but the growth was more spread out and the middle class had much more confidence than they do today.

The changes that have occurred since then, are not—I am not blaming George Bush for all of them, or even most of them. Most of them are due to the changes in the economy and because of technology. But, when that changes, we have to adapt, and just sticking with the same policies that might have been good in 1980, or even 1990, probably doesn't work today.

There are no four better witnesses than the four who are here today: Bob Rubin, Larry Summers, and Alan Blinder, need no introduction to people who have followed economic policy in this country over the past decade or more. Their reputations are stellar, and deservedly so.

We all wish we could go back to the times of the 1990s, when everyone was doing so well and everyone thought they were doing so well, as well.

I'm going to give each a proper introduction before they give their testimony. I also want to welcome Dr. Vedder. Professor Richard Vedder is the distinguished professor of economics at Ohio University, and he's going to lend a different perspective than maybe Dr. Blinder, Mr. Rubin, and Dr. Summers. We welcome hearing that, as well, because we should always be hearing different points of view to keep us all on our toes and challenge our assumptions.

With that, let me call on Jim Saxton.

[The prepared statement of Senator Schumer appears in the Submissions for the Record on page 38.]

OPENING STATEMENT OF HON. JIM SAXTON, RANKING MINORITY, A U.S. REPRESENTATIVE FROM NEW JERSEY

Representative Saxton. Mr. Chairman, thank you. It's a pleasure to be here to be able to congratulate you as you take the gavel of this very useful and important Joint Economic Committee.

I have had the pleasure on three occasions, to serve as Chairman, and, during the years, since 1995, I have found this to be a challenging set of issues, that gives us, as Members of the House and the Senate, and gives those who wish to attend, a view through technology to observe the great witnesses that we have had over the years in discussions of economic issues.

As you pointed out very well and accurately in your opening statement, it's also a pleasure to join in welcoming the distinguished panel as witnesses before us today, all of whom, I believe, have appeared here previously.

So, former Treasury Secretary Bob Rubin; former Treasury Secretary Larry Summers; Professor Alan Blinder; and Professor Richard Vedder, thank you for being here with us today.

The hearing today will likely cover a number of topics, including the performance of the U.S. economy. It is useful to recall that in 2003, a new policy mix of accommodative Federal Reserve policy and tax incentives for investment, led to a rebound in investment.

The pace of economic growth picked up, and the employment growth rebounded. Since August of 2003, over 7 million jobs have been created and the unemployment rate has fallen to 4.5 percent—good news for all Americans.

Economic growth has generally been quite good in 2005. The Fed referred to the solid performance of the economy and said that it should continue to perform well through 2006 and 2007.

Some have criticized the U.S. economic performance for producing excessive income inequality. However, according to the Census Bureau, its key measure of income equality has been statistically unchanged since 2001.

Some have also focused on slow wage growth, that many of the data used understate progress, because they are based on measures that overstate inflation and exclude fringe benefits from the equation.

Even so, various measures of real wages and earnings growth have been rising at a faster pace recently. It should be noted that

during the 1990s expansion, it also took several years before real wages and earnings increased at a strong rate.

The continued prosperity of middle-income households, can be facilitated by pro-growth economic policies. It would also be reasonable to examine Federal policies regarding research, personal savings and investment, education, and social safety net programs, to determine what changes might be helpful.

For example, I have long supported various tax incentives for personal savings, to provide tax security and a reserve fund for middle class investors.

However, in Congress today, there is in some quarters, increasing support for a policy response that would be profoundly destructive to middle-income families, in my opinion. That is generally known as protectionism.

Much has been said about the effect of international trade on our economy. According to many economists, the quickening pace of technological change is more responsible for shifting employment patterns, than is international trade.

The economic policies that promote the flexibility and dynamism of the U.S. economy are the best course for improving the future of middle-income Americans.

As Congress examines these issues, it should avoid policies that would hamper the ability of the economy to adapt to future change. Mr. Chairman, you and I certainly agree on that point.

Let me take the opportunity, again, to thank you, Mr. Chairman, for the courtesies extended by you. I look forward to hearing from our witnesses, as you have said you do, as well. Thank you.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 39.]

Chairman Schumer. Thank you, Congressman. Would you like to make a statement, Jeff? Bob?

OPENING STATEMENT OF HON. ROBERT F. BENNETT, A U.S. SENATOR FROM UTAH

Senator Bennett. Normally, Mr. Chairman, I would pass, but since I have to go to the Banking Committee—and I don't think you'll give me your proxy for that, to hear Secretary Paulson, if I could, I would like to make a bit of an opening statement, and welcome the witnesses here, people with whom I have worked in the past.

I congratulate you, Mr. Chairman, on your assignment here. In anticipation of a different kind of outcome in the election, I had assumed I would be Chairman, and, therefore, prepared some material,* and I would like the material* included in the record.

Chairman Schumer. Without objection, and you would have been a good Chairman.

Senator Bennett. You're very kind to say that, and I'm sure you will be.

Let me just share with you, out of this material, two charts that I think summarize what we need to understand about the issue of income inequality. I don't know if we have them in large form. I have copies which I will distribute.

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*The material referred to was unavailable at press time.

We often hear of the gap in household income, income distribution, and say that the highest quintile is 10 times—more than 10 times higher than the lowest quintile.

In this chart, Mr. Chairman, see the blue on the chart, that's the lowest quintile and that's the highest quintile. That is the Census figures on income.

That's right; it's more than 10 times, because over there, it's only 3.5 and over here, it's 49.6. However, if you include taxes and transfers in your calculation, because the folks down here don't pay very many taxes and the folks up here pay a lot, and down here, you get the Earned Income Tax Credit, so, transfers, this number goes up and this number, appropriately, comes down.

Now, in the light tan bars, we have the number of people per household. Many of the folks in the lowest quintile, are retired, and there are only two people or one person per household, whereas the folks here, are younger and have bigger households, so, this goes up and this comes down, when you adjust there.

Finally, in the green bar, you adjust for hours worked, because, again, many of these people are not working; they are retired, and these folks are working, and, therefore, have more income.

So, you see that the difference between the green bars of the lowest and the highest, is 3:1, rather than 10:1. I think we need to keep that in mind, as we talk about income distribution, instead of just, as some people do, take the blue bar at the end and say, gee, it's 10, 11 times, the top quintile to lower quintile.

The other chart I would share with you is one I share with my grandchildren and children as an incentive on this whole situation. This is earnings, income, and wealth by education level.

Earnings is the blue bar; income is the purple bar—pardon me—yes, income, and then the green is the wealth. These folks have relatively low earnings, but, from a variety of sources, they have a little bit higher income and that's as much wealth as they are able to acquire, $68,000 in wealth.

These are the folks with no high school. The next one is high school, and there's virtually no difference. It's $58,874, high school; $68,530, no high school, in the amount of wealth that they've accumulated.

Then, as I say, this I share with my children. They've all gone to college, but with others in the families, this is what happens when you go to college.

This——

Chairman Schumer. I'd just ask, is it any college, or graduates?

Senator Bennett. The narrative that goes along with this, simply says household heads with a college education, earned 3.7 times more than those without a high school education, so——

Chairman Schumer. Senator, your staff says it's graduates.

Senator Bennett. It's graduates, OK, that's pretty dramatic, and as we talk about trying to solve the problem of income gap, we should help people understand that the best way to solve income gap—it's basically a skill gap, and if you don't go to college, you're not getting it.

With that, Mr. Chairman, I would ask your permission to move on to the Banking Committee. I apologized to our witnesses, and

I have a number of other neat charts with wonderful colors that I'd be happy to submit to the record.*

Chairman Schumer. Well, thank you, Senator, and, as usual, your thoughtful approach makes us think. I don't think anybody, and certainly I would not dispute that education is really probably the No. 1 key to all of the problems we are facing, or most of them, anyway.

Senator Klobuchar, would you like to make an opening statement?

Senator Klobuchar. Yes, I would.

Chairman Schumer. Please, and welcome, welcome to the Committee and to the Senate.

OPENING STATEMENT OF HON. AMY KLOBUCHAR, A U.S. SENATOR FROM MINNESOTA

Senator Klobuchar. It's wonderful to be here with these distinguished guests, and thank you for heading this up. I think I heard someone say yesterday that this is not going to be your daddy's Joint Economic Committee anymore, and we're going to really focus on these middle class issues and what matters.

I can tell you that in Minnesota, this is what I heard for the last 2 years: It's about rising healthcare costs—many of our people in our State have jobs, we have a strong economy, but basically, it's getting harder and harder for them to get by with health premiums up 60 percent in the last 6 years.

Tuition at the University of Minnesota is up 80 percent in 7 years. We had gas prices, as you know, up toward 3 bucks a gallon this summer, and it was tough for people, for two income families, barely getting by.

It was getting harder and harder for them to make it. And we would have these living room forums all across our State, where people would suddenly stand up and they realized they were blaming themselves. They said, I have a job, but my kid went to college and now he can't afford to get a house, or I'm a small business owner and it's getting harder and harder for me to afford health care and I have a pregnant employee and I don't want to drop the health care, but I can't afford it anymore.

Those were the things that we were hearing throughout our State, in what is really a strong economy.

The other thing that people, surprisingly, were aware of, was the debt. And they were very focused on what the government was going to do to try to rein in the spending and also do something about what they perceived as unfairness in the system.

One in 12 tax dollars, as you know, goes to service the debt. We pay $900 million a day in interest and we're also seeing an increase in the interest rates, as a result of the national debt.

One of the things I'd hear from people a lot, is that they didn't understand why, in the past, Congress and Washington were giving tax shelters to wealthy people and multimillionaires, while it was getting harder and harder for them to make it.

The tax cut gave, by our calculations, $111 to the super wealthy for every dollar that a middle class family got.

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* The charts referred to were unavailable at press time.

They passed healthcare legislation that was written, in part, by the pharmaceutical companies and an energy policy that was written by the oil companies.

We actually put out a budget plan. I'm not sure it would pass muster with you two, but we put out a plan of how to basically get rid of the deficit by rolling back the tax cuts for the top 1 percent, by closing the tax loopholes for multimillionaires that were shielding money on the Cayman Islands; by closing down the oil royalties, which this Committee has already put a report out on; by posting capital gains taxes so that people who were not posting capital gains, people that were not paying them, would be required to pay them.

And we put all these things together and presented it to the people of our State, including rolling back the tax cuts on the top 1 percent, and they responded very positively to this, because, with this, came help for them: $10,000 in tax deductibility for college tuition; help for adults who are helping their elderly parents; trying to look at how you can help first-time home buyers with a $3,000 tax credit.

And we put those things out and showed the disparity of what was going on in the government and how it was hurting everyday people.

When I was a prosecutor, we'd always say, follow the money, and when you follow the money, you find the bad guys. Well, that's what I hope, Senator Schumer, that this Committee does, which is to follow where some of the money has been going in Washington, and put it back in the hands of the people who deserve it, and that's the people who are driving this economy, which is the middle class.

Chairman Schumer. Thank you, Senator Klobuchar, and welcome in many ways.

Senator Klobuchar. Thank you.

Chairman Schumer. We're now ready to move on to our witnesses. Let me give a brief introduction. None of them need much of an introduction, because of their reputations, their fine reputations, proceed them.

Robert Rubin is director and chairman of the Executive Committee and member of the Office of the Chairman of Citigroup, Inc. He has been involved with financial markets and public policy debates all of his professional life.

As Secretary of the Treasury from 1995 to 1999, Mr. Rubin played a leading role in a host of issues, including: Balancing the Federal budget; acting to stem financial crises in Mexico, Asia, and Russia; and guiding sensible reforms at the Internal Revenue Service.

Lawrence Summers is the Charles W. Eliot University professor at Harvard University. He served as its 27th president from 2001 to 2006. Dr. Summers has taught on the faculty at Harvard and MIT, and he has served in a series of senior public policy positions, including succeeding Bob Rubin as Treasury Secretary.

Alan Blinder is the Gordon S. Renchler Memorial professor of economics at Princeton, and director of Princeton Center for Economic Policy Studies, which he founded in 1990.

He served as Vice Chairman of the Board of Governors of the Federal Reserve System from June 1994 to January 1996, and, before that, he served as a member of President Clinton's original Council of Economic Advisors, January 1993 to June 1994.

And Richard Vedder, last but certainly not least, holds the title of distinguished professor of economics at Ohio University. He is a Visiting Scholar at the American Enterprise Institute.

Dr. Vedder is the author of several books, including: The American Economy in Historical Perspective; Out of Work—Unemployment and Government in 20th Century America; and the Wal-Mart Revolution—How Big-Box Stores Benefit Consumers, Workers, and the Economy.

Secretary Rubin, please proceed.

STATEMENT OF ROBERT RUBIN, DIRECTOR AND CHAIRMAN OF THE EXECUTIVE COMMITTEE, CITIGROUP; FORMER U.S. SECRETARY

Secretary Rubin. Thank you, Mr. Chairman. Let me start by saying that I believe that, as you and I have discussed, that you're holding this hearing at an exceedingly important time. I think of this as a critical juncture for the longer-term outlook with respect to the American economy, and I think that your Committee can contribute enormously by catalyzing serious public discussion of the kinds of issues you just illuminated, and by helping develop sound approaches to the complex and uncertain issues that this country faces.

The American economy has enormous strengths: A dynamic society, a willingness to take risks, flexible labor markets, and a great deal else. On the other hand, we face hugely consequential, longer-term challenges, and I'll touch on those briefly in a moment.

At the same time, the global economy is undergoing change of historic proportions, including: Technological developments, globalization, effective productivity regimes in quite a number of emerging market countries.

And as a consequence of all of this, China and India are emerging not only as large potential markets, but as powerful competitors. I don't think that there is any question that we can thrive in this environment, but I believe that in order to do so, it is absolutely imperative that we meet our challenges, and I believe that failure to meet our challenges, could lead to very serious difficulty.

Currently, in my judgment, we are on the wrong track on almost every front, independently of how you allocate political responsibility.

This contributes substantially, No. 1, to the unsound fundamentals underlying our economy, despite good GDP growth, which could auger badly for the future; and, No. 2, to the struggle that far too many Americans are having economically.

Median real wages and median real compensation have been roughly stagnant for the last 5 years, and grew at relatively slow rates for 25 of the last 30 years, the only exception being the last 5 years of the 1990s, while inequality benefiting a very small top tier, has increased substantially.

Moreover, economic dislocation and economic insecurity have increased substantially.

I believe strongly, Mr. Chairman, in markets as the most effective organizing principle for economic activity, but government also has a critical role in providing the requisites for economic success that markets, by their very nature, will not optimally provide.

Moreover, I believe that the objectives for economic policy should be growth, but also, and, absolutely critically, broad participation in that growth and improved economic security, both as a matter of values and because these objectives can be mutually reinforcing.

More specifically, sustained growth is the single most effective way of promoting broad income growth, both because you have a larger pie to split and because of sustained tight labor markets.

Conversely, broad income increases and increased economic security are critical to economic growth, for two reasons: First, they provide workers with resources to access education, training, rapid redeployment into the mainstream economy when dislocated, and other factors that contribute so importantly to productivity, and, second, as you said, Mr. Chairman, sound economic policies around trade and market-based economics, will only have broad public support, if the great preponderance of our people expect to benefit from those policies.

I think we can most effectively achieve our interrelated economic objectives by meeting the challenges I mentioned earlier, and I think of those challenges as falling into four categories:

Number one, our multiple financial imbalances, including the debt that you mentioned, Senator;

Two, serious shortfalls in education, infrastructure, basic research, energy policy, healthcare policy, inner city programs, and so much else that are critical with respect to economic success.

Number Three: Cost/benefit imbalances in our regulatory and litigation regimes, and,

Number Four: International economic policy, including trade, relatively open immigration, and working toward flexible exchange rates around the world.

These all occur alongside of serious exogenous risks: Terrorism, oil shock, and so many others that are a serious threat economically.

In my limited time, I will not try to describe the relationship between each of these challenges and the three objectives I set out. Let me just comment on two of these challenges, and very briefly.

As to financial imbalances, current economic conditions rest on high levels of borrowing at multiple levels in our society. These include:

Significant projected deficits over the 10-year Federal budget window, assuming the 01 and 03 tax cuts are extended permanently, as proposed, and assuming AMT reform, and that is instead of the surpluses we should have had in a time of healthy GDP growth;

A net national savings rate of something under 2 percent, a projected increase of the major entitlements—Social Security, Medicare and Medicaid—as a percentage of GDP of over 50 percent over the next 15 years;

A current account deficit, that is to say, a trade deficit, plus some other items of almost 7 percent of GDP, caused partly by our fiscal

deficits and heavy over-weighting of dollar-denominated holdings in many foreign portfolios.

The combination of these factors, in my view, is a deep threat to American job creation, American standards of living, and our American economy.

The vast flows of capital from abroad that have sustained us are exceedingly unlikely, in my view, to continue indefinitely in the face of these imbalances, though the timing of trouble, whether in the near term or years out is unpredictable.

I believe that we should establish a fiscal path that systematically reduces the debt-to-GDP ratio, year-by-year, instead of that ratio increasing, as is going on at the present time, and that leads to balance, and, at the same time, we must make room for critical public investments.

As to globalization and trade, the pressures from globalization on wages and economic security are one of the factors, along with the even greater effect of technological change, that has led to real economic difficulty that so many Americans are experiencing.

In this context, there is an understandable temptation to erect trade barriers, but in my view, that would be deeply harmful, leading to higher consumer prices, higher input costs for our producers versus foreign competitors, loss of the benefits of comparative advantage, loss of the pressure of open markets on business to increase productivity, and, finally, likely retaliation by countries to which we export, and possible disruptive effects on the dollar.

Moreover, and very importantly, other countries are continuing to move forward with trade liberalization and trade agreements, so that the only question is whether we will be in or out of this network of preferential arrangements.

However, and having said all that, trade liberalization, which I believe, on net, greatly benefits our economy and the great preponderance of our people, must be combined with a powerful domestic agenda to promote productivity, broad-based income growth, and greater security along the lines I briefly discussed.

Mr. Chairman, I believe we can have a bright economic future, but we must address with great seriousness of purpose, many complex and uncertain matters, and this Committee can contribute greatly to achieving those purposes. Thank you for the opportunity to be here today, Mr. Chairman.

[The prepared statement of Secretary Rubin appears in the Submissions for the Record on page 53.]

Chairman Schumer. Secretary Summers.

STATEMENT OF DR. LAWRENCE SUMMERS, CHARLES W. ELIOT UNIVERSITY PROFESSOR, HARVARD UNIVERSITY; FORMER U.S. SECRETARY

Secretary Summers. Thank you very much, Mr. Chairman. Not surprisingly, I find myself in substantial agreement with what Secretary Rubin said, and I too, am grateful to this Committee for undertaking these investigations at what I believe is a critical time in our economic history.

It is a cliché, following elections, to declare that policy is at a critical juncture and that we are at a unique moment, but in this case, it is, in very important respects, correct.

Without precedent, are:

The magnitude of our current account deficit and looming problems;

The degree of integration between the United States and the global economy;

The rise of major trading partners, where economic growth in China is now rising at a level where the size of their economy doubles every 7 years;

The pervasive and changing impact of technology on the way Americans work and consume, and;

The unprecedented increases in economic inequality and insecurity that have been observed in recent years.

We are, to an important extent, in uncharted territory, and so this Committee's discussions and deliberations are of great importance.

I believe the United States faces three main economic policy challenges at this juncture:

Making, assuring that its finances are on a sustainable basis, because without sustainable finance, one runs the risk of disruption that will make the achievement of any other goal, impossible.

Assuring an adequate foundation for growth, through a sufficient rate of investment, and

Assuring that the benefits of growth are widely shared, and so that we continue to have the strong middle class that has long been the underpinning of our democracy.

Let me say a few words about each of these challenges: First, the nation's finances are not now on a sustainable basis. While projections vary, most observers believe that without a significant policy change, the debt-to-GDP ratio of the United States will increase quite rapidly in the next decade and beyond.

In part, this is the reflection of an aging society; in part, it is a reflection of the fiscal policies of the last 5 years, in which very large tax cuts have coincided with substantial increases in both defense and domestic spending.

This move toward fiscal unsustainability has been one of the drivers of the deterioration in the international economic position of the United States, as our current account deficit has now reached record levels and is approaching a trillion dollars.

The current account deficit reflects both the very substantial international borrowing by the United States, due to significant fiscal deficits, as well as the continuing decline in the private savings rate.

Indeed, for the first time in our history in recent years, we have observed moments when the net national savings rate of our country approached zero.

The consequences of these adverse and unsustainable developments have been masked by the very substantial investment in U.S. short-term financial securities made by central banks around the world, and, in particular, made by the central banks of emerging Asian countries and oil exporting countries.

This has created a unique, and, I believe, unprecedented situation where the world's greatest power is also the world's greatest borrower.

In the short run, the United States benefits from the availability of low-cost capital, however, this low-cost capital has as its counterpart, our very substantial trade deficit. And it also raises profound questions of how long foreign investors will be prepared to lend us funds on such generous terms.

Clearly, a policy priority has to be increasing the stability of the nation's financial position.

The most important step that Congress can take is to adopt a fiscal policy that puts the government's finances on a sustainable footing. There is no silver bullet here. It is important to address the excesses of recent years, to take on entitlement issues, and perhaps, most critically and immediately, to return to budget discipline with respect to any new initiatives on either the spending or the tax side.

The second large economic policy challenge is assuring adequate growth in the years ahead. For reasons that economist do not fully understand, productivity growth fluctuates substantially.

It was rapid from the end of the Second World War until the mid-1970s. It slowed radically from the mid-1970s until the mid-1990s. After the mid-1990s, it has accelerated substantially again, although there are some signs that this acceleration may be tailing off.

There can be no certainty as to the links between public policy and productivity, but equally, there is no question that public investments are essential. I would highlight three areas of public investment:

First, our investments in research and development, after increasing rapidly during the 1990s, have materially lagged. In a time when the world stands on the brink of revolutionary progress in the life sciences, it cannot be rational for the NIH budget to decline as it did this past year for the first time in nearly 40 years.

If one looks at funding levels adjusted for inflation, the decline in our national commitment to basic research is even more remarkable.

As President of Harvard, I had the opportunity to observe the remarkable potential of research in the life sciences. I've also had the opportunity to observe many extraordinarily talented young scholars abandoning the field, as the average age of funded investigators rose in the face of budget pressures. Similar trends can be observed in the physical sciences.

The second key element to public investment in productivity growth is education funding. Ultimately, nothing is more important to our prosperity than the quality of the American labor force. It is essential at the level of preschool, where an increasing body of evidence suggests very high rates of return on investment in preschool education, particularly for disadvantaged children.

It is essential at the level of the Nation's public schools, as you know better than I, and it is crucial in terms of affordability of higher education.

Of the many disturbing statistics I have encountered in recent years, one of the most disturbing is the observation that in our leading universities, only 10 percent of the students come from families in the lower half of the American income distribution. This

is clearly not a matter of ability; it is, importantly, a matter of access.

There are also crucial issues in infrastructure investment, as well.

The third, and in some ways, most pressing economic challenge, is that of assuring a strong middle class. This has three related but distinguishable elements:

Assuring equality of opportunity; assuring long-term economic security for those who currently have good jobs; and assuring that prosperity and economic growth are shared widely, rather than benefiting a small part of the population.

How best to do this is a question that will require all our efforts in the years ahead, but I think there are at least three crucial areas that require attention:

First, assuring the fair collection of taxes. There are a number of ways in which we can improve the effectiveness of the tax system, while at the same time, increasing its fairness.

These include: Making a serious assault on the tax gap resulting from noncompliance with the Internal Revenue Code. I would note that the tax gap is greatest for those categories of income that go disproportionately to the upper ends of the income distribution.

There are also important issues and abuses associated with transfer pricing and the sheltering of both individual and corporate income that require Congressional attention. I'm convinced that substantial revenues can be gained from these sources.

If we are to assure adequate economic security for all of our citizens, we need to recognize that in a world where jobs are going to be increasingly impermanent, economic security cannot come only from the employment relationship.

This will require new approaches in the areas of health insurance and retirement security. I believe it is also appropriate that consideration be given to thinking about methods of wage insurance that would enable increasingly inevitable economic mobility to take place, without significant and painful dislocation.

A third type of response to economic insecurity involves taking comprehensive and systematic policy approaches to the issue of the future of key industries and regions.

I was struck, Mr. Chairman, by the recent report that you and other leaders from your State released on the steps necessary to keep New York at the center of the global financial services industry.

I could not help but wonder whether similar comprehensive efforts to devise a strategy and assure the leadership of American firms and opportunity for American workers in other regions, would not be availing with respect to many different sectors.

Indeed, reliance on the strength of communities of clusters of Americans, is, it seems to me, profoundly important for our economic future. Any individual faces the possibility of competition with the lower-earning and equally skilled individual abroad, but it is much more difficult to compete with or replicate entire clusters of economic activity. Indeed, the supremacy of New York City as the world's financial capital, illustrates this point.

Mr. Chairman, these are just a few of the crucial areas of policy that we face. I look forward to answering your questions and en-

gaging in a wide-ranging discussion. Thank you for inviting me to be here this morning.

[The prepared statement of Secretary Summers appears in the Submissions for the Record on page 54.]

Chairman Schumer. Thank you, Dr. Summers.

Dr. Blinder.

STATEMENT OF DR. ALAN BLINDER, PROFESSOR OF ECONOMICS AND DIRECTOR OF THE CENTER FOR ECONOMIC POLICY STUDIES, PRINCETON UNIVERSITY; FORMER VICE CHAIRMAN OF THE FEDERAL RESERVE

Dr. Blinder. Thank you, Mr. Chairman. I'd like to devote my time to two big problems that you mentioned in your opening statement that haven't been mentioned too much by the two distinguished witnesses that preceded me, although both mentioned them.

One is having to do with income inequality and one having to do with globalization. I'm not going to mention the word "deficit" in my 7 minutes, because I anticipated it would be pretty well covered by the distinguished former Secretaries of the Treasury that preceded me, but suffice it to say that I align myself with their remarks; that's it.

The first problem, rising income inequality, has been with us so long now that I feel that this country is becoming inured to it, as if it's part of the normal patterns of life.

Statistical measures of poverty and inequality can be and have been disputed. You already heard some of that this morning from Mr. Saxton and from Mr. Bennett, and you'll hear some more, I believe, from the next witness.

That notwithstanding, the basic story is very clear, which is that inequality in the United States was mostly falling for the 30 or 35 years or so from the end of the Second World War, until the late 1970s, and has been mostly rising since then.

The main factor behind this story has not been vast capital gains accruing to a tiny minority, nor a massive shift of income from labor to capital, although both of those have played roles at particular intervals, including right now.

But rather, the basic story is that earnings from work have grown vastly more unequal over these three decades or so. There are many ways to measure that change, but here's one that I find both dramatic and very easy to understand:

According to IRS data on wages and salaries, in 1979—so that's when this process started—the average taxpayer in the upper one-tenth of 1 percent of the income distribution, way at the top, earned about as much as 44 average taxpayers in the lower half—44.

By 2001, that ratio had risen to about 160, and we're pretty sure, from other fragmentary data, it's gotten worse, not better since then.

Now, let me be clear. As you yourself said, Mr. Chairman, at the beginning, the main culprit in this story was not the government, but the marketplace.

While there are a number of competing explanations, some of which have been alluded to already, the fact is that starting in the late 1970s, the market turned ferociously against the less skilled.

Now, you could ask yourself, how should the government, in the abstract, how should a government react to such a development? Well, one clearly wrong approach would have been to try to stop the market forces that were generating the rising inequalities.

Such an effort would have produced undesirable side effects and probably would have failed anyway. A much more reasonable approach would have been—would have included using the tax and transfer system to cushion the blow, raising the minimum wage, devoting more resources to compensatory education, making health insurance, universal, and so on and so forth.

These, by the way, are still useful ideas, because this is not a problem of the past; this is a problem of the present.

Now, a social Darwinist would have looked at this phenomenon and rejected palliatives like that and said, let the market rule and the chips fall where they may.

Now, you might think that that sounds heartless, but the fact of the matter is, for the most part, over these 30 to 35 years, the U.S. Government followed a much harsher policy than that.

As the market forces turned ferociously against the middle class and the poor, the government pile on, by enacting tax cuts for the rich, while permitting large holes to develop in the social safety net.

We're about to have the Superbowl. In football, we call that unnecessary roughness and we penalize it 15 yards. It should have been penalized, in fact, in national economic policy, as well. It's a policy direction that was misguided, always, I believe, and needs to be changed right now.

The second issue I want to talk about is one whose present importance, ironically, has been greatly exaggerated, but whose future importance appears to be underappreciated, and that's the off-shoring of service jobs from the United States and other wealthy countries. But I'm going to concentrate on the United States.

Now unfortunately, no comprehensive numbers on the size of this phenomenon are available. It's not in the government's statistical gathering system, but from fragmentary evidence from a number of sources, it appears certain that fewer than a million U.S. service jobs have been off-shored to date.

Now, when I say "a million," that sounds like a lot, but in a Nation of over 140 million jobs, it's a drop in the bucket, not even 1 month's normal turnover of the U.S. workforce.

However—and this is the point, I believe that what we've seen so far is just the tip of what will be a very big iceberg, once it's revealed, and here's why:

Only a minority of American workers, mainly manufacturing workers, have historically faced job competition from abroad. Now, while they haven't liked it over the years, they've grown to understand that foreign competition is one of the hazards of industrial life, like bankruptcies and business cycles. It happens.

But most American workers have never, never had to worry about foreign competition. Until recently, neither low-skilled work

like call centers, or high-skilled work like computer programming, could easily be move offshore.

Now, both of them can be, and, of course, are being done. And the share of American jobs, that is, potentially—and I want to underscore the word, "potentially," because it's mostly a story of the rest of the iceberg that we haven't seen yet—potentially vulnerable to off-shoring, is certain to rise over time as the technology improves and as countries like India and China modernize and prosper and move up the skill ladder.

These are inevitabilities; we know they're going to happen. As this occurs, tens of millions of additional American workers who have never experienced such competition from abroad before will start to experience this additional element of job insecurity on top of the job insecurities they have now, which you've already—you and others have mentioned, and the concomitant downward pressure on wages. This kind of competition does have an effect on wages.

Problems that have been reserved for manufacturing workers up till now—and I want to remind the Committee that manufacturing workers these days constitute about 10 percent of the U.S. workforce. Service workers, depending on how you define it, are 60 to 70 percent of the U.S. workforce.

Now, many people have concluded, falsely, I believe, that off-shoring is a particularly acute problem for the less well educated workers, precisely the people that have been left behind over the last 25 years.

I'm not so sure that that is right. Indeed, I suspect it's wrong. As I see it, the key labor market divide in the information age, going forward, will not be between the high-skilled and the low-skilled, which has been the right way to look at the problem for the last 25 years, but rather, between those who provide services that can be delivered electronically with little loss of quality, and those who provide services that cannot be so delivered.

And that cuts across the skill spectrum, so think about a few examples. It seems to me most unlikely that the services of either waiters or brain surgeons will ever be delivered over the Internet. On the other hand, we know that both typing services, a low-end skill, and security analysis, a high-end skill, are already being delivered electronically from India at very high quality.

These disparate examples illustrate two important points: First, the dividing line between jobs that are deliverable electronically and those that are not does not correspond to the traditional distinctions between high-end work and low-end work that we've become so accustomed to thinking about.

Frankly, I don't have any idea whether the future off-shoring is going to make the distribution of wages more unequal or less unequal.

Second, the fraction of U.S. jobs that can be moved offshore is certain to rise as the technology improves, and it only improves; it never deteriorates.

In some ongoing research that I'm doing right now, I've estimated that something between 22 and 29 percent of all current U.S. jobs might potentially be off-shore-able. That's a very big num-

ber. And I want to emphasize "potentially." It's not all going to happen, of course.

Now, finally, what can or should the government do about all this? I don't have a laundry list of concrete proposals to suggest to you, but I think the appropriate governmental responses fall into two generic categories which Congress should be thinking about:

First, we need to repair and extend the social safety net for displaced workers. That includes unemployment insurance, trade adjustment assistance, job retraining, the minimum wage, EITC, universal health insurance, pension portability, all of those things—maybe not the pensions, maybe—all of those things have been mentioned up to now, plus other newer ideas like wage loss insurance.

If we fail to do these things, or, perish the thought, turn back to social Darwinism, or worse, the piling on, then a large fraction of the U.S. population is going to experience a great deal of anxiety and economic distress.

These people, by the way, will constitute a much larger, more vocal and more politically engaged group than the poor and the uneducated. You will hear about them in this building.

Second, we must take steps to ensure that our workers and our businesses supply and demand the types of skills and jobs that will remain in America, rather than the ones that will move offshore.

So, among other things, that may require substantial changes in our educational system. After all, the 5-year-old that comes into the kindergarten system now, 17 years from now, comes out with a college degree to a quite different world.

And it will certainly entail a variety of steps to ensure that the United States remains the home of innovation and invention; that we get there first.

Now, notice that I didn't mention a third possible category of governmental response, which is trying to impede globalization, in general, or off-shoring, in particular.

The U.S. Government, powerful as it is, cannot hold back the tides of history, and it shouldn't try. Mr. Chairman, you may be and I am old enough to remember a 1960s musical comedy called "Stop the World, I Want to Get Off." I understand the sentiment very well. You hear a lot of it these days.

But the truth is that we can't stop the world, and we certainly can't get off. Instead, we Americans need to prepare ourselves for the future, whether we like it or not. Thank you for the opportunity to testify here today.

[The prepared statement of Dr. Blinder appears in the Submissions for the Record on page 56.]

Chairman Schumer. Thank you very much, Dr. Blinder, and now, Dr. Vedder.

STATEMENT OF DR. RICHARD VEDDER, DISTINGUISHED PROFESSOR OF ECONOMICS, OHIO UNIVERSITY; VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE; Co-AUTHOR OF THE WAL-MART REVOLUTION

Dr. Vedder. Thank you, Mr. Chairman. By the way, as an economic historian, I would note that, if memory is correct, this Committee is now beginning its 61st year. It has just completed 60 years in existence, having come into service with the Employment

Act of 1946. You've done good deeds over the last 60 years, and I hope it continues, as I'm sure it will in the future.

Chairman Schumer. It was intended as a counterbalance to the Council of Economic Advisers when it was passed. They were passed in the same legislation.

Dr. Vedder. Yes, and as a former employee of the Committee, I appreciate that point.

I anticipated, since two of my predecessors are tenured professors, that they would ignore the 10-minute limit, and speak for 15, so I will omit part of my prepared statement, but I would like the whole thing entered into the record.

Chairman Schumer. Without objection.

Dr. Vedder. My distinguished colleagues have painted a somewhat pessimistic and perhaps mildly alarming picture of the American economy. We learn that many Americans have not shared in our Nation's rising prosperity.

The income and wage gap between the rich and the poor is growing. We are told that we're becoming a more economically divided and bankrupt Nation.

My message is somewhat more optimistic and skeptical of the analysis that suggests vast portions of the American populous are languishing economically.

Let me just briefly touch on three points: First, the conventional measures that are typically cited to denote greater inequality are fundamentally flawed and grossly overstated, as Senator Bennett pointed out in his earlier analysis.

And, second, even if you accept the proposition that America has insufficient equality of economic condition, history tells us that public policy efforts to deal with the problem often are relatively ineffective.

Third, some policies that conceivably might lower inequality, as conventionally measured, would, if adopted, have serious adverse consequences to the economy as a whole, and on this point, I entirely agree with all of the panelists with respect to most of their comments with respect to globalization, outsourcing, and the need not to try to impede market forces.

We might disagree on some other aspects of that, but there is an inevitability to globalization. Markets need to be encouraged, and public policy should not try to stop it.

But first, turning to my first major point, looking at the conventional statistics on income distribution, three factors make them overstate inequality: First, and least important is that statistics traditionally are based on pre-tax income, and exclude a variety of in-kind, non-cash payments that primarily benefit lower-income persons—Medicaid benefits, food stamps, housing subsidies, and so forth.

Any analysis or comparison of income levels or of income inequality today, with, say, 1960, using published income data, will tend to overstate the rise in inequality because of the growth of the social safety net.

A second factor that we should be truly interested in is the economic well being of Americans which is best measured by consumption, not by income.

Dollar-for-dollar, people derive more joy from what they spend than from what they earn. As many elementary economics textbooks point out in the first chapter, the ultimate purpose of economic activity is consumption.

And we also know that in any given year, consumer spending is far more equally distributed than income. If you compare the income distribution statistics derived from the Current Population Survey with the BLS's Consumer Expenditure Survey, you get revealing results.

For example, the poorest one-fifth earned only slightly over 7 percent as much income as the richest one-fifth in the year 2002, but they consumed more than 24 percent as much. Roughly speaking, conventional measures show that consumption inequality is at least one-third less than for income inequality.

The third point relating to the overstatement of inequality, relates to the remarkable income mobility of the American people. For example, at the request of this Committee, the Treasury Department in the 1990s, provided data suggesting that the overwhelming majority of persons in the bottom quintile of the income distribution were in another quintile a decade later, and a large percent even moved up and down from one year to the next.

Researchers at the Urban Institute and other places have reached similar conclusions.

Now, while we're talking about measurement problems, they are particularly prevalent in our discussion of changes in earnings over time which have been alluded to in previous testimony.

Go to page 338 of the latest Economic Report of the President—a new one's coming out shortly—but go to the last Economic Report and go to page 338. We learn that average weekly earnings of workers in private, non-agricultural industries in 2005, were over 8 percent less than they were in 1964, the year Lyndon Johnson announced his Great Society initiative.

This isn't a 5-year problem; it's a 40-year problem, if you believe page 338. But go to page 340—turn the page—and look at real compensation per hour in the non-farm business sector in the same period. We learn it has gone up 75 percent.

Page 338 is consistent with a Marxian, even, or a Malthusian interpretation of our economic history, a tendency for wages to fall to subsistence, or mass exploitation of the working proletariat by exploitive capitalists.

Page 340 is consistent with the view that with economic growth, the earnings of workers have risen sharply, and it's also consistent with national income accounting data that shows real per capita consumption spending has increased about 2 percent a year.

Even the data on page 340 suffers from deficiencies, which gets to some other things that we mentioned earlier. We learned that productivity in the non-farm business sector in 2005 was 2.3 times as great as it was in 1964. Compensation was only 1.8 times as great, a pretty huge difference inconsistent with neoclassical economic theory and suggesting that owners of capital are indeed deriving extraordinary profits as a result of paying workers less than what they contribute to output at the margin.

This should have resulted in a significant decline in compensation of workers as a percentage of the national income, but going

to page 314 and 315 of the same book, we see a different picture. Compensation of employees actually rose in this time period. The share of national income accounted for by corporate profits actually fell, albeit very slightly, in the same time period.

I'm making two points here. First, the interpretation of economic data can be exceedingly misleading. Second, the analysis of broader measures of economic performance suggest that workers as a group have shared in our national prosperity of the past several generations. You don't need a Ph.D. in economics to observe that never has a society had a middle class more used to what once were considered goods and services available only to the uber-rich. Middle income people today live in larger homes, buy more gadgets like iPODs and cell phones, live longer, are more if not better educated and take nicer vacations than either their parents did or do their counterparts in any other major nation in the world.

I just returned 2 days ago from a trip to the Caribbean on a cruise traveling less with business executives or even elite Ivy League professors than with equipment salesmen, butchers and teachers, ordinary folk. That just simply didn't happen 30 years ago.

My second major point relates to public policy dealing with economic inequality. Time certainly doesn't permit a detailed exegesis of past efforts. But a reminder of some historical experiences is sobering in this regard. Attempts, for example, to make the tax system more progressive have often had unintended effects. For example, the sharp reductions in marginal tax rates in the 1920s, the 1960s and 1980s, seen by some as favoring the rich, actually led to sharp increases in the tax burden of the rich relative to the poor.

I worked for this Committee in the 97th Congress, 1981–82, in a political environment exactly like today: Divided government, Republicans controlling the executive while Congress was more under Democratic control, yet the two branches seemed to work together to fashion a more growth-oriented tax policy, with lower marginal tax rates that contributed mightily to the boon that followed. I hope the 110th Congress is capable of similar accomplishments.

Taxes have behavioral consequences. The CBO greatly underestimated revenues that would be realized from reducing the top capital gains rate to 15 percent, for example, as falling rates unlocked billions in unrealized gains that have helped fund our rapidly expanding government. Sharp reductions in the number of estates subject to death taxation as a result of reform in those laws has not led to a sharp decline in revenues from that source, as some may have expected.

I think it would be a tragedy to reverse the positive effects of the tax reductions of the past few years that, like the Kennedy tax reductions of the sixties, has had a positive impact on economic activity.

On the spending side, history again shows disappointing results of many initiatives to help the poor and middle classes. The January 20th issue of The Economist shows work training programs of governments have internationally been largely failures. Spending initiatives in the area of education, medical care and public assistance usually have brought about disappointing results. Despite spending far more in real terms per student than a generation ago.

American students do not appear to be learning much more and the education for lower income students is particularly deficient.

A tripling of Federal aid to college students since 1994 has been accompanied by a decline, not an increase in the proportion of students from the lowest quartile of the income distribution attending and graduating from our finest universities. Picking up on Secretary Summers' comment, our universities are increasingly becoming taxpayer-subsidized country clubs for the children of the affluent.

While Medicaid has certainly brought about increases in medical care for the poor, it has not done so at an enormous cost to society and the cost pressures of a highly inefficient system are leading companies to cut back on health care benefits for working middle class Americans. We can go on and on and I will not do so because of time limitations.

I agree with everything that's been said about protectionism or the implication of the earlier testimony that protectionist policies would be undesirable for the economy. Almost all economists would agree with that. And I would hope that what I might call the intelligent wing of the Democratic party prevails in intraparty debates and that Secretaries Rubin and Summers and Professor Blinder win that battle with the money bags in the labor unions.

Now at the macro level, I believe the single biggest factor in the slowdown in growth rates in this decade relative to the eighties and Nineties has been the sharp increase in government expenditures. I think we agree on that. From fiscal 2001 to fiscal 2006, total Federal outlays rose 42 percent, $790 billion. Tax revenues went up 20 percent, about the same percent as GDP, so the problem has not been that our tax burden has been falling, the problem has been that our expenditures have risen and we need to bring that under control.

I thank you for listening to me and I'll be glad to engage in the discussion that inevitably will follow.

[The prepared statement of Dr. Vedder appears in the Submissions for the Record on page 58.]

Chairman Schumer. Thank you. I want to thank all four of our witnesses for really stimulating testimony in reference to what Mr. Rubin, Dr. Summers and Dr. Blinder have talked about. You all paint a far more sobering picture than the President's view. The President is speaking on Wall Street today. We don't know what he's going to say, but based on what he said in Peoria yesterday, I think it's a very fine and pointed contrast.

I'd also thank Dr. Vedder for his enthusiasm and it's sort of interesting here, at least on this little panel. Democrats are more emphasizing issues like productivity and production and Republicans are emphasizing consumption. There's a little bit of switch here, which is sort of interesting.

Dr. Vedder. The hearing talked about income and equality as a focus. I love to talk about productivity, too.

Chairman Schumer. Good. We'll have that at another hearing. We're going to proceed to the questions where each Member will get 5 minutes.

My first question is to all of the panelists. You've given very interesting—particularly Secretary Summers and Rubin and Dr.

Blinder, very interesting analyses of the economy which, as I say, are sobering and a contrast, I think, to what the President is saying. I'd also note that when we look at income and equality I think these days to do it in just quintiles probably doesn't tell the whole story. If you look at the top 1 percent or even the top 0.1 percent, you'd get a much more pointed picture than a picture in quintiles.

But my two questions are these. Again, if each of you could elaborate if you believe it to be true, how a slowdown in upward mobility for the middle class takes its toll on economic growth as a whole. In other words, just looking at the macro picture is not enough.

And the second, if you could have one wish for a significant change in government policy to reverse that, what would you point to? I'll just give you something to play off of.

When I talk about globalization, one of the people who couldn't come today—we invited him—Chairman Greenspan basically said that if we were to significantly improve our educational system K through 12, at college, that would be the greatest, the best thing we could do to ensure growth and particularly ensure less income inequality among the classes.

Secretary Rubin.

Secretary Rubin. Mr. Chairman, in brief, on the first question, I think the Senator said it before. Unless the American people believe that trade liberalization and multinational economics generally are going to benefit them, support for those policies—which I think are central to a strong economy—will continue to diminish. I think also having broad based income growth better equips the average American to access education and so much else that's critical to productivity.

On your second question, I'm going to take one wish with a semicolon. President Clinton said in 1993 there was a tremendous amount he wanted to do but that the threshold issue was to get our country back on a sound fiscal path. Chairman Bernanke said I think 2 or 3 weeks ago that he thought the long-term fiscal prospects for the United States were a real threat to our economic well being. There's much else we need to do in the areas of education, infrastructure and everything else. I do think the threshold question remains the same then as it did for President Clinton, so that would be my answer. But I do think we need to combine that with all these areas of public investment.

Let me just add on inequality, if I may say so, Chairman Greenspan also said some time ago, Mr. Chairman, that growing inequality was a deep threat to what he called democratic capitalism and I think that is correct.

Chairman Schumer. Secretary Summers.

Secretary Summers. You know, in a long historical perspective, Mr. Chairman, in the first decade of the last century when industrialization was having profound effects, we instituted a whole set of public policies: Antitrust laws, the first wave of regulation, that they in a very important sense saved capitalism and support for the market economy from itself. Something similar happened when the market system stopped working in the 1930s and, in historical terms, what Franklin Roosevelt did was save the market system by enabling it to work for the vast majority of citizens.

And ultimately the same thing is at stake in the response to the middle class concerns right now. So the stakes in this era of globalization are very large. I would agree completely with Secretary Rubin on the urgency of restoring our finances to a sustainable basis, but I would emphasize that that is in a sense defensive. If we don't do it, we are taking an enormous and imprudent risk. But we're not going to drive the economy forward merely by putting our finances on a much sounder footing.

And I would emphasize the issue of addressing our health care system as absolutely central to questions of security, questions of competitiveness, and questions of everybody feeling like they're part of the same country.

Chairman Schumer. Dr. Blinder.

Dr. Blinder. I guess I think that there's probably more fear of falling mobility than actual falling mobility. Secretary Rubin made the point that it gives people a reason and a motive to try to resist change in general, from whatever source. And, in particular, as an example of that, it gives people a reason to resist globalization—which, as I said before, is an inevitable force and will raise productivity in the United States and elsewhere.

To illustrate what I mean, just imagine if the United States had tried to hunker down in 1958—when we were undisputed kings of the hill in everything—and say "we're going to try to defend this economy, this industrial structure" and so on. That's a loser's strategy, from which we have to stay away. We're vastly different now than we were in 1958; and 50 years from now we're going to be vastly different still.

If I had a wish list, I guess I would put at the top some of the things I mentioned earlier. It starts with the theme that we have to do a better job of cushioning the people who fall. I would say, stronger than that, we want to turn the cushion or the safety net, as it's called, into a trampoline that bounces people back into productive employment. These are not easy things to do. But I don't think we've tried that hard, and we just need to try a lot harder.

Chairman Schumer. Dr. Vedder.

Dr. Vedder. I actually agree largely with Chairman Greenspan with respect to education, but I think the important thing to keep in mind, the critical role that education plays in income mobility as well as in economic growth.

Incidentally, I also would in large part agree with Secretary Summers on the R&D comments that he made. A colleague of Professor Summers, however, Carolyn Hoxby, once estimated in recent years that the productivity of K through 12 education in the United States has fallen by up to 60 to 65 percent in the last 30 to 40 years and we have productivity declines occurring in the education sector. I think it's also occurring in higher education. I've written a lot about that and I've served on the Spellings Commission recently on that.

So I think we have some inefficiencies, a need to restructure our educational system to make it able to be more competitive, to make it less of a Soviet style system and more of a competitive, lean and mean system. In doing that, we may need to devote more resources to it. That's a possibility. But I think an essential prerequisite is making the system work.

Chairman Schumer. Thank you.

I'd just like to go back and just ask Secretary Rubin to elaborate on one thing and Dr. Summers on a second, then my time will expire.

Could you draw out the link a little bit between fiscal responsibility and economic growth? I think many people in the country—some reject it; I guess the President sort of rejects it or gives it lip service—but many others think it's a moral thing to do, but it doesn't really get to growth and some other things.

To Dr. Summers, you mentioned health care first and foremost. I have mentioned education because I believe that without the growth in education our incomes, our international share of income but also our relative growth in income will decline and we wouldn't have the dollars to do what we need in health care or other things. Could you answer that?

Secretary Rubin. Mr. Chairman, in brief, to the extent that the Federal Government through deficits absorbs our savings, we have less savings available for investment and we've had these enormous inflows from abroad, largely to support the dollar and in order to maintain exports mainly from petrodollar countries for safe haven. It's almost inconceivable that that's going to continue indefinitely in the face of these imbalances.

I think Dr. Summers said that this—somebody said, I think it was Dr. Summers—this masked our real problems. So one problem is crowding out private investment. I'm deeply involved in markets every day of my life and I'm deeply troubled at the potential that at some point—and it may be years out, it could be near term, there's no way of predicting which—that the global markets will develop concerns about the combination of our low savings rate, our high current account deficit, our fiscal prospects, the large increase in entitlements coming in, and, as a consequence it will have serious disruptions with respect to our markets which will mean much higher interest rates and all that flows from that, including serious economic slowdowns. As I say, that could be way off in time. It has been masked, as I think Dr. Summers said, by these vast inflows. But that won't go on indefinitely.

What we discovered in 1993 but did not anticipate, but I think it was very important, was that once we reestablished sound fiscal conditions that greatly increased business and consumer confidence generally. What had happened was that our deficits had become kind of a symbol for more general concern about our ability to manage economic affairs in this country.

And finally two other items. President Clinton made this observation: If we're going to have serious public investment, the American people have to have confidence in government. That in turns requires you to have sound fiscal conditions.

Finally we had the tragedy of 9/11. We also had a recession. The economic resilience, the budgetary resilience to deal with that came because we had substantial surpluses. Had we had deficits, we'd then have to pile additional deficits on top of that. It might have been deeply harmful to our economy.

Secretary Summers. I would not want to contrast health and education in any way that would disparage. What I would agree with you is the overwhelming importance of improving our edu-

cational system. There's much, as I did mention in my testimony, that can be done at every level.

I would stress that in the education area the investment of resources is essential, but the improvement of performance is also absolutely essential to any success and that there are probably some limits on how much of that can be done at the Federal level, which is why I emphasized the health care issue—which it seems to me is increasingly important to the perception of security or middle class families, is essential to the competitiveness of very large numbers of American businesses and to the overall sense that this society is working well.

Chairman Schumer. I want to thank all of our witnesses. You have provided a real contrast to what we are hearing from the White House and I hope we certainly on this Committee are going to continue to make those points, then take it from there and try to figure out the kinds of policies that you have discussed, put them into practical terms so we can address our future with confidence. Thank you, all four of you, for your comments.

Senator Klobuchar. Thank you.

Dr. Blinder, you talked about, I think it was in your words, "unnecessary roughness on people and some of the government policies that have made it worse." This is apart from your testimony about the need to fix the safety net. But when you talk about these tax policies and how they made it worse, could you elaborate on that?

Dr. Blinder. Glad to. I think you yourself were talking about this in your opening statement. We've cut taxes several times in this decade. If you leave aside incentive effects—which is something that is very relevant and we should argue about, because it is important—and look at the distributional aspects of these tax cuts, it's hard to imagine a less progressive, a more regressive set of tax cuts. If you had solved the hypothetical problem of giving away this much revenue in the most regressive way we can, that's pretty close to what we got.

The minimum wage—which is in the Congress right now—has been allowed to dwindle in real terms to its lowest in 50 years. We haven't raised the Earned Income Tax Credit since we did it at the beginning of the Clinton Administration in 1993. That's the biggest—I don't want to quite call it an antipoverty program, because it's antipoverty and near poverty because lots of people collect EITC that aren't below the poverty line. But it's probably the best redistributive tool that we have in the arsenal. These are the kinds of things that I was talking about.

Then if you look on the other side of the ledger, what did we do to try to cushion the blow for the people who were taking the blow? The answer is essentially nothing, except for a few things that happened in the 1990s like the EITC liberalization and so on. We had a little bit of greater trade adjustment assistance put into one of the tax bills. Was that in the tax bill of 2003? I'm forgetting. People from the staff behind you will know the answer to that. And there's been almost no take-up, there's been almost no use of enhanced trade adjustment assistance. That's another example.

Senator Klobuchar. Thank you.

Then the other thing, I was reading this great book last night, I don't know if you've seen it——

[Laughter.]

Senator Klobuchar [continuing]. Called "Positively American" by our Chairman——

Chairman Schumer. The Senator from Minnesota has half an hour additional.

[Laughter.]

Secretary Rubin. Senator, I plan to wait until it becomes a television series.

Senator Klobuchar. In addition to learning a lot about what the Chairman likes to eat, like grilled octopus and all these oatmeal cookies, he makes a point of all the things we can do to help the middle class, including investment in education, which you, Dr. Summers, had mentioned.

What I'm trying to reconcile here, I guess, is how we do this and we still manage to bring down the deficit—and I threw out some ideas that I had—and start working on the debt. Because I think in the end that's going to eat away at the middle class that we're trying to help.

What exact policy prescriptions do you have where we can start doing things with this Congress where we're actually reducing the debt, bringing down this deficit and at the same time helping the people that the Chairman talks about?

Secretary Summers. I think in your statement, Senator, you pointed to a number of areas where I believe that tax changes would both raise revenue and, in all likelihood, improve the function of the tax system as a contributor to economic health. One is the tax gap where the volume of taxes that are owed, but not paid, is large and growing.

It defies belief that in a world where the CitiGroup organization is able to track people who spend money on their Visa cards at 30 million locations around the world, get them a statement within 30 days and collect what they owe, that we cannot collect as a country more than 85 percent of the taxes that are owed, and the gaps are far and away the largest in categories related to profits and various kinds of capital income that go disproportionately to people who are very well off.

If you look at the location of U.S. corporate foreign profits, where are the foreign profits as reported on tax returns greatest for U.S. companies? You might expect them to be in places like Japan and Germany and England that have the largest economies where they would be doing business. They are, in fact, much more in places like Ireland and various Caribbean locales that provide extraordinarily generous tax treatment. And there is room for improvement in that area as well.

One of the things that we launched—initially raised during Secretary Rubin's time as treasury secretary that I pushed very hard during my time was the issue of corporate tax shelters where it's very difficult to know, but there appear to be very significant losses. And I might say that this is an area where I think the technical economic community has some work to do, because our efforts to address these problems are, I think, held back by the fact that they are often scored in extremely conservative ways that reflects a legitimate concern that they've sometimes been used as a somewhat phone item in various Congressional budget efforts. So they're

scored in a very, very conservative way which in turn makes it harder to build the impetus for necessary policy changes.

So I think there is a significant agenda of things that would actually make the tax code more of a level playing field, more efficient in the way it collected income and also raise revenue that could be coupled with the various initiatives that I think you have in mind to address key needs of middle income families.

Senator Klobuchar. Thank you.

Chairman Schumer. Senator Webb.

Senator Webb. Thank you, Mr. Chairman.

I want to thank all the witnesses for their testimony today. This is a great opportunity for us to hear from some of the great minds in America about how we can work to solve these problems, and I appreciate your holding these hearings. I look forward to more of them and participating.

And, if I may say with the greatest deal of respect, Mr. Chairman, I think you got 10 minutes in your questioning and we're getting 5. In the spirit of egalitarianism.

Chairman Schumer. Ask our Chief of Staff. I said what's that all about, everyone should have the same before you even brought it up. We don't want to have time income inequality here.

[Laughter.]

Senator Webb. First of all, Dr. Summers, I appreciate what you just said in your response to Senator Klobuchar. It goes a long way toward, I think, what a lot of us are thinking.

Dr. Blinder, your comments about the functional breakdowns here in terms of globalization among skill sets, electronic transmission and those sorts of things, I think if you look at where the typical American worker is having to see the challenges, the squeeze they're facing come from three directions. That is certainly one of them.

The other is, looking at the manufacturing base, when we are having such dramatically different economic systems with which we are competing, the iPODs and the cell phones that are mentioned are made in China. Even on infrastructure issues, you can't export a waiter's job. But the situation we have right now with respect to immigration is that in many cases the wage levels are being held down by this vast labor pool that's kind of under the water, infrastructure projects in such places as waiters and this sort of thing. That's sort of a dilemma when we're talking about these issues across the aisle and in other ways, it does often depend on whether you're focusing on the economy writ large or whether you're talking about the opportunity for personal advancement.

I know, Dr. Summers, you mentioned access. This is such a key of what's going on right now, all this talk of social Darwinism really neglects the reality of starting points of access of the ability, quite frankly, of people with wealth and power to manipulate government policies, as well as to take care of their future generations. And those are the sorts of things that I and other people have been trying to focus on.

I wanted to ask a specific question. I was really taken by an article in the Economist last summer—I don't have it in front of me.

It was a 19-page special on the impact of globalization. And, as you would expect, it was very positive about the future of globalization.

One thing that it did point out was that the impact on the American workforce is quite different than the other so-called first world economies and that it extended beyond the blue collar workforce. In fact, Dr. Blinder, as you were pointing out, it is now beginning to dramatically affect white collar America. Some of the conclusions that they had reached, outsourcing, the impact of outsourcing on our economy, some of them talked about illegal immigration. And the other, I think, really focused differential we were talking about was the way that we traditionally construct our medical programs, our health care programs—which all of you addressed. Their prediction was basically that if we don't come to some sort of fair conclusions on these issues, we are going to move toward protectionism in the political system and possibly toward political unrest.

As I'm listening here about the comments about education being a fix, that's a very long-term fix. It's certainly a laudable goal, but we have to have some other things that we can put into the works. Health care is possibly a shorter-term fix, but I'm also curious as to the recommendations that the people on the panel would have—or even if you agree, particularly in the case of Dr. Vedder.

Dr. Rubin, if you could start.

Secretary Rubin. Thank you, Senator. I don't think that any of the three Ph.Ds on the panel would agree with my being called "Doctor Rubin." But nevertheless, I think you identified a very serious issue and I don't think it's a simple one to deal with because the reality of life is that China and India have very effective productivity regimes and as they become more and more productive—as I think Dr. Blinder said—it's going to create serious competitive pressure with respect to our economy.

I think there are productive things to do and counterproductive things to do. Too much of the temptation goes in the counterproductive direction. Having said that, I think health care is certainly one.

Another area that we should pursue is trade adjustment assistance. It isn't just trade adjustment, but assistance for any sort of dislocation.

There's a man named Bruce Katz at Brookings who has a project around local economic development, to approach job creation and new activity creation not in some national sense directly from Washington but, rather, around local strengths, building on our great university systems and building around the strengths of localities. I think there's a tremendous potential in that.

But I think the answer to this, Senator—such as portable pension funds, there are a lot of specifics you can get together, but I think trying to interfere with markets or stop markets isn't going to work and I think there's an enormous amount we can do in a dynamic society to create greater opportunity here, and that's the direction in which I, at least, think we ought to go.

If I could just say, by the way, Dr. Vedder, you referred to the struggle within the Democratic party and hoping we would prevail. I don't view it that way at all. I think what you've got is a very serious set of issues which we've all been raising—including the

Senator right now—and within our party, we're all working to find sensible solutions, recognizing the difficulties.

Thank you.

Secretary Summers. A couple points that I would add. First, I don't think any of us on this panel have minimized the magnitude of the challenges that we face. At the same time, I would rather face our problems than the problems facing any other industrialized country in the world in terms of the tremendous productive capacity, dynamism and growth potential of the American economy. That's why I believe so strongly that it is important to make neither of the two major errors that are so often suggested in the political debate: One is to simply be passive and reliant on the market and assume that all will be well—that's the mistake we avoided in the first part of the century, that's the mistake we avoided in the 1930s, that's the mistake we've consistently avoided to our very great benefit.

The other is to take a whole set of measures that would go against the grain of the market system, which I think would run the risk of creating the kinds of problems for ourselves that Europe and Japan face, which have essentially become stagnant societies in ways that have reduced enormously their potential to take on whatever challenges they define for themselves. That's why I think the challenge.

And if there's one theme, it would be to take a more collective approach to prosperity and economic security by having broad systems that assure that health care is available for all, that whatever happens to you in the market economy, you don't lose your home, you don't lose your capacity to have an adequate retirement, that the economic success of the area where you live is not just a matter of the individual economic successes of a set of individual people there, but is a collective responsibility to formulate a strategy. And I think it is taking that kind of more collective view of prosperity and economic security, while at the same time insisting that you go with the grain rather than against the grain of the basic market system that has produced all this potential. That's, I think, the policy challenge.

Dr. Blinder. I very much agree with that. I appreciate the sense of your question, Senator. Some of the hard truth of this matter is that, in terms of cures, the short-term plate is kind of bare, but not empty; I'll come back to that in 1 second. And the long-term plate is bountiful; but these are hard things to do, and they take a long time. When prescribing long-term remedies, it's very good if you're in a position like we on the panel are; you don't have to run for election, because they do take a long time.

On the short-term plate, I think the right way to think is just where Secretary Summers finished. When we teach our students about the gains from international trade, most of us emphasize that there are winners and losers. And to make the case intellectually airtight, you need to compensate the losers for their losses. And there are losers. People lose their jobs. They lose their health insurance. They lose their pensions. They shouldn't be losing all of that stuff.

We in the United States ought to be taking much more seriously the ideas that the losers should be compensated so that the society

can reap gains from trade. Some of this can be done in the short run, like pension reform and maintenance of health insurance. There is COBRA, for example we can do more things like that. The long-term fixes have to do with education.

You mentioned health care.

I believe it was an historic mistake, though made for understandable reasons, that the United States made a long time ago when—just about uniquely in the world it decided—to attach health insurance to employment. It's now a huge burden. It wasn't such a burden in the good old days of the 1950s, but it's a big burden now. It's an anchor that is pulling down real wages.

You know, when you look at total compensation—which most economists prefer to look at—a large and growing hunk of that is health insurance.

If the worker is getting more and more compensation to pay for less and less health insurance, he's not really better off. It's an anchor on wages, to some extent, and it's an anchor pulling down business competitiveness. You talk about long term? It's going to take us a long time to get out from under that system.

Dr. Vedder. Senator, I've been sort of mystified in this hearing. To some extent, I think we're proceeding from sort of an erroneous factual basis on some of these things and I think we're overly concerned. Now I'm not saying that everything is right about our economy, and I'm not a apologist for the Bush administration's policies, some of which I would disagree with as strongly as others on this panel. But it is a fact that in November of last year there were 8,630,000 more jobs than there were 5 years earlier. Maybe globalization is a problem, but it is a fact that in the year 2006 the unemployment rate will come in as the fourth lowest in the last 37 years. That is a fact.

It is a fact that our budget deficit this year, while it is a deficit—I don't know if it's a fact, because we're in the midst of the fiscal year, but if the numbers run the way they have run in the early part of the fiscal year, it seems likely that the budget deficit this year will be less than 2 percent of GDP. That's a deficit and zero is better than 2 percent.

But 2 percent relative to modern historical experience, not only in the United States, but certainly in Europe, Japan, anywhere else, is actually on the conservative side. It's relatively modest. True, maybe it should be zero.

The trade deficit—we ran a trade deficit from 1607 to 1870, nearly every year for 263 years. The Nation somehow muddled through. And I think with respect to income inequality—Census data show that in 2005 there's no statistically significant difference in the G&E coefficient using the conventional income measures than there were 5 years ago. We should reach some common ground on what the problem is before we try to solve it.

Chairman Schumer. Thank you, Dr. Vedder.

I just want the record to show Mr. Webb has gotten 4 more minutes than he asked.

Senator Webb. I owe you for the next hearing.

Chairman Schumer. Senator Casey.

Senator Casey. Mr. Chairman, thank you very much. I don't have your book in front of me. I was going to show it if I did. But Senator Klobuchar is out advertising it, so I'll do it later.

Chairman Schumer. You can't do it too often.

Senator Casey. I do want to thank Senator Schumer for focusing the work of this Committee and especially the work we're doing here today in this hearing. I think on a very important distinction which gets lost in the translation which is growth and numbers can be presented and some of them are positive, but the different between growth and who benefits is the disconnect there and I think that's very important. It gets lost in the discussion beyond this hearing room. It's not happening today because we're focused on that.

I wanted to focus on just maybe two areas to stay within my time limit. First of all, Secretary Rubin, again I want to thank the entire panel for your great work here today, your scholarship, and your contribution to helping us better serve the people we represent.

I was struck—as a Senator from Pennsylvania having just gone through a long, long campaign, I was struck by much of what was said here this morning, some of which I missed earlier. But I wanted to focus in particular, Secretary Rubin, on your statement starting at the top of page 4 and continuing from page 3, if I'm reading it—and I don't want to simplify this too much. But I break this down as growth equals income growth plus increased security. That kind of juxtaposition of growth plus security.

I thought it was interesting and important for the people I represent in Pennsylvania that you said that we must provide workers with—quote—"the resources to access education, training, rapid deployment into the economic stream" and then you go on from there.

I thought it was important that sometimes in Washington when we're debating these issues about programs and support for workers we talk about education and training or some people talk about them as something that we're giving. It's kind of a handout, so to speak. But I appreciate the fact that you identified them as resources for those workers to bring about economic growth. I'd ask for your comment on that.

Plus, later on that page, where you talk about serious shortfalls in education, infrastructure, basic research, energy policy, and especially the last two that I'll cite here, health care policy and inner-city programs, as much as you and Dr. Summers and others have contributed to the Democratic party's better understanding that growth is good, that balanced budgets are good, and fiscal discipline is good—and I appreciate that because we don't focus on it enough as a party, I speak only for my fellow Democrats here. But I guess just a general comment on how those supports help our workers create better economic growth and, in particular, the impact of health care and focus on the inner city. I know that's broad, but if you could just elaborate on that.

Secretary Rubin. Let me try to make just a broad general statement on the inner city piece, but first I'd like to make another comment. As a general proposition, the point I was trying to make was that these are exactly what you said, Senator Casey, these are economic issues and by providing education and health care and effective energy policies and so much else, we're enabling our work-

ers to be more productive and more competitive and that, in turns, fuels economic growth.

I was also trying to make the point that if you have broad-based income growth and workers are able themselves to better access all of this through their incomes and so forth, that was the point there. Both Dr. Summers and Dr. Blinder can speak better to health care issues than I can on the specifics.

I would like to make one comment, if I may though, because I believe the inner city issues are every bit as much of an economic issue as they are a values issue. I don't think there's any question that there are tremendous productivity gains to be had if you can reduce the social costs to America by having effective programs to bring people in the inner cities back or into the economic mainstream and there are tremendous productivity gains to be had.

When I have been in China and have met with public and private sector leaders and in India as well—in both, the political leaders, the governmental leaders will say to you that one of the great economic productivity challenges for them is to equip the poor to enter the economic mainstream. We should have exactly the same focus for pure hard-headed economic reasons, and that was the point of that.

By the way, I might add that all three of us happen to be involved in something called the Hamilton Project, which has been developing a series of projects relating to all these kinds of issues.

Senator Casey. Thank you.

I wanted to ask one more in my limited time here. Dr. Summers, as you know from your work and the great work that President Clinton's administration did on returning us to fiscal stability and a path to sustain that, one of the most important things that I thought that Administration did was make a major commitment on children's health insurance. We have an opportunity this year, in my judgment—if the Congress fails to do a very good job on that reauthorization, it's not only a moral failing, I think it's a big economic failing.

So I ask in light of the fact that we now have a very solid program on children's health insurance but we also have 8.3 million kids with no health insurance at all, based upon your earlier statement about the critical impact of health care, if you could elaborate on them, on what's ahead of this Congress with regard to children's health insurance and health insurance generally.

Secretary Summers. I'm not an expert on these specific issues regarding children's health insurance, but let me make three comments that may be relevant. First, it's a basic policy problem that we all have difficulty dealing with, which is if you don't fund somebody's health insurance, to some extent they don't get health care and that's terrible.

But to a substantial extent, they get health care by going to an emergency room and getting the care and not paying for it and then we all pay for it in higher insurance premiums, in higher costs for government programs. It's a kind of stealth—the uninsured represent a kind of stealth tax increase.

When we address the problem of non-insurance, we're reducing that stealth tax increase, but we don't have good ways of taking full account of it and, therefore, we move forward with insufficient

energy. If we could always recognize that a lot of what we're doing is when we're paying for the uninsured is taking a burden off businesses, off the rest of us who pay premiums, off the taxpayers who pay for government insurance, I think we would get toward better outcomes.

Second, there are critical issues here for children for others that go beyond questions of simply the categories of insured and uninsured. I was exposed to some data not long ago on hypertension, which is an easily controllable condition with the right medical care and the right follow-up, but accounts for major gaps in life expectancy, and the particular studies that I was exposed to suggested that less than a quarter of those with hypertension in America were having it adequately and sufficiently controlled.

That's in part a matter in part of not having health insurance, in part a matter of the way the health care system functions. And the costs down the road when it is uncontrolled, in terms of disability, not to mention the moral costs, are enormous. In part, these are questions of the way in which care is organized to be provided.

The third point that I would make is that I believe—and it's not something that can be proven—that the degree of anxiety surrounding questions of health care is crucial to our capacity as a society to accept a whole set of dynamic changes that are necessary if we're to move our economy forward. So I could not imagine morally, in terms of its consequences for the premiums and the burdens all people in this society bear in terms of the ultimate impact on the ability to be educated and to be a productive member of our society, or in terms of the impact on our sense of economic security as we take on the challenges of globalization that it would be wise for the Congress to do anything other than to strongly support the reauthorization and expansion of the benefits in the child health care area.

Senator Casey. Thank you. I know we're over time, but do any of the other panel members want to follow up on that?

Dr. Blinder. If I could just say very briefly, a lot of Americans, though not all, believe that universal health care is an imperative—eventually. That we have to get there, and that it's a disgrace that we have so many Americans without health insurance. It's also economically inefficient and all of that.

But I think it starts with the view that it's a national disgrace that we have this many people uninsured. Politically, over the years, Congress has picked off the low-hanging fruit. We had Medicare; we've got a national consensus that senior citizens should not be without health care. Then we got Medicaid so poor people would not be out on the streets without health care. And then, in the nineties, we got coverage for children—but not all of them, as you pointed out.

I think, in some sense, the next logical step along the road is children. I started by saying this yellow brick road is leading eventually to universal health care. But we're doing it categorically. I think it makes all the sense in the world to not only, of course, continue to reauthorize the program we have, but to extend it to more children.

Senator Casey. Good point. Thank you.

Chairman Schumer. Thank you.

I have a bunch of things. First, to my colleagues who are here, but particularly our three freshmen who are on the Committee, I think everyone can see why the rest of us have so much faith in their coming and really injecting a lot of enthusiasm, a lot of knowledge, different perspective as we move forward.

Finally, I want to thank our witnesses. I think this was a great panel. I want to thank you, Dr. Vetter, for a forceful and lively opposition to the three big artillery here. But I want to thank our three witnesses. I think we accomplished—began to accomplish two things today. There is—as I mentioned, the President's giving his speech and he basically is saying everything is great and you're focused on some of the anxieties that average folks have in terms of income and service and everything else, I think shows, the contrast and shows that all is not well.

But second, we're attempting here to sort of lay out or begin to lay out a new vision, where do we go? I think you all put it so well, each in a different way, that we're at a real crossroads economically and the new vision we're trying to grapple with here, if I had to describe it and maybe describe what you're saying and I agree with it—accepts economic forces but acknowledges and deals with the changes that have occurred within those forces and it's the latter that the Administration hasn't done.

Now we have a real problem if we run away from economic forces. You put it one way, stop the world, I want to get off, Dr. Blinder. I put it—I wrote this in my book—you can't have water flow uphill. But you can have water down one side of the mountain rather than the other side of the mountain and our job is to make sure that we acknowledge and accept those economic forces, but also are able to use them and direct them for the greatest benefit of the greatest number of our people. And you can't ignore the changes that have occurred economically, you just can't. That's why we're at such a crossroads here. It's a different economy than it was 20 years ago or even 10 years ago when all of you served in the government in the last decade of the 20th century.

So our challenge here, as we try to develop a new vision, is to understand and accept those forces, but also acknowledge that changes have occurred and figure out the best way to deal with those changes for the benefit of our people, and you've given us a terrific first start.

I want to assure all my colleagues, present and not, that this Committee is going to pursue that vision and that goal, I think, hopefully not in a partisan way, in a bipartisan way as best we can. But the future of our country really depends on it.

We're in interesting times, as the Chinese say. Thank you.

Mr. Secretary, please.

Secretary Rubin. Could I just make one brief comment, Mr. Chairman? You made a comment before, and I'd like to suggest a slightly different framework. The panel was presenting an overly sober view of the contrast to the more optimistic view of the Administration. I actually feel—I have a slightly different way of thinking about that. I think all of us expressed a very robust view of the potential for the American economy and believe the American economy can do very well. I think what we are saying, though,

is in order to do that, we've got to recognize the challenges that relate to the economy and also relate to making sure, as you just said, that the great preponderance of our people benefit from our economy, and we need to meet our challenges.

Chairman Schumer. I think you put it better than I did. I think the challenges are sobering. But the economy itself, I like what Dr. Summers said, if you had to pick a developed country to be in, there is no question, we'd pick this one with our vigor, with our open system with immigrants, with everything we have to offer. It's simply if we put our head in the sand and ignore the changes that have occurred, it may not be that way 25 years from now. And our challenge is to begin to lay out a new vision. There are moments in history that you need to sort of—where ideas make a real difference. Then, after that, society carries along. I believe this is one of those moments and we're just at the start of it and all of you have made a real contribution toward moving us forward.

I thank you for taking the time to come and the interest, erudition and concern which you really showed for this great country of ours. Thanks. The hearing is adjourned.

[Whereupon, at 11:40 a.m., the Committee meeting was adjourned.]

Submissions for the Record

Joint Economic Committee
Senator Charles E. Schumer
Chairman

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER, CHAIRMAN

Good morning. I am pleased to open the first hearing of the Joint Economic Committee in the 110th Congress. I want to welcome Ranking member, Mr. Saxton, who was a colleague of mine when I was in the House.

I know we will have some disagreements over solutions along the way, but I hope that we will be able to develop a shared view of the problems the American people will want us to be working on. And I look forward to working closely and, dare I say, neighborly with all of you.

This is a committee that will ask difficult questions, challenge our assumptions, and seek to define our nation's economic challenges using the best minds in the Nation as our witnesses.

For much of the next 2 years, our hearings are going to focus on the middle class. That is because I believe that the middle class is the engine of the American economy.

When they are doing well, America is doing well. When they are anxious, America is anxious.

If we want to expand or reform aid to the poor, we can only do so if the middle class feels that they are prospering, moving ahead, and are secure.

If we want to expand trade because we believe it grows the economy, we can only do so if the middle class feels that they will benefit as much from our national growth as those at the very top.

This hearing couldn't come at a better time because on all of those measures, the middle class feels a bit shaky. They are not struggling to get by, but they are struggling to get ahead. They are unsure of their footing in an economy and world that is about change, technology, and disruption.

They feel they are alone to navigate the contours of change and that government isn't really helping them where they need it.

They see the economic fortunes of different groups in our economy growing apart—not together. And they are rightfully worried that this gap will widen into an unbridgeable chasm.

We all know the statistics: we went through the most prolonged jobs slump since the 1930s after the 2001 recession; productivity continued the strong trend that began in the mid-1990s, but real wages stagnated as the benefits of economic growth showed up in the bottom lines of companies and in executive salaries but not in the paychecks of most workers.

But the middle class doesn't need statistics to tell them they're on shaky ground. American families know they can't work any harder than they already do, and that for the last 6 years they have mostly run in place.

This morning, President Bush will give a "State of the Economy" address in my home state of New York. And he will try to make the case to the American public that our economy is strong and everyone is benefiting.

The President will surely point to today's news that economic growth picked up in the fourth quarter and a key measure of wages showed some real growth as well. No one is happier than me that we had a nice quarter.

But if you really spend time out in middle class America—if you descend from the 30,000 foot level to the communities of Main Street America—you know that all is not well with the middle class.

The basic successes and aspirations of middle-class life—raising a family—buying a home—paying for college—saving for retirement—are becoming intimidating hurdles for average, ordinary people.

The price of college, for example, the ticket to the middle class for future generations—has increased faster than inflation for 26 consecutive years.

So, the President is right when he says that a future of hope and prosperity in this country begins with a growing economy. But he could not be more wrong when he says that all Americans have benefited from economic growth over the past several years. The fact is that the middle class has never been so unsure of its footing since I came to Congress in 1980.

I believe that we need a new direction to promote economic growth for all Americans in the 21st century. We need to throw away the old map that has been favoring those with influence and wealth and leaving the middle class behind. Our economic fortunes need to grow together, not apart.

I said that the JEC would seek advice from the best of the best and that's what we have to offer for our first hearing.

Bob Rubin, Larry Summers, and Alan Blinder really need no introduction to people who have followed economic policy in this country over the past decade or more-although I will give them a proper introduction before they give their testimony. We also welcome Professor Richard Vedder, Distinguished Professor of Economics at Ohio University to lend us a different perspective.

I want to give the Vice Chair, the ranking member, and the senior Senate Republican a chance to make their opening statements, but I hope we can proceed quickly to our witnesses and get down to business.

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, RANKING MINORITY

It is a pleasure to join in welcoming the distinguished panel of witnesses before us today: former Treasury Secretary Robert Rubin, former Treasury Secretary Larry Summers, Professor Alan Blinder, and Professor Richard Vedder. I would also like to congratulate Senator Schumer in joining the Committee and being designated as the incoming Chairman.

The hearing today will probably cover a number of topics, including the performance of the U.S. economy. It is important to recall that in 2003, a new policy mix of accommodative Federal Reserve policy and tax incentives for investment led to a rebound of investment. The pace of economic growth picked up and employment growth rebounded. Since August of 2003, over 7 million jobs have been created, and the unemployment rate has fallen to 4.5 percent. Economic growth has generally been quite good. In 2005, the Fed referred to the "solid performance" of the economy and said that it "should continue to perform well in 2006 and 2007."

Some have criticized U.S. economic performance for producing excessive income inequality. However, according to the Census Bureau, its key measure of income inequality has been statistically unchanged since 2001. Some have also focused on slow wage growth, but many of the data used understate progress because they are based on measures that overstate inflation and exclude fringe benefits. Even so, various measures of real wages and earnings growth have been rising at a faster pace recently. It should be noted that during the 1990s expansion it also took several years before real wages and earnings increased at a strong rate.

The continued prosperity of middle income households can be facilitated by pro-growth economic policies. It would also be reasonable to examine Federal policies regarding research, personal saving and investment, education, and social safety net programs to determine what changes might be helpful. For example, I have long supported various tax incentives for personal saving and investment to provide financial security and a reserve fund for middle class investors.

However, in Congress today there is increasing support for a policy response that would be profoundly destructive to middle income families: protectionism. Protectionism would undermine economic growth, trigger international retaliation, and raise prices for middle income consumers.

Three of the witnesses before us this morning are associated with the Hamilton Project of the Brookings Institution, a project that seems designed to head off the rising tide of protectionism among the Majority in Congress. While I may not agree with the Hamilton Project recommendations, the project is a well-intended effort to fend off a very real threat to middle income families. Protectionist policies would be a very valid reason for middle class anxiety.

According to many economists, a quickening pace of technological change is more responsible for shifting employment patterns than is international trade. Thus economic policies that promote the flexibility and dynamism of the U.S. economy are the best course for improving the future of middle income Americans. As Congress examines these issues, it should avoid policies that will hamper the ability of the economy to adapt to future challenges.

PREPARED STATEMENT OF REPRESENTATIVE CAROLYN B. MALONEY, VICE CHAIR

Thank you, Chairman Schumer. I am pleased to be here at the first hearing of the Joint Economic Committee held under your leadership and I am proud that I will be the Vice Chair of the Committee. Together, we and the other members of the Committee have an exciting opportunity to take economic policy in this country

in a new direction that helps American families meet the challenge of continuing to compete and prosper in an increasingly competitive world economy.

I am pleased to welcome our witnesses, three of whom helped President Clinton preside over the longest economic expansion in our nation's history—when 22.7 million jobs were created, the unemployment rate came down to 4 percent, and families up and down the income ladder made real economic progress and had a sense of confidence in their economic future.

I am proud to have Bob Rubin as a constituent. Americans benefited from his skillful work as Treasury Secretary and they are continuing to benefit from his wise counsel about how to address the economic challenges we face. Professor Summers and Professor Blinder each have combined highly distinguished academic careers with equally distinguished careers in public service and I am pleased that they are here so that we can draw on their experience and wisdom. Dr. Vedder, I am sure that you will be coming at these issues from a different perspective, but I look forward to a serious policy discussion and competition among ideas.

The issues we are discussing today are critically important. The middle class is the fabric of our nation, but they are feeling a bit frayed at the moment. And they probably feel frustrated when they hear the President and his surrogates continually heap praise upon this country's economic performance. Many of them are probably thinking: Is the President talking about the same economy? And: If the economy is doing so well, then why am I left with this empty feeling?

When the President says his policies are working to make the economy strong and that all Americans are benefiting, he is only looking at the situation from a distance. The bird's eye may not look so bad, but the facts on the ground tell a different story.

Despite 4 years of economic expansion, job growth has been modest, wages are barely keeping pace with inflation, real incomes have fallen, household debt is rising, employer-provided health insurance coverage is declining, and private pensions are in jeopardy. These are the economic barometers that matter most to families. These are facts and figures that affect their pocketbooks.

The growing divide between the 'haves' and the 'have nots' is also tearing the fabric of our nation. A recent analysis by the Congressional Budget Office shows that the President's policies have aggravated the widening gap between the rich and everyone else in the last several years. The policies of this Administration simply do not address the problems of families trying to maintain a middle class way of life and they certainly do not address the problems of working families trying to make it into the middle class.

The American people want us to create an economic environment that produces better jobs with better pay, raises the minimum wage, makes health care and college more affordable, cuts middle-income taxes, guarantees a dignified retirement for our seniors, moves the Nation toward energy independence, and restores fiscal responsibility. In the House of Representatives, we have already acted on many of these issues, but there is much work left to do.

I look forward to the testimony of our witnesses and their thoughts on policies that can help us fulfill our promise to restore the American Dream to middle-class families.

Prepared Statement of Senator Edward M. Kennedy

In the decades following World War II, increased overall productivity and economic expansion brought an increased standard of living for Americans across the economic spectrum. It provided a strong middle class in stark contrast to today's economy where the middle class has felt more insecure than at any time since the Great Depression.

GDP is rising, productivity is up and corporations are earning record profits, but economic growth is largely leaving working families behind. Middle class wages have been virtually stagnant, while prices for essentials such as housing, health care, gas and utilities have skyrocketed. Families are exhausting their savings and falling into debt. To keep their heads above water, they put in longer hours at work or accept multiple jobs, sacrificing time with their families and jeopardizing their children's well-being.

More and more middle class jobs with decent wages and benefits are disappearing. Millions of jobs are being shipped overseas, and the new jobs being created often come with lower pay, fewer benefits, and less stability.

The American economy is becoming more and more stratified, and that threatens our democracy. The divide between the haves and have-nots is the largest since the

Depression and it's growing wider every year, putting our economy and our society at greater risk.

We need to find concrete solutions to these very real challenges that employees are facing. We need to restore their confidence that the American Dream still exists. Citizens need to believe again that we can all find a good job with fair wages and benefits that can support a family.

The Administration touts the productivity and job growth numbers to show how well the Bush economy is doing. But the vast majority of the American people know differently. The hard-working men and women of America deserve real solutions to the economic challenges that they face every day.

I commend my colleague Senator Schumer for holding this hearing on this very important challenge, and I look forward to the testimony and recommendations from this distinguished panel.

Mr. Chairman, between March and December last year, The *Washington Post* published an excellent series of ten editorials on the issue of inequality. I believe they will be of interest to all of us concerned about this issue, and I ask that the series be made part of the record for today's hearing.

[The editorials referred to follow:]

[From the Washington Post Series on inequality, Sunday, March 12, 2006; B06]

A RISING TIDE?

THIS NATION prefers not to discuss inequality. Lacking a unifying religion, ethnicity or even language, it is held together by an appealing faith: that anyone who works hard and plays by the rules can attain the American dream, sharing the fruits of economic progress. But the trends of the past quarter-century compel a reexamination of this creed. When President Kennedy promised that "a rising tide lifts all boats," he was correct. Today that claim could be disputed.

A few numbers show why. In the 25 years from 1980 to 2004, a period during which U.S. gross domestic product per person grew by almost two-thirds, the wages of the typical worker actually fell slightly after accounting for inflation. So, too, did wages for the 50 percent of the work force that earned less than the typical, or median, employee. The rising tide helped only workers at the top. Wages for workers in the 90th percentile—that is, workers who earned more than 90 percent of their peers—jumped by more than a quarter.

Other measures tell variants on this story. More women are working, so household income, as distinct from individual wages, has risen. The value of health benefits has increased, so counting these plus other non-wage income from investments also paints a brighter picture. Between 1980 and 2003, total after-tax income for the bottom fifth of households rose 8 percent, and the second-bottom fifth gained 17 percent; in other words, all boats did rise, albeit by less than 1 percent per year. But it's hard to celebrate such modest gains when the top fifth advanced 59 percent over the 24-year period.

Depending on which statistics you choose, the tide is either not lifting most boats or lifting many of them modestly. At times over the past quarter-century, commentators have hoped that this disappointing performance was temporary. Perhaps it was caused by a one-time shock from the arrival of the personal computer, which made junior clerical workers less valuable? Perhaps it reflected a one-time jump in competition from foreign workers following the creation of the World Trade Organization and the North American Free Trade Agreement? Or maybe it reflected social pathologies among the poor that could be changed by welfare reform? All these theories had their day; but after a quarter-century of disappointment, the struggles of Americans in the bottom half of the income distribution cannot be viewed as temporary.

Many argue that, as long as most households are not retreating, inequality shouldn't be a worry. The rich are entitled to the fruits of their labor: These reflect talent, hard work, risk-taking and innovation, and only an economy that rewards such things can be dynamic. This is true up to a point. But when big rewards for high achievers don't produce an economy that helps ordinary folk, the case for big rewards loses some of its appeal.

Moreover, Americans have tolerated divisions between rich and poor because they believed that anyone could get ahead, given enough talent and determination. But the truth is that rags-to-riches stories have never been the norm: One study of people reaching adulthood between 1968 and 1998 found that 42 percent of those born into the poorest fifth ended up there also. As the distance between the top and bottom grows wider, it becomes harder to traverse the gulf. Family background has a

larger impact on people's prospects. The talent of people born into poor families goes wasted.

The idea that everyone should start life with decent opportunities helped to inspire the American Revolution and the civil rights movement; it is an idea that this nation forsakes at its peril. But there are other reasons to worry about inequality. Surveys find that if you ask people whether they'd prefer to earn $100,000 in a society in which the average pay is $80,000, or $110,000 in a society in which average pay is $130,000, respondents pick the lower salary in order to feel rich in relative terms.

This isn't just irrational. Riches and poverty are partly relative concepts. The more unequal a society, the more citizens in the bottom half will experience hardship. When people at the top gain more disposable income, they bid up the prices of goods in limited supply—homes in top school districts, or places at top colleges. Tuitions at 4-year colleges have more than doubled since 1980, with the result that gaps in enrollment by class and race, which declined in the 1960s and 1970s, are as wide now as 30 years ago. The wealth of people in the top half also bids up the common understanding of what a middle-class lifestyle entails. People feel obliged to spend more on birthday gifts, children's sneakers or a suit for the next job interview. Since 1980, the median size of a newly built house has increased by a third—even while the household savings rate has fallen to about zero.

So it's not quite true that the rich can enjoy their riches without harming anyone; their money changes life for people lower down. This might not matter if inequality brought compensating gains: if the growth of relative disadvantage were offset by absolute wage rises or by social mobility. But increases in wages have been small or negative, and the United States has become less socially mobile than nations such as Sweden and Germany.

This editorial marks the start of an occasional series about inequality. We do not believe that reducing it should become the sole priority for economic policy, as the next installment will explain, and we recognize that trends in the global economy may make some rise in inequality inevitable. But the quest for a more equal society should not be smothered by protests of "class warfare." Yes, some popular remedies for inequality would backfire, stifling growth or wasting money. But there are promising policies out there, too: policies that would reduce inequality without damaging growth; in fact, policies that might boost it.

[From the Washington Post series on inequality, Wednesday, March 22, 2006; A20]

JOINING THE INEQUALITY DEBATE

THE BUSH administration seems ready to debate inequality, the subject of the occasional series that we began 10 days ago. In recent conversations with us and with the Wall Street Journal, Treasury Secretary John W. Snow has described inequality as "the new sort of battle line in the political arena," suggesting that this may have something to do with desperation among the administration's critics. The way the secretary tells it, economic pessimists used to gripe that the economy was not growing; then, when the economy accelerated, they grumbled that growth was not producing jobs; now, with unemployment down at 4.8 percent, they protest that jobs aren't paying enough to ordinary folks. Mr. Snow, for his part, is an optimist. "We may now be at a tipping point for higher real wages going forward," he told us.

The secretary bases his optimism partly on short-term arguments. He correctly points out that declines in unemployment are generally followed by increases in wages; given that joblessness has declined from 6.3 percent to 4.8 percent during the current recovery, wages may indeed rise over the next year or so. But the question is whether these gains will dent the long-term pattern of stagnation. For the bottom half of the workforce, wages have actually fallen since 1980 after accounting for inflation. Although it's true that households have done better, this is not exactly comforting. The gain in income for the typical household, about a fifth since 1980, has been smaller than the increase in the household workload. Since 1980, the number of hours worked by the average husband-and-wife team has increased by a quarter, as more women have entered the labor force.

In his conversation with The Post, Mr. Snow drew attention to an apparent fall in inequality between 2000 and 2003. In 2000, according to data compiled by the Congressional Budget Office, the top fifth of households pocketed 51.3 percent of all post-tax income; in 2003 they pocketed 48.8 percent, allowing the rest of the country to increase its share of the pie. But this isn't the basis for optimism that Mr. Snow supposes. The top fifth lost ground for 2 years after 2000 because they stopped cash-

ing in on the stock market bubble. But between 2002 and 2003 their share of national income rose again, a fact obscured by Mr. Snow's choice of statistics; the numbers for 2004 and 2005 have not yet been crunched. Besides, Mr. Snow's focus on 3 years' worth of data should not distract him from the bigger picture. Between 1980 and 2003, the top fifth of households increased their share of national income by 6 percentage points.

At other times in the conversation, Mr. Snow accepted that inequality has grown over the long term but sought to explain it as the natural product of market forces. It's true that the "star system" has grown more pronounced in many professions, from sports to medicine to academia: Globalization has allowed top performers to attract a global following, driving remuneration up. But if this is a big reason for inequality, as indeed seems likely, one should expect the gap between the stars and the majority to grow even more in the future—globalization is not about to go away. Far from providing a reason to embrace inequality as "natural" and therefore, presumably, acceptable, Mr. Snow's argument underlines why inequality is a rising social challenge that policymakers must reckon with.

Mr. Snow indicated an open-mindedness on these issues, which is a good thing. "I want to get deeper into the data because it's a very important question," he said of wage disparities. We look forward to the debate.

This is the second editorial in an occasional series on inequality.

[From the Washington Post series on inequality, Sunday, April 2, 2006; B06]

The Case for Economic Growth

It may not lift all boats as it used to, but it's still essential.

FOR PERHAPS half a century, the central preoccupation of economic policy has been to promote growth. Until 1980, the reasons for this were evident: Expanding national output boosted everybody's living standards, and advancing living standards were presumed to underwrite that most American of occupations, the pursuit of happiness. Yet the cult of gross domestic product is now open to question. Because of rising inequality, growth is a less reliable provider of higher living standards to most Americans, as earlier articles in this series have noted. And a new area of research, blending psychology and economics, challenges the assumed connection between income and happiness.

Despite headlong growth in rich countries since 1950, there has been no rise in the share of people who describe themselves as "happy" in opinion surveys. So what, you might say; how can people accurately report on such a fickle and subjective mood?

Well, self-reported happiness can be cross-checked by asking friends and colleagues how happy someone is, and neuroscientists have figured out how to measure the experience of good feelings in the left front of the brain. People who say they are happy do turn out to be objectively happy. The stature of this new science was recognized 4 years ago when one of its founders, psychologist Daniel Kahneman, received a Nobel Prize in economics.

The evidence from this new science is unsettling for advocates of growth. It shows that as nations escape poverty they benefit greatly; progressing from African-style penury to the condition of South Korea or Portugal entails huge jumps in happiness. But once nations pass the $10,000-per-person mark, roughly a third of today's level in this country, the happiness payoff ceases. Individual Americans can still grow happier by becoming richer, because it feels good to do better than the neighbors, but society as a whole can't raise its income relative to itself. As a national objective, therefore, GDP growth no longer makes such obvious sense.

An impressive range of thinkers, from Benjamin M. Friedman, a former chairman of Harvard University's economics department, to British economist Richard Layard, has accepted this critique of growth. We would not go as far as they do: Even if a higher national income does not measurably raise human happiness, it will expand opportunities to travel, learn, yak with grandma on her cellphone—surely this is worth something? Moreover, there remain two other reasons to care about growth.

The first comes from Mr. Friedman: It's that as Americans get richer relative to their past, forward momentum makes them optimistic and tolerant: They expect life to get better, so they act more generously toward racial minorities, immigrants and the poor. In a recent book on this subject, Mr. Friedman has argued that steady economic growth promotes enlightened social policies. In the late 19th century, stagnation in the American South created the conditions for the reimposition of segregation. In the 1960s, galloping growth created the conditions for civil rights legislation

and the Great Society programs. Perhaps if France were growing more robustly, it would not have experienced the riots and demonstrations of the past few months.

The other argument for growth is a particularly American one: To exercise global leadership, the United States needs financial clout. In a narrowly economic sense, it's great if foreigners catch up to U.S. living standards; this means richer markets for American products, so everybody gains. But in a political sense, a loss of economic preeminence would be crippling—both for American statecraft and for the enlightened causes that it defends. The world relies on the United States to secure the world's sea lanes, lead the push for trade liberalization, fight international diseases, contain terrorism and stabilize failed states. The rise of China, with its vast population and illiberal values, underscores the importance of U.S. vitality.

In sum, the case for economic growth remains convincing, but policymakers need to balance its pursuit with a concern for equity. Mr. Friedman's argument—that growth can cause a society to feel more optimistic—depends on the sharing of its benefits. Equally, our sense that higher incomes expand the range of human experience, even if they don't expand the sum of happiness, carries weight only if the boost to incomes is broadly shared. The policy challenge, therefore, is to promote growth while also promoting equity. That is where this series will go next.

This is the third editorial in an occasional series on inequality.

[From the Washington Post series on inequality, Sunday, April 23, 2006; B06]

DO NO HARM

Some remedies for inequality would be worse than the disease.

INEQUALITY IN the United States has been growing for a generation. The top fifth of households enjoyed post-tax incomes worth 6.7 times those of the bottom fifth a quarter of a century ago; that multiple has since jumped to 9.8, a 46 percent increase. But this distressing trend hasn't forced the right policy response, in part because advocates of equity are often their own enemies. Some of their proposed remedies would be ineffective, wasteful or harmful to the economy.

One unproductive critique of inequality targets corporations for cutting wages and benefits. Companies must respect market forces: If they pay workers more than is necessary to keep them, they will lose out to competitors, as thousands of jobless car workers can testify. You can debate whether government should force all companies to increase pay or benefits—by raising the minimum wage or by requiring employers to offer health insurance, as Massachusetts has just done. You can talk about fairer government enforcement of the collective bargaining rights of workers or opportunities for shareholders to control executive salaries. But to blame corporations for ripping up the social contract is to misunderstand their function. Firms began offering workers health coverage because government controls capped what they could offer in wages; now that wage controls are history, the health plans that companies provide reflect tax rules. So politics and government create the social contract; it is not managers' place to do so.

The next sort of blunt critique calls for policies that sound good but don't work. Cracking down on immigration, for example, is no solution. Tough enforcement is expensive, harsh and doomed to be at best partially effective; moreover, the best economic studies predict that it would lift the pay of unskilled natives imperceptibly if at all. Equally, economists find no evidence that tax-privileged empowerment zones in depressed areas boost local wages, though this didn't stop President Bush from proposing a "GO Zone" (Gulf Opportunity Zone) as part of his response to Hurricane Katrina. The same applies to tax credits for employers who hire people on welfare or food stamps; in at least two-thirds of cases, firms that hire such workers don't even know they are eligible for the tax break, according to studies by Sarah Hamersma of the University of Florida. Training programs for jobless youths also have a disappointing record: They boost future earnings of participants marginally and may do so at the expense of youths who don't attend the sessions. Because they achieve so little, all these interventions set back the fight against inequality by making it seem wasteful or futile.

The most pervasive and misplaced reaction to inequality is protectionism. Trade liberalization since 1945 has delivered a vast stimulus to growth, boosting U.S. incomes by $1 trillion a year, according to an extensive survey of the evidence by the Institute for International Economics. It's true that these gains are unevenly distributed, but the skewing is subtle. Unionized labor in the heavily traded manufacturing sector has been hit hard. But the poorest and least skilled Americans actually gain from trade, because they tend to work in low-end service jobs that do not

face foreign competition. As a result, trade does nothing to depress their pay, but it does ensure that the goods they buy are cheaper.

Moreover, additional trade liberalization would help the poor, because the nation's remaining trade barriers are regressive. Cheap sneakers are subject to a tariff of 48 percent, whereas expensive leather shoes face a border tax of 10 percent. Polyester underwear attracts a tariff of 16 percent, while fancy silk underwear glides into the country with a tariff of 1 percent. Edward Gresser of the Progressive Policy Institute calculates that residual trade barriers cost a low-wage working mother 2 percent of her income, four times more than the impact on a high-income family.

So protectionism would have disastrous consequences for growth and would help limited numbers of exposed workers rather than the majority of poor and middle-income families. But the pressure to close borders, bash corporations and experiment with ineffective social programs will continue until government addresses inequality in a serious way. The next installments in our series will suggest how to do this.

This is the fourth editorial in an occasional series on inequality. Previous editorials in the series may be found at http://www.washingtonpost.com/inequality

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[From the Washington Post series on inequality, Sunday, May 7, 2006; B06]

THE TOP TAKES OFF

That rhetoric about giveaways for multimillionaires? It's accurate.

THE QUEST for ways to reduce inequality begins with taxation. Unlike spending programs, redistribution through taxation is administratively simple; besides, putting money directly into people's pockets allows them to spend it on whatever they need most. But the tax tool has been wielded badly. Rather than using it to offset rising inequality, politicians have contrived to do the opposite.

The Bush administration refuses to acknowledge this extraordinary fact. It argues that the tax system has grown more progressive because the rich provide a larger share of government revenue than in the past. But this isn't because tax rates for the rich are higher; it's because the pretax earnings of the rich have taken off. While the income of the families in the middle fifth of society has grown 12 percent since 1980, the income of the top tenth has grown 67 percent, and the income of the top 1 percent has more than doubled. In short, the rich have grown a whole lot richer: That's why they pay a larger share of total tax.

The administration also argues that the Federal income tax is already progressive enough. Thanks to the earned-income tax credit and Mr. Bush's refundable child credit, almost a third of tax filers pay either zero income tax or less than zero—meaning that they take money out of the system. But it's nonetheless true that the income tax is less progressive than it used to be. People still have to pay the regressive payroll tax. And changes to the estate tax must be factored in as well.

Our chart shows the combined effect of the Bush tax cuts. It leaves no doubt that the tax system has become less progressive, even as the need for progressivity has grown. Over the past quarter of a century, the tide of the American economy has failed to lift the bottom half of society, damaging the faith on which capitalism depends. Seven out of ten say the Nation is headed in the wrong direction even though economic growth is galloping, and many are hostile to trade, immigration and big business. But rather than crafting a tax policy that responds to those sentiments, the administration has done the opposite.

The chart makes a second point. The loss of tax progressivity has not occurred in the middle of society; it's not as though someone a quarter of the way down the income scale is doing better at the expense of someone three-quarters of the way down. Rather, it's the top tenth who have benefited, and the top within the top has done fabulously well. According to Thomas Piketty of the École Normale Supérieure in Paris and Emmanuel Saez of the University of California at Berkeley, the top 0.01 percent of households has seen its tax bite fall by 6 percentage points since 2000 and by an astonishing 25 percentage points since 1980.

It's clear that some of these changes should be rolled back. Yes, raising taxes on the rich can mean more evasion and duller incentives. Some footloose financiers might leave the country. Some managers might spare themselves the heartache of restructuring companies if their performance-linked bonuses were subject to high taxes; they might prefer to coast along comfortably—as many do in Europe or Japan and as many did in the United States of 30 years ago. But the risks of raising taxes have to be weighed against the risks of not raising them. Inequality is not only bad in itself; it also will intensify pressure for bad policies that threaten growth more acutely than higher taxes would.

Economics cannot predict how high taxes can be raised before they reach counter-productive levels. But it would almost certainly be safe to increase taxes on the top 1 percent by 5 percentage points, restoring the level of the mid-1990s—hardly a period of lethargic chief executives. This tax hike would raise $85 billion annually or perhaps a bit less if it spurred some extra tax evasion; sharing that revenue among the bottom three-fifths of households would give each family $970 a year. That would be a big help to families at the bottom, but it would deliver a boost of less than 3 percent to the median household.

To remedy stagnant middle-class living standards, more radical tax hikes would be necessary. But given that taxes will have to increase anyway because the budget deficit is running at around $300 billion, raising more than $85 billion for the purpose of redistribution is possible only if it's part of a wide-ranging tax reform.

Which brings us to the possibility of closing loopholes in today's tax system. Closing loopholes that allow people to shelter income does not dull incentives, because it does not raise tax rates on the additional income people earn by putting in an extra effort. Meanwhile, closing loopholes does reduce the time Americans devote to gaming the tax code, freeing their energy for more productive things. Since the rich make greatest use of loopholes, closing them is good for equality and good for efficiency. The next editorial in this series will explore some of these win-wins.

This is the fifth editorial in an occasional series on inequality. Previous editorials in the series may be found at http://www.washingtonpost.com/inequality.

[From the Washington Post series on inequality, Sunday, June 4, 2006; B06]

A PLAN FOR MR. PAULSON

An economic agenda that might bring both parties together.

IN ACCEPTING President Bush's invitation to serve as Treasury secretary, Henry M. Paulson Jr. is said to have extracted a promise that he will be more than just a salesman for policies devised in the White House. So the big question is: How will Mr. Paulson use his clout? He is not going to reverse the administration's tax cuts; unfortunately, neither he nor Mr. Bush has any appetite for that. He is unlikely to tackle entitlements; unfortunately, congressional Democrats showed in last year's Social Security fight that they will frustrate any such effort. But if Mr. Paulson really has authority to push sound policy regardless of any misgivings of political operatives in the White House, he should focus on tax reform. Done right, this could be good for economic growth and for social equity. Indeed, it could correct the central failings in the administration's economic record: its indifference to long-term budget deficits and to the accumulating evidence that a rising tide no longer lifts all boats.

The goal of tax reform is to rationalize the deductions that clutter the tax code. There are tax incentives to encourage saving for retirement and education; to promote home ownership; to buy medical and life insurance; to own municipal and local bonds; to give to charities. Not all these tax breaks achieve what they are supposed to: Britain and Australia have no subsidies for home ownership in their tax codes, yet Britain has the same rate of home ownership as the United States and Australia has a higher one. But besides being sometimes ineffective, tax incentives are often scandalously regressive. According to the Congressional Joint Committee on Taxation, in 2004 more than 55 percent of mortgage-interest subsidies went to taxpayers with an income of $100,000 or more, even though that group represents only 12 percent of tax filers.

Tax incentives to buy health insurance are also egregious. In 2004 the 12 percent of households in that $100,000-plus group pocketed 27 percent of the tax breaks for health spending. These subsidies cause people who would buy health insurance anyway to choose overly inclusive Cadillac plans, which in turn fosters indifference to medical prices; the resulting boost to health inflation puts insurance beyond the reach of some lower-income workers. According to Treasury estimates, the ranks of the uninsured could be reduced by 1 million to 2 million if Cadillac plans lost their privileged status. Capping tax deductions for health insurance at around $11,000, a level sufficient to purchase an ordinary family plan, would simultaneously prevent affluent workers from shortchanging the Treasury by overspending on doctors.

Tax incentives to promote retirement savings cry out for reform also. In 2004, 49 percent of subsidies for IRAs, 401(k)s and other defined-contribution pensions flowed to the richest one-tenth of households, according to analysis done by the nonpartisan Tax Policy Center; the bottom two-fifths got only 3 percent of the subsidy. This upside-down system, in which savings incentives are directed at the people who least need them, is economically inefficient as well as socially unfair: Affluent households

capture the subsidies by putting money they would have saved anyway into tax-favored accounts, so national savings are unchanged. Meanwhile households that are not saving don't get an adequate incentive to do so: A chance to boost national savings is squandered.

Badly designed tax breaks are not a marginal problem. Taken together, incentives in the tax code reduced Federal revenue by a stunning $730 billion in 2004, according to the *Government Accountability Office*. That's the equivalent of nearly one-third of Federal spending; it's more than three times the cost in 2005 of all the Bush tax cuts and seven times the annual cost of the wars in Iraq and Afghanistan. Eliminating just a quarter of these subsidies would generate twice as much money for redistribution as an increase of 5 percentage points in tax rates for the richest 1 percent, a measure we proposed in a previous *editorial* in this series.

Of course, some tax breaks either cannot or should not be eliminated, but they should at least be reformed. Many take the form of deductions: Taxpayers subtract privileged types of spending from their income before calculating what tax they owe. The value of these deductions depends on your tax bracket: The richer you are, the higher your bracket and the more valuable the tax subsidy. Converting these deductions into refundable credits that are worth the same to all taxpayers would reduce inequality sharply. Thus a poor family that pays no income taxes currently gets no tax subsidy if it puts, say, $2,000 into a retirement plan, whereas a rich family in the 35 percent tax bracket gets a Federal subsidy of $700. Under a recent *proposal* that replaces deductions with credits, both families would get $600.

This sort of reform ought to attract support from both parties. Republicans should favor curbing wasteful subsidies because the alternative is higher tax rates. Democrats should seize the chance to refashion a regressive class of government programs and thus counter the forces of technology and globalization that are deepening inequality. Judging by the administration's rhetoric, which includes a number of creative claims about the progressive impact of the tax cuts, it should embrace both arguments for reform. Opposition will come from special interests that benefit from tax loopholes—real-estate developers, mortgage lenders, health insurers and so on.

Those special interests have a powerful voice in politics, which is why the Bush administration has yet to act on last year's sensible proposals from its own tax-reform commission. But now, at least according to the spin from the administration, there is a brand-new Treasury secretary with the power to push serious policy ideas. We look forward to discovering whether that spin has substance.

This is the sixth editorial in an occasional series on inequality. Previous editorials in the series may be found at http://www.washingtonpost.com/inequality.

[From the Washington Post series on inequality, Wednesday, October 11, 2006; A18]

GLOBALIZATION AND SCHOOLS

It's time to recall Martin Luther King's challenge.

BACK IN 1979, the average worker with a college degree earned 75 percent more than the average high school graduate. Because of technology and globalization, the gap has leapt to 130 percent. This rising "college premium" does much to explain the growth of inequality over the past generation, so any serious response to inequality must make access to college broader and fairer. It should be broader because a higher rate of college attendance would share the fruits of globalization more widely. It should be fairer because, if the prizes for attending college are growing, it's essential that everyone begin life with a decent shot at winning them.

Because education boosts economic growth, and because it threatens no powerful lobby, virtually everyone claims to support it. The question is how it should be improved. Some commentators, pointing to the fact that schools in low-income districts already spend more per pupil than schools in affluent ones do, argue that failures at poor schools reflect complacent management rather than a lack of resources. Signaling at least partial acceptance of that theory, the Bush administration has tried to improve schools by holding them accountable and subjecting them to competition. Choice and accountability are attractive in principle, but studies of voucher programs in New York City, Milwaukee and Cleveland have found negligible gains from them. Costlier interventions must also be part of the solution.

The first opportunity for extra investment in education comes when children are young. That's when they are most malleable and when poor children start to fall behind: Even at age 3, researchers find class-based differences in linguistic and emotional maturity. The Federal Head Start program, bolstered by a variety of state preschool programs, has succeeded in reaching many poor 3- and 4-year-olds. In 2001, 49 percent of 4-year-olds whose mothers were high school dropouts attended

some type of preschool program, up from 36 percent a decade earlier. But that participation was still way below the 70 percent rate for children of college graduates. And the quality of many preschool programs is poor.

Head Start requires that only half of its teachers have 2-year college degrees. In contrast, a 1960s experiment in Michigan known as the Perry Preschool program provided a fully qualified teacher for every six or seven students, and teachers visited each child at home weekly. The program raised IQ test scores by eight to 10 times the increase achieved by Head Start. It also reduced the likelihood that a student would require special education (by 43 percent), drop out of high school (by 25 percent) or be arrested (by 50 percent). A range of other studies, including recent ones in Michigan and Chicago, confirms that high-quality programs have lasting effects on poor children. Upgrading the 900,000 children in Head Start programs to something like the Perry program might require around $2 billion a year, according to W. Steven Barnett of Rutgers University. But quality preschools reduce spending on special education, jails and welfare, saving money for society in the long term.

Early intervention would help schools from kindergarten through 12th grade do their job properly, since teachers would face fewer students who can't keep up. But it also makes sense to invest in K–12 education directly. Although it's true that low-income districts already spend more per pupil than do rich ones, this slight advantage is swamped by the challenge of teaching poor children, who on average have more discipline problems and require more remedial attention—and will continue to do so even if preschool is improved. Because of the challenge of teaching poor children, the higher cost of special education and other factors, schools in low-income neighborhoods have less-experienced teachers and worse facilities than do schools in affluent ones, according to research by Cecilia Rouse of Princeton and Lisa Barrow of the Federal Reserve. These schools might spend more money per pupil, but they lack more money per pupil, too.

Which K–12 investments would be effective? Smaller classes are a leading candidate: A Tennessee experiment that divided pupils into classes of differing size in kindergarten and then returned them to regular-size classes in third grade found benefits from smaller classes that persisted to high school. Improving the quality of teachers is also likely to boost performance, though teacher quality is not necessarily linked to teacher certification. Publicly funded summer school could make a difference. The performance gap between privileged and poor children appears to be linked to the way they spend their summers, with the privileged attending enrichment programs while the poor are underoccupied.

Nearly 30 years ago, Martin Luther King Jr. declared that the challenge for schools is "to teach so well that family background is no longer an issue." By increasing the rewards for education, globalization has added urgency to King's argument, but globalization paradoxically creates a temptation to ignore him, too. By driving down the cost of tradable goods such as cars and DVD players, it leaves untradable ones such as education looking expensive. There's a tendency for policymakers to say that education spending is growing a bit faster than inflation—isn't that generous enough? But inflation is low partly because globalization brings us goods from cheap foreign suppliers. The economic challenge posed by those cheap foreign suppliers is precisely the reason we should invest more in our children.

[From the Washington Post series on inequality, Wednesday, December 13, 2006; A20]

INEQUALITY AND HEALTH CARE

Two fixes for middle-class insecurity

THE RISE of inequality over the past generation calls for a rethinking of tax and education policies, as earlier editorials in this series have said. But it also calls for reform of the health system. Because of a historical accident—wage controls during World War II drove employers to compensate workers with perks such as medical insurance—the health system is tied to corporations. This exacerbates inequality.

In most countries, rising medical costs are shouldered by taxpayers. Because tax systems are progressive, this means that the extra cost is borne by those who can afford it. But in the United States, where health spending per person has doubled since 1975 (after adjusting for inflation), the non-poor and non-elderly are expected to pay their own way. This is most clearly the case for Americans who lack a company health plan and must pay directly out of pocket. It's increasingly the case for Americans who have corporate coverage that comes with high deductibles and co-payments. But even workers who have generous, all-you-can-eat health plans end up paying indirectly, since their wages are held down to offset the cost of the plans.

This individualistic system goes a long way toward explaining the "middle-class squeeze" so frequently invoked on the campaign trail. Workers' total compensation may be rising, but health benefits gobble up an increasing share of that, so wages lag. Equally, out-of-pocket medical expenses are believed to cause at least 425,000 bankruptcies annually, and one in six working-age adults carries medical debt.

The U.S. health system distributes risk as unforgivingly as cost. Because health care comes courtesy of the human-resource policies of big companies, anyone who gets pushed out of a big company may lose coverage. According to Yale's Jacob Hacker, 82 million people, or one in three non-elderly Americans, went without health insurance at some point during the 2 years beginning in 2003. As more companies drop coverage, the prospect of losing health care will be a growing source of anxiety for all but the most financially secure Americans. This will reduce people's willingness to change jobs or set up their own ventures. The flexibility of the workforce, one of this nation's traditional economic trump cards, may be compromised.

HOW TO DEAL with the twin problems of insecurity and squeezed pay? The answer starts with a fix for the insurance market that serves individuals and small firms. As health insurance has grown more expensive, young and healthy individuals, or small firms that employ mainly young and healthy individuals, have chosen to go without coverage. As low-cost patients leave the insurance pool, health plans are left with older, sicker people, which forces them to raise premiums further—which in turn drives more young and healthy workers to exit. Because of this vicious cycle, health insurance for individuals and small firms has become prohibitively expensive. Even among workers earning the median wage or higher, an astonishing 19 percent of 35- to 44-year-olds lack insurance, a near doubling of the percentage in 1979.

The best-known solution to this problem is the Massachusetts health reform, enacted earlier this year. This approach prevents healthy individuals from dropping out of the insurance pool by mandating that everyone buy coverage; it promotes affordability by subsidizing individuals who are at or below 300 percent of the poverty line; it ensures that coverage is available by allowing people to buy into the plans that are currently offered to Medicaid patients. There are other ways to achieve the same objectives. Rather than mandating individual coverage, taxpayers could cover part of the cost of insuring sick individuals, thereby driving premiums down and enticing healthier people to buy insurance. Rather than allowing individuals to buy into Medicaid, states could invite them to buy into the health plans that are offered to state employees. Whatever the precise formula, some fix for the insurance market should be adopted by all states. Or it could be done nationally by allowing people to buy into Medicare or into the health system for Federal employees.

This reform would make insurance available for everyone. It should be affordable: The current system, in which 47 million go without insurance, is wasteful as well as shameful because it obstructs the use of cheap preventive medicine and funnels people into expensive emergency rooms.

But promoting universal insurance may be easier than reining in the costs that cause the middle-class pay squeeze. However strange it is that health care should have grown out of corporate compensation policies, switching to an entirely tax-financed system (euphemistically known as "single-payer") may be politically infeasible at this point. The challenge is to graft cost-cutting reforms onto the public-private jumble that is the U.S. system.

The Bush administration's approach is to turn patients into cost-conscious consumers by steering them into high-deductible plans. The idea is that when people pay out of pocket for health care, they will refuse to overpay for it; witness the dramatic fall in the price of procedures that insurance does not cover, such as Lasik eye surgery. But this approach has a cost—it shifts more risks directly onto individuals—and the benefit is smaller than advertised. Consumers can't be expected to start researching which doctors offer good value for the money when they face a medical emergency, and emergencies account for a large chunk of health spending. Besides, major medical events are likely to cost more than the deductibles of even high-deductible policies, so patients would still have little incentive to shop carefully for surgery and other big-ticket procedures.

SO A SHIFT to out-of-pocket spending can only discipline medical costs up to a point. A better approach is for insurers to take the lead on price discipline. Back in the 1990s, this meant health maintenance organizations crudely denying care and turning themselves into pariahs. But the cost containment of the future could be smarter and more palatable if government encouraged doctors to maintain electronic records.

Consider one cost in the system: the overuse of diagnostic tests. At present, doctors order these tests because they perceive (maybe wrongly) little medical downside to doing so; insurers resist them because they are expensive. But if detailed patient

records allowed researchers to measure the benefits of doing tests on certain types of patients, this dispute could be resolved intelligently. Data on millions of cases, stripped of personal information to protect privacy, could show whether patients with herniated discs gain anything from MRIs, or whether whole-body CAT scans achieve anything. Equally, the data could show which sorts of patients benefit from a brand-new anti-inflammation drug and which will do fine on cheap ibuprofen. In this way the medical system could switch from the indiscriminate use of expensive new technology to a more targeted approach based on evidence.

The health system is a huge problem in its own right, irrespective of inequality. The United States spends almost twice as large a share of its economy on health care as do other rich countries, yet it still has lower life expectancy; it still has 47 million uninsured; and future health costs threaten crippling budget deficits. But the rise of inequality provides an extra reason to tackle the health challenge. Struggles with medical bills and fears of losing coverage are at the root of middle-class anxiety, and that anxiety creates pressure for misguided populist policies that would spread the dysfunction of the health system to the broader economy. So long as a third of the workforce lives in fear of losing access to doctors, nobody should expect the Nation to believe that a rising tide is lifting all boats.

This is the eighth editorial in an occasional series on inequality. Previous editorials in the series can be found at http://www.washingtonpost.com/inequality.

[From the Washington Post Series on inequality, Friday, December 22, 2006; A32]

JUST CAPITALISM

Not all attacks on business are crazy. Here is the sane version.

THIS SERIES has described ways to address inequality: Increase tax progressivity; invest more in education; reform health care. But there's pressure to reach beyond that: to tackle inequality where it apparently originates, meaning the workplace. This pressure can be dangerous. Companies are not instruments of social policy; their first duty is to make money by serving customers, and they can provide for their workers only so long as they do that. Nevertheless, two sorts of corporate reform are warranted. It should be easier for labor unions to organize. And it should be harder for top executives to pay themselves outlandish sums.

Union membership has fallen from 20 percent of the workforce in 1980 to 13 percent in 2005, and part of this decline is inevitable. It reflects attrition in the manufacturing industries that are most easily organized. It reflects the rise of sophisticated human resource departments that provide workers with training, savings plans and grievance procedures—usurping some of unions' traditional functions. And it reflects the deregulation of domestic industries such as trucking and airlines, plus tougher foreign competition. These forces spur businesses to innovate, but they also constrain their ability to make wage concessions to unions. In competitive markets, companies will pay workers what it takes to prevent them from being lured away by rivals—and not more.

Yet the decline of organized labor also reflects a legal climate that is neither inevitable nor desirable. The way labor law is enforced now, employers can block attempts to establish unions by intimidating workers; a supervisor can summon an employee to daily meetings to discuss the dangers of unions or ban discussion of a union during work hours. If these tactics are not enough, employers can fire union organizers; although this is supposed to be illegal, the penalties are too feeble to serve as a deterrent. Meanwhile, a series of decisions from the National Labor Relations Board has narrowed the definition of workers who are eligible for union membership. Two months ago, for example, the three board members appointed by President Bush outvoted the two appointed by President Bill Clinton in ruling that relatively junior workers can be defined as "supervisors," thus restricting their right to join a union.

A fairer legal climate might reduce inequality slightly. According to David Card of the University of California at Berkeley, de-unionization explains about 15 percent of the increase in wage inequality among men over the past quarter-century. But the larger gain from reforming labor law would be political. Freedom of association is a core democratic right, and polls suggest that between 30 and 50 percent of nonunion workers would choose union representation if they had a chance to vote for it. The suppression of freedom of association is wrong in itself, and it fosters the suspicion that the rules of the economy are rigged against workers. Setting aside the debate over how much union membership can improve wages or benefits, the option of union membership is crucial to the legitimacy of capitalism.

The same goes for rules on executive compensation. Since 1970, the pay of chief executives has jumped from less than 30 times the average wage to almost 300 times that level. This helps explain why the richest 1 percent of Americans pocketed 21.6 percent of all the gains in national income between 1996 and 2001, according to Ian Dew-Becker of the National Bureau of Economic Research and Robert J. Gordon of Northwestern University. As with the decline of labor unions, some of the rise in executive compensation reflects market forces and is inevitable. Yet similar market forces are at work in other advanced nations, where executive pay has grown more modestly. In 2003, the ratio of U.S. chief executives' pay to that of manufacturing workers was more than double the norm in 13 other rich countries.

This reflects the way that bosses' pay is often set in the United States. Chief executives negotiate with a committee of board members whose independence is sometimes suspect, whose personal interests (particularly if they are CEOs of their own companies) may be served by rising executive-pay scales and who see little upside in risking a fight with the chief executive. In the absence of real discipline from compensation committees, CEOs can get away with pointing to the typical pay rate in their industry and asserting that they deserve a little more. The result is an inflationary spiral in executive compensation, unhinged from CEOs' real contribution to firms' performance.

What proportion of bosses' pay should be regarded as excessive? In a paper published last year, Harvard's Lucian Bebchuk and Cornell University's Yaniv Grinstein take a careful look at this question. They begin by noting that executive pay was already raising eyebrows back in 1993 and that it has nonetheless grown mightily since then. Then they observe that sales and profits of top companies have risen, which would tend to cause the bosses' pay to rise in tandem; and that an increasing share of the top companies are new-economy outfits, which tend to pay more. By analyzing the statistical relationship between executive pay and firms' size, profits and product mix, Mr. Bebchuk and Mr. Grinstein calculated how much compensation could have been expected to rise between 1993 and 2003. Their result: In 2003 the top five executives at the average public company could have been expected to earn a collective $6 million—but they actually received almost twice that.

Overall, that means that the 1,500 companies studied "overpaid" a total of $8.7 billion in 2003—and this number is an understatement because it leaves out executive pensions, which are thought to have grown especially dramatically. If corporate governance reforms reestablished discipline over executive compensation, that excessive pay might shrink a bit. Inequality would decline, though only slightly—the money would flow to shareholders, and more than three-quarters of all stocks are owned by the richest 10 percent of the population. But, as with labor law reform, the chief gain from corporate governance reform would be political. Executive overpayment running into the billions sends a terrible signal about the justice of the capitalist system.

Most critics of business are misguided. It is wrong to denounce managers who relocate factories to other countries or who fight to control wages; they are responding to market signals, as indeed they should. But when managers distort market forces by rigging the legal environment, that is a different matter. An entire industry of consultants exists to advise companies on how to avoid recognizing a union; a second industry of consultants exists to legitimize super-sized executive pay. Until this changes, the growing material inequality in the Nation will be compounded by the corrosive perception that the rules are unequal, too.

This is the ninth editorial in an occasional series on inequality. Previous editorials in this series can be found at http://www.washingtonpost.com/inequality.

[From the Washington Post Series on inequality, Sunday, December 24, 2006; B06]

SEIZE THE CHANCE

The politics of inequality have shifted. Now policy must follow.

THIS SERIES opened with the observation that Americans prefer not to discuss inequality. Nine months later, the climate has changed. John W. Snow, who served as Treasury secretary until July, broke ground for this administration by acknowledging that inequality was worth debating—though he never quite conceded it was a problem. His successor, Henry M. Paulson Jr., forthrightly declared that "amid this country's strong economic expansion, many Americans simply aren't feeling the benefits." Meanwhile, Ben S. Bernanke, installed by President Bush as Federal Reserve chairman, has called for the fruits of globalization to be distributed more evenly. During his 2000 Presidential campaign, Mr. Bush quipped that his base consisted of the "haves and the have-mores." We doubt he would make this joke now.

The question is whether the new climate will lead to a policy breakthrough. Some of the Democrats who unseated incumbents in the midterm elections—notably Sens.-elect James Webb in Virginia and Sherrod Brown in Ohio—campaigned on the issue of inequality and feel that they have a mandate for action. But the action they emphasize is trade protectionism, which would harm growth without necessarily reducing inequality. Higher tariffs might help workers in struggling manufacturing companies, but they would push up prices for workers in the service sector, which includes janitors, fast-food workers and other low-income employees.

The field is therefore open for leaders in both parties to come up with better ideas. This series has suggested several options and explained their policy merits. But we also believe that our proposals are politically marketable.

Take our suggested tax increase: A 5-percentage-point increase in the rate paid by the top 1 percent of households. Members of Congress appear to believe that calling for a tax increase—any tax increase—is political suicide. But can it really be true that voters are wedded to all of the tax cuts enacted this decade, even though the richest 1 percent stand to pocket more than a third of the windfall? By definition, the tax increase we suggest would not affect 99 percent of households, and it would not damage growth either. It would merely restore the top rate that existed in the 1990s—a period when the U.S. economy performed excellently.

The same goes for tax reform, another policy endorsed in this series. Members of Congress may think they'll be skinned alive for messing with mortgage-interest deductions or tax shelters for savings. But what if they explained that half the benefits of these schemes flow to the richest tenth of households? What if they promised that the majority of voters would keep their tax breaks, and only those with mortgages of $500,000 or more would suffer the indignity of reduced subsidies? If voters understood that these tax deductions are unfair, inefficient and condemned by policy experts of all stripes, they would applaud the politician who tamed them.

This series has also proposed a boost to education spending, including an increase of $2 billion annually to upgrade the quality of the Head Start preschool program. Of all the policies we offer, this is perhaps the easiest sell. Mr. Bush has demonstrated that it's possible to generate a bipartisan coalition on education, and this month a commission headed by former education and labor secretaries from both parties endorsed the idea of starting school for most children at 3 years old. The chief obstacle to action is the fear that education reform seldom yields real improvement. But experiments with high-quality preschool have shown dramatic reductions in later dropout and arrest rates for students, proving that education investments are effective and save money for society in the long run.

Then there is the dysfunctional health system, which national politicians often shy away from in the belief that it is impossibly complex. But the pressure for reform is stronger now than it was when President Bill Clinton's proposal crashed spectacularly: The nation has suffered another decade of galloping health costs that eat into take-home wages, damage the bottom lines of companies and leave a shamefully large number uninsured. Besides, the idea that ambitious health-care proposals will explode in the face of their sponsors is belied by recent experience. Gov. Mitt Romney of Massachusetts signed a plan for universal health coverage and is now running for president. A dozen other states are pushing health-reform experiments; California's Governor, assembly speaker and Senate president are coming out with rival ways to expand coverage. This month Sen. Ron Wyden, Democrat of Oregon, unveiled a voluminous bill that promises to extend coverage to all Americans without costing taxpayers a cent more.

Inequality has increased in most rich countries over the past quarter-century. We do not claim that eliminating it is possible, nor even desirable: Unequal rewards help motivate people to work and innovate. But excessively unequal rewards can backfire. They can allow a successful elite to insulate itself from the rest of society, actually dulling competition and incentives, which is why economists find no evidence that more unequal societies grow faster—and some evidence of the opposite. The level of inequality in the United States is bad for the social fabric without being good for economic dynamism. There are win-win opportunities to reduce inequality and at the same time boost efficiency. When the new Congress convenes in January, it should seize them.

This is the 10th and final editorial in a series on inequality. Previous editorials in this series can be found at http://www.washingtonpost.com/inequality.

PREPARED STATEMENT OF ROBERT E. RUBIN, DIRECTOR AND CHAIRMAN OF THE EXECUTIVE COMMITTEE, CITIGROUP; FORMER U.S. TREASURY SECRETARY

Thank you Mr. Chairman. I believe that you are holding this hearing at an historic juncture with respect to the longer-term outlook of the American economy, and that your Committee is exceedingly well positioned to catalyze serious public discussion and to develop sound approaches with respect to the issues that face us.

The American economy has enormous strengths: the dynamism of our society, the willingness to take risk, our flexible labor markets, and much else. On the other hand we also face hugely consequential longer-term challenges, which I'll touch on briefly in a moment. Moreover, the global economy is undergoing change of historic proportions, including technological developments, globalization, effective productivity policies like education and market-based economics in a number of emerging market economies, and, as a consequence of all this, the emergence of China and India as potentially large markets but more immediately as powerful competitors. We can thrive in this transforming environment, but to do so it is imperative that we meet our challenges, and failure to meet our challenges could lead to serious difficulty.

Currently, in my judgment, we are far from being where we need to be on almost every front, independently of how you allocate the political responsibility. This contributes substantially both to the unsound fundamentals underlying our economy despite good GDP growth, which could augur trouble for the future, and to the struggle that many if not most Americans are having economically. As to this latter, median real wages and median real compensation have been roughly stagnant for the last 5 years, and grew relatively slowly for the last 30 years, except for the last 5 years of the 1990s, while income inequality, focusing on a very small top tier, has increased substantially. Moreover, economic dislocation and economic insecurity have increased substantially.

As we address all of these conditions, I believe strongly in markets as the most effective organizing principal for economic activity; but government has a critical role in providing the requisites for economic success that markets, by their very nature, will not provide. Moreover, the objectives of policy should be growth, but also broad participation in that growth and improved economic security, both as a matter of values and also because these objectives can be mutually reinforcing.

More specifically, sustained growth is the single most effective way of promoting broad income growth and economic security—through the effect of sustained tight labor markets. And, broad income growth and increased security are critical to growth for two reasons. First, they provide workers with the resources to access education, training, rapid redeployment into the economic stream when dislocated, and other contributors to productivity, and, second, because sound economic policies around trade and market based economics will only have broad public support if the great preponderance of the people expect to benefit from these policies.

I think we can most effectively achieve the three objectives I set out—growth, broad distribution of that growth, and greater economic security—by meeting the challenges I mentioned earlier, which I think of as falling into four baskets: (1) our multiple financial imbalances; (2) serious shortfalls in education, infrastructure, basic research, energy policy, health care policy, inner-city programs and so much else that are critical requisites for economic success; (3) the cost/benefit imbalances in our regulatory and litigation regimes; and (4) international economic policy, including trade, relatively open immigration, and working toward flexible exchange rates. These all occur alongside of economically significant exogenous risks, including terrorism, oil shock and others.

Addressing our challenges will require a dramatic change in our strategic orientation and commensurate change in our policies. In my limited time, I won't try to describe the relationship between each of our challenges and the three objectives I set out, but just comment briefly on two of those challenges.

As to financial imbalances, current economic conditions rest on high levels of borrowing at multiple levels in our society. These include significant projected fiscal deficits over the 10–year Federal budget window—assuming the 2001 and 2003 tax cuts are made permanent as proposed—instead of the surpluses we should have had in a time of healthy GDP growth; a net national savings rate of about 2 percent of GDP; a projected increase in Social Security, Medicare and Medicaid entitlements as a percentage of GDP over the next 15 years of 50 percent; a current account deficit of almost 7 percent of GDP, caused partly by our fiscal deficits, and heavy overweighting of dollar denominated holdings in many foreign portfolios. The combination of these factors is a deep and multi-faceted threat to job creation, to standards of living, and to our economy. The vast capital flows from abroad that have

sustained us are exceedingly unlikely to continue indefinitely, though the timing of trouble—whether in the near term or years out—is unpredictable.

I believe that we should establish a fiscal path that systematically reduces the debt to GDP ratio year-by-year and leads to balance, and at the same time makes room for critical public investments. These critical public investments—and other key domestic policy issues—also will require change that will be very difficult, substantively and politically, but that are imperative.

As to globalization and trade, let me start by saying again that many Americans are experiencing real difficulty economically, and the pressures from globalization on wages and economic security are one of the factors—including, far more significantly, technological change—contributing to this.

Thoughtful people on this committee and your colleagues in both chambers are working to find effective policy responses to these difficulties, a search made more complicated by the transformative change taking place in the global economy.

There is an understandable temptation to erect trade barriers. However, I believe that would be deeply harmful: that path would lead to higher consumer prices, higher input costs for our producers vs. foreign competitors, loss of the benefits of comparative advantage, loss of pressure of open markets on business to increase productivity, and finally, likely retaliation of the countries to which we export and possible disruptive effects on the dollar. Moreover, other countries are continuing to move forward on trade liberalization; the only question is whether we will be in or out of the net of preferential arrangements.

However, trade liberalization—which I believe on net still greatly benefits our economy and the great preponderance of our people—must be combined with a powerful domestic agenda to promote productivity, broad-based income growth, and greater security, along the lines I already discussed, and drawing on past experience but also innovative and creative thought.

Mr. Chairman, we can have a bright future, but we have much substantively and politically difficult work to do, and this committee can contribute greatly to achieving those purposes.

PREPARED STATEMENT OF DR. LAWRENCE H. SUMMERS, CHARLES W. ELIOT UNIVERSITY PROFESSOR, HARVARD UNIVERSITY; FORMER U.S. TREASURY SECRETARY

Mr. Chairman, Members of the Committee, I appreciate very much this opportunity to testify before the Joint Economic Committee at what I believe is a critical juncture for U.S. economic policy. There are a variety of features of the current economic environment that are without precedent. These include:

- the magnitude of our current account deficit and looming fiscal problems;
- the degree of integration in the global economy;
- the spectacular rise of China, India and other emerging markets;
- the pervasive impact of technology; and
- the substantial increases in inequality and economic insecurity that have been observed in recent years.

We are, to an important extent, in un-chartered territory in setting economic policy and so this Committee is to be commended for taking up these policy challenges at this crucial juncture.

In this new economic environment, the United States faces three main policy challenges:

- returning its finances to a sustainable basis;
- making necessary investments for the continuation of rapid economic growth; and
- assuring the benefits of growth are widely shared, and in particular, that we continue to have the strong middle class that has long been the underpinning of our democracy.

Let me say a few words about each of these challenges.

First, the nation's finances are not now on a sustainable basis. While projections vary, few observers believe that without significant policy changes the debt-to-GDP ratio of the United States will increase quite rapidly in the next decade and beyond. In part, this is a reflection of an aging society. In part, it is a reflection of the fiscal policies of the last 5 years in which very large tax cuts have coincided with substantial increases in both defense and domestic spending.

This move toward fiscal un-sustainability has been one of the drivers of the deterioration in international economic position of the United States, as our current account deficit has now reached record levels and is approaching one trillion dollars. The current account deficit reflects both the very substantial international borrowing by the United States government due to significant fiscal deficits as well as

a continuing decline in the private savings rate. Indeed, in recent years, the United States has had a net national savings rate that is close to zero.

The consequences of these adverse and unsustainable developments have been masked in recent years by the very substantial investments in U.S. short-term financial securities made by central banks around the world, and in particular by the central banks of emerging Asian countries and the oil-exporting countries. This has created a situation where the world's greatest power is also the world's greatest borrower.

In the short run, the United States benefits from the availability of low-cost capital. However, this low-cost capital has as its counterpart the very substantial volume of exports to the United States in excess of our own imports and the resulting significant trade imbalances. There is also the question of how long foreign investors will be prepared to lend us funds on such generous terms to support deficits of this magnitude.

Clearly, a policy priority in this regard has to be increasing the stability of the nation's financial position. The most important step the Congress can take is to adopt a fiscal policy that puts the government's finances on a sustainable footing. There is no silver bullet here. Undoubtedly, it is important to address the excesses of recent years, to take on entitlement issues, and, perhaps most critically, to return to budget discipline with respect to any new initiatives on either the spending or the tax side.

The second large economic policy challenge is assuring adequate growth in the years ahead. From the end of the Second World War until the mid nineteen-seventies, Americans benefited from rapid productivity growth. Subsequently, a sharp slowdown in productivity growth manifested itself and lasted until the mid nineteen-nineties. Since then, productivity growth has been quite rapid, though there are signs that it may be slowing once again. Economists do not fully understand all the determinants of these trends.

There can be no certainty as to how best to increase productivity growth going forward in the United States. But equally, there is no question that public investments are essential. I would highlight three areas of public investment where I believe our national effort has been insufficient in recent years.

First, our investments in research and development, after increasing rapidly since the nineteen-nineties, have lagged. In a time when the world stands on the brink of revolutionary progress in the life sciences, it cannot be rational for the NIH budget to decline as it did this past year for the first time in nearly forty years. If one looks at funding levels adjusted for inflation the decline in our national commitment to basic research is even more remarkable.

As President of Harvard, I had the opportunity to observe the remarkable potential of research in the life sciences. I also had the opportunity to observe many extraordinarily talented scholars abandoning the life sciences as the average age of funded investigators rose in the face of budget pressures. Similar trends can be observed in the physical sciences.

The second key element of public investment in productivity growth is education funding. Ultimately, nothing is more important to our prosperity than the quality of the American labor force. It is particularly important that investments be made to ensure that all of our citizens have a chance to fully participate and share in our prosperity. A growing body of evidence suggests that pre-school education has an enormous rate of return, particularly for children from disadvantaged background, and funding these kinds of programs should be a high priority.

There is also a major need for national investment to ensure the affordability of higher education for all of our citizens. One of the most disturbing statistics I encountered in recent years is the observation that just 10 percent of students attending our leading universities come from the lower half of the American income distribution.

The third crucial area of investment is in infrastructure. Here, there are clearly areas in which there has been excess national investment in response to political pressures. But there are also key areas such as transportation and other infrastructure facilities where investment has been grossly inadequate.

The third, and in some ways most pressing, economic challenge is that of assuring a strong middle class. This has three related but distinguishable elements: assuring equality of opportunity; assuring long-term economic security for those who currently have good jobs; and assuring that prosperity and economic growth are shared widely, rather than benefiting a small part of the population. How best to do this is a question that will require all of our effort in the years ahead, but I think there are three crucial areas that require attention.

First, assuring the fair collection of taxes. There are a number of areas in which we can improve the effectiveness of the tax system while at the same time increas-

ing its fairness. These include making a serious assault on the tax gap resulting from non-compliance with the Internal Revenue Code, which may represent as much as fifty billion dollars per year. I would note the tax gap is greatest for those categories of income that go disproportionately to the upper ends of the income distribution. There are also important issues and abuses associated with transfer pricing and the sheltering of both individual and corporate income that require Congressional attention. I am convinced that substantial revenues can be obtained from these sources.

If we are to assure adequate economic security for all of our citizens, we need to recognize that in a world where jobs are going to be increasingly impermanent, economic security cannot come only from the employment relationship. This will require new approaches in the areas of health insurance and other benefits. I believe it is also appropriate that consideration be given to thinking about methods of wage insurance that would enable increasingly inevitable economic mobility to take place without significant and painful dislocation.

A third type of response to economic insecurity involves taking comprehensive and systematic policy approaches to the future of key industries and regions. I was struck, Mr. Chairman, by the recent report you and other leaders from your state released on the steps needed to keep New York at the center of the global financial services industry. I could not help but wonder whether similar comprehensive efforts to devise a strategy and assure the leadership of American firms and other regions would not be availing in many different sectors. Indeed, reliance on clusters is, it seems to me, profoundly important for our economic future. Any individual faces the possibility of competition from a lower earning and equally skilled individual, but it is much more difficult to compete with or replicate entire clusters of economic activity. Indeed, the supremacy of New York City as the world's financial capital illustrates this point.

Mr. Chairman, these are just a few of the crucial areas of policy that we face. I look forward to answering your questions and engaging in a wide-ranging discussion. Thank you again for inviting me to be here this morning.

PREPARED STATEMENT OF DR. ALAN S. BLINDER, PROFESSOR OF ECONOMICS AND DIRECTOR OF THE CENTER FOR ECONOMIC POLICY STUDIES, PRINCETON UNIVERSITY; FORMER VICE CHAIRMAN OF THE FEDERAL RESERVE

Thank you for holding this hearing, Mr. Chairman. I'd like to use my brief time to focus on two broad-brush, long-term issues, one pertaining to income disparities and one pertaining to globalization. They are, of course, related.

RISING INCOME INEQUALITY: FIRST, DO NO HARM

The first problem has been with us for so long that I fear we may be becoming inured to it. The plain fact is that America does a very poor job of caring for its poor, for its weak, and for its downtrodden—as was illustrated, for example, by the woefully inadequate response to Hurricane Katrina.

Although specific statistical measures of poverty and inequality can be—and have been—disputed, the basic outlines of the story are clear enough. Inequality in America was basically constant for the 35 years or so from the end of World War II until the late 1970s, but has been mostly rising since. The one notable exception was the boom years of the second Clinton administration, when labor markets were extraordinarily tight.

This phenomenon has not been mainly a story of vast capital gains accruing to a tiny minority, nor of a massive income shift from labor to capital-although both of these have played roles in certain time periods. Rather, the basic story is that earnings from work have grown vastly more unequal over the last quarter-century. There are many ways to measure that change, but here is one that I find both dramatic and easy to understand. According to IRS data, in 1979 the average taxpayer in the top 1/10th of 1 percent of all wage and salary earners earned about as much as 44 average taxpayers in the bottom half.[1] By 2001, that number had risen to almost 160.[2] And we know from other data sources that inequality has gotten worse since.

What accounts for this alarming trend? Let me be clear: The main culprit has *not* been the government but the marketplace. While there are a number of competing

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[1] The unit of observation in tax data is the tax return, not the individual or the family.

[2] These are my calculations, based on data in Table 7 (p. 104) of Ian Dew-Becker and Robert Gordon, "Where did the Productivity Growth Go?," *Brookings Papers on Economic Activity*, 2005:2. 2001 is the last year for which comprehensive tax data were available at the time.

theoretical explanations, the fact is that, starting sometime in the late 1970s, the market turned ferociously against the less skilled and the less well educated.

How should the government have reacted to such a development? One clearly *wrong* approach would have been to try to stop the market forces that were generating rising inequality. Such an effort would have produced undesirable side effects and would probably have failed anyway.

A more reasonable approach would have included using the tax-and-transfer system to cushion the blow, raising the minimum wage and the EITC, devoting more resources to compensatory education, making health insurance universal, etc. These are still useful ideas, and we should use them.

A Social Darwinist would have rejected palliatives like these in favor of letting the market rule and the chips fall where they may. (By the way, it strikes me as ironic that some of these Social Darwinists are not biological Darwinists.)

That may sound heartless. But, with a few notable exceptions, the U.S. Government has followed an even harsher policy course for most of the past quarter century.[3] As market forces turned against the middle class and the poor, the Federal Government piled on by enacting tax cuts for the rich while either permitting or causing large holes to emerge in the social safety net. In football, that would be called "unnecessary roughness"—and penalized severely. It's a policy direction that, in my view, needs to be changed—and fast. The first step is to stop piling on.

OFFSHORING: THE SLEEPING GIANT

Let me now turn to an issue whose present importance has been greatly exaggerated, but whose future importance appears to be underappreciated: offshoring of service jobs. While no comprehensive numbers are available, scattered studies make it appear likely that fewer than a million U.S. service jobs have been lost to offshoring to date. A million may sound like a lot, but in a nation with over 140 million jobs, it is not even 1 month's normal turnover. No big deal, in other words.

However, I believe we have seen only the tip of a very big iceberg. Here's why. Only a minority of American workers—mainly manufacturing workers—have historically faced job competition from abroad. They haven't welcomed it, of course. But they have long understood that foreign competition is one of the hazards of industrial life, like bankruptcies and business cycles.

But most American workers, including the vast majority of service workers, have never had to worry about foreign competition. Until recently, neither low-skilled work like call centers nor high-skilled work like computer programming could easily be moved offshore. Now both can be. My point is that the share of American jobs that is potentially vulnerable to offshoring is certain to rise over time as the technology improves and as countries like India and China modernize and prosper. As this occurs, tens of millions of *additional* American workers will start to experience an element of job insecurity—and downward pressure on real wages—that has heretofore been reserved for manufacturing workers. It is predictable that they will not like it.

Many people have concluded that offshoring will be a particularly acute problem for less-skilled and less-well-educated workers—precisely the people who have been left behind for the last 25 years. I'm not so sure. As I see it, the key labor-market divide in the Information Age will not be between high-skilled and low-skilled workers, as it has been in the recent past, but rather between services that can be delivered electronically with little loss of quality and those that cannot be.[4]

Consider a few examples. It seems unlikely that the services of either waiters or brain surgeons will ever be delivered over long distance. On the other hand, both typing services and security analysis are already being delivered electronically from India—albeit on a small scale so far. These disparate examples illustrate two fundamentally important points. First, the dividing line between jobs that are deliverable electronically (and thus are threatened by offshoring) and those that are not does not correspond to traditional distinctions between high-end and low-end work. Frankly, I have no idea whether future offshoring will make the distribution of wages more or less equal. Second, the fraction of U.S. jobs that can be moved offshore is certain to rise inexorably as the technology improves. Despite all the fuss, it is pretty low now; but it will eventually be quite high. In some ongoing and still preliminary research, I have estimated that 22–29 percent of all (current) American

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[3] The main exception was the Clinton administration's huge increase in the Earned Income Tax Credit in 1993.

[4] See Alan S. Blinder, "Offshoring: The Next Industrial Revolution?," *Foreign Affairs,* March/April 2006, pp. 113–128.

jobs might potentially be *offshorable,* although only a fraction of those jobs will actually be *offshored.*[5]

What can or should the government do about all this? I don't have a laundry list of concrete proposals, but I think the appropriate governmental responses fall into two generic categories.

First, we need to repair and extend the social safety net for displaced workers. This includes unemployment insurance, trade adjustment assistance, job retraining, the minimum wage, the EITC, universal health insurance, and pension portability—plus other, newer ideas like wage loss insurance. If we fail to do these things or, perish the thought, turn again to Social Darwinism or piling on, a large fraction of the U.S. population is going to experience a great deal of anxiety and economic distress. These people will constitute a much larger, more vocal, and more politically engaged group than the poor and uneducated. So it seems unlikely that they will just sit there passively and take their medicine. Rather, Congress will hear from them.

Second, we must take steps to ensure that our labor force and our businesses supply and demand the types of skills and jobs that are going to remain in America rather than move offshore. Among other things, that may require substantial changes in our educational system—all the way from kindergarten through college. And it will certainly entail a variety of steps to ensure that the U.S. remains the home of innovation and invention, for we will never compete on the basis of cheap labor. Nor do we want to.

Notice that I did not mention a third category of governmental response: trying to impede globalization in general or offshoring in particular. The U.S. Government cannot hold back the tides of history, and it should not try. Mr. Chairman, you may remember a popular 1960s musical comedy called *Stop the World, I Want to Get Off.* I understand the sentiment. You hear it a lot these days. But we cannot stop, and we cannot get off. Instead, we Americans need to prepare ourselves for the future of globalization, whether we like it or not. There is much to be done.

Thank you.

PREPARED STATEMENT OF DR. RICHARD VEDDER, DISTINGUISHED PROFESSOR OF ECONOMICS, OHIO UNIVERSITY; VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE; CO-AUTHOR OF THE WAL-MART REVOLUTION

Good morning Senator Schumer and members of the Committee. The JEC has just completed 60 years of existence, and during those six decades it has assisted importantly in the making of economic policy, and I am pleased to be part of today's proceedings.

My distinguished colleagues on this panel have painted a somewhat pessimistic and perhaps mildly alarming picture of the American economy. We learn that many Americans have not shared in our nation's rising prosperity. The income and wage gap between the rich and the poor is growing. We are told we are becoming a more economically divided nation.

My message is somewhat more optimistic and skeptical of the analysis suggesting that vast portions of the American populace are languishing economically. Let me very briefly touch on three points. First, the conventional measures that are typically cited to denote greater inequality are fundamentally flawed and grossly overstate inequality in this nation, and the growth in it over time. Second, even if one accepts the proposition that America has insufficient equality of economic condition, history tells us that public policy efforts to deal with the problem often are ineffective. Third, some policies that conceivably might lower inequality as conventionally measured would, if adopted, have serious adverse consequences to the economy as a whole.

Turning to the first point, looking at conventional statistics on income distribution, three factors lead us to overstate inequality. First, and probably least important, those statistics are traditionally based on money income, excluding a variety of in-kind, non-cash payments that primarily benefit lower income persons—Medicaid benefits, food stamps, and housing subsidies are three good examples. Any comparison of income levels or income inequality today with, say what existed in 1960 using published income data will tend to overstate any reported rise in inequality, and understate any estimate of income gains for lower income Americans, since non-cash payments have become relatively more important in the intervening time period.

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[5] Alan S. Blinder, "Estimating the Potential for Offshoring in the United States," unpublished, Princeton University, December 2006.

A second factor is that what we should be truly interested in is the economic well-being of Americans, and a far better measure of that economic well-being is consumption spending. Dollar for dollar, people derive more joy from what they spend than from what they earn. As many elementary economics textbooks point out in the first chapter, the ultimate purpose of economic activity is consumption.

We know that in any given year consumer spending is far more equally distributed that income. Comparing the income distribution statistics derived from the Current Population Survey with the BLS's Consumer Expenditure Survey is revealing. For example, the poorest one-fifth earned only slightly over 7 percent as much income as the richest one-fifth in 2002, but they consumed more than 24 percent as much. Using the most recent data for 2005, we see the richest one-fifth of the population earned 3.47 times as much as the middle quintile, but consumed only 2.31 times as much. Roughly speaking, conventional measures show consumption inequality is at least one-third less than for income inequality.

The third point relating to the overstatement of inequality relates to the remarkable income mobility of the American people. For example, at the request of this Committee, the Treasury Department in the 1990s provided data suggesting that the overwhelming majority of persons in the bottom quintile of the income distribution were in another quintile a decade later, and a large percent even moved up or down the distribution from one year to the next. Researchers at the Urban Institute and other organizations have made similar observations. This phenomenon helps explain the narrowness of the distribution of consumption spending relative to the distribution of income, as observed decades ago by the late Milton Friedman and in a different context by Albert Ando and Franco Modigliani. Failure to consider the income mobility of people contributes to the inadequacies of traditional measures of income distribution and also leads us to create some inequities and inefficiencies when devising tax policies based on single year definitions of income.

While we are talking about measurement problems, they are particularly prevalent in our discussions of changes in earnings over time. Go to page 338 of the 2006 *Economic Report of the President*. We learn that average weekly earnings of workers in private nonagricultural industries in 2005 were over 8 percent less than they were in 1964, the year Lyndon Johnson announced his Great Society initiatives. Yet turn the page, to page 340. Looking at real compensation per hour in the non-farm business sector for the same time period, we learn it has risen 75 percent. Page 338 is consistent with a Marxian or even Malthusian interpretation of the economy—a tendency for wages to fall to near subsistence, and evidence of mass exploitation of the working proletariat by exploitive capitalists. Page 340 is consistent with the view that with economic growth, the earnings of workers have risen sharply, and also consistent with national income accounts data that shows per capita real consumption has increased about 2 percent annually.

Yet even the data on page 340 suffer from deficiencies. We learn that productivity per hour in the non-farm business sector in 2005 was 2.28 times as great as in 1964, yet compensation rose only 1.75 times, a pretty big difference that is inconsistent with the neoclassical economic theory of factor prices and suggestive that owners of capital are indeed deriving extraordinary profits as a result of paying workers less than what they contribute to output at the margin. This should have resulted in a significant decline in compensation of workers as a percent of national income. Yet the national income data taken from pages 314 and 315 of the same source show a radically different story. Compensation of employees actually rose from 60.75 to 61.51 percent as a percent of the national income. The share of national income accounted for by corporate profits fell slightly in the same time period.

I am making two points here. First, interpretations of economic data can be exceedingly misleading. Second, the analysis of broader measures of economic performance suggests that workers as a group have shared in our national prosperity of the past several generations. The original wage data I cited suffer from two enormous deficiencies. First, they fail to take account non-wage forms of compensation, particularly health care and retirement benefits. These have soared in magnitude over time. Second, the calculation of changing values in constant dollars is fraught with peril, and the Consumer Price Index used in these calculations very significantly overstates inflation in the eyes of virtually every mainstream economist, liberal, conservative, vegetarian, Presbyterian, what have you. Similarly, analysis of wage changes by wage or income category suffers not only from these problems, but from the aforementioned phenomenon of the rapidly changing economic status of individual members of our opportunity society over time.

You don't need a Ph.D. in economics to observe that never has a society had a middle class more used to what once were considered goods and services available only to the uber rich. Middle income Americans live in larger homes, buy more gadgets like IPODS and cell phones, live longer, are more if not better educated,

and take nicer vacations than either their parents did or do and their counterparts in any other major nation. I returned 2 days ago from a 2-week cruise in the Caribbean, traveling less with top business executives or even elite Ivy League professors than with equipment salesmen, butchers, and teachers -ordinary folk. That simply did not happen even 30 years ago.

My second major point relates to public policy dealing with economic inequality. Time does not permit a detailed exegesis of past efforts. But a reminder of some historical experiences is sobering. Policy can come from the tax, spending or regulatory side. I will ignore regulatory matters in the interest of time, although I would hasten to commend Senator Schumer for recent statements showing his concerns about the abusive use of the tort system as a growth-impeding way of redistributing income. Looking at taxes, attempts to make the system more progressive often have unintended effects. For example, sharp reductions in top marginal tax rates in the 1920s, 1960s, and 1980s, viewed by some as favoring the rich, actually led to sharp increases in the tax burden of the rich relative to the poor. I worked for this Committee during the 97th Congress in 1981 and 1982 in a political environment much like today with divided government, with the Republicans controlling the Executive while Congress was more under Democratic control, yet the two branches managed to work together to fashion a more growth oriented tax policy with lower marginal tax rates that contributed mightily to the boom that has followed. I hope the 110th Congress is capable of similar accomplishments.

Taxes have behavioral consequences. The CBO greatly underestimated revenues that would arise from the reducing in the top capital gains rate to 15 percent, for example. Falling rates unlocked billions in unrealized gains that have helped fund our rapidly expanding government. Similarly, sharp reductions in the number of estates subject to death taxation as a result of reform in those laws has not led to a sharp decline in revenues from that source, as some had expected. It would be a tragedy to reverse the positive effects of the tax reductions of the past few years that, like the Kennedy tax reductions of the 1960s, have had a positive impact on economic activity.

On the spending side, history again shows disappointing results of many initiatives to help the poor or middle class. As the January 20 issue of the Economist notes, government job training programs have internationally been largely failures. Spending initiatives in the areas of education, medical care, and public assistance have usually brought about disappointing results. Despite spending far more in real terms per student than a generation or two ago, American students do not appear to be learning much more, and the education for lower income students is particularly deficient. A tripling of Federal aid to college students since 1994 has been accompanied by a decline, not an increase, in the proportion of students from the lowest quartile of the income distribution attending and graduating from our finest universities, which are increasingly becoming taxpayer subsidized country clubs for the children of the affluent. While Medicaid has brought some increase in medical care for the poor, it has done so at an enormous cost to society, and the cost pressures of a highly inefficient system are leading companies to cut back on health care benefits for working middle class Americans. As to public assistance, it is far greater today in real per capita or per poor person terms than in 1973, yet the current poverty rate is higher. The welfare reforms of the 1990s were an important achievement, but the overall picture is, at the very least, mixed.

Speaking of public assistance, I have to make one statement that may sound a bit callous or insensitive to some, but it is an important but often neglected truism. Comparing the rich and the poor, it is worth noting that the rich work a lot more. Of those persons in poverty, only a tiny minority work full-time. We have relatively few working poor in America. And it is worth noting that employment creation is greatest in periods when the government allows the incredible job machine generated by the competitive private sector operating in a market environment to work. The job creation of the 1980s was stimulated by a halt to the growth in government's share of GDP characterizing earlier decades, and by tax reductions that stimulated the spirit of enterprise. The job creation of the 1990s was stimulated by an unprecedented decline in government expenditures as a percent of GDP for eight consecutive years—a reverse crowding out phenomenon that propelled an enormous outpouring of American creative and entrepreneurial endeavor.

Turning to my final point today, there is a temptation to do things in the interest of protecting middle and lower income Americans that might have highly undesirable effects on the economy as a whole. In this regard, the rise in protectionist sentiment in Congress is appalling, particularly as is largely centered in a party which historically has favored free trade, a policy that has brought prosperity to almost all Americans while at the same time has contributed enormously to eliminating global disparities in the distribution of income and wealth. I hope the intelligent

wing of the Democratic Party, represented by able persons such as those who preceded me on this panel, will be able to prevent a return to policies reminiscent of that old Democratic bete noire, Herbert Hoover. The Smoot-Hawley Tariff and rising taxes were a factor, along with Hoover's inane wage policies, for the Great Depression of the 1930s. Let us not repeat that today. I hope the Democratic Party will try to emulate Franklin D. Roosevelt, John F. Kennedy and Bill Clinton in the area of trade policy, not Herbert Hoover.

At a macro level, I believe the biggest single factor in the modest slowdown in growth rates in this decade relative to the 1980s and 1990s is the sharp increase in government expenditures. From fiscal year 2001 to fiscal year 2006, total Federal outlays rose by 42.4 percent, or $790.1 billion. By the way, the overwhelming majority of that was for non-defense or national security purposes. This was nearly double the percent growth in GDP. Receipts rose well over 20 percent or roughly equal to the growth in GDP, so the burgeoning deficit reflected a spending binge that resulted in some crowding out of private economic initiatives. Dollar for dollar, the evidence is crystal clear that private spending has more productivity-enhancing effects than public spending because of the discipline that competitive markets impose on market enterprise. The tax cuts largely corrected for the natural tendency for taxes to rise relative to national output. Raising taxes again would reduce the deficit, but would have direct unfortunate disincentive effects on human economic behavior and would also reduce the political costs to Congress of incremental spending initiatives, which almost certainly would have severe economic effects. I hope some early indications of spending constraint are maintained in the months and years ahead. While I am not the financial guru that Secretary Rubin is, an analysis that I have conducted with Lowell Gallaway for this Committee in the past suggests that the two best determinants of the growth of wealth as measured in equity prices are the rate of inflation and government spending as a percent of GDP. Rising government spending is associated with falling market values and wealth, with all the adverse consequences that has for pensions. And stable prices are much better than inflation. The Fed has done a pretty good job on the inflationary front, but the Congress and the Executive are guilty of having shown insufficient constraint with respect to Federal expenditures.

Again, I praise the JEC for providing a needed forum for the analysis of policy possibilities informed by factual evidence. I hope the next 60 years are as successful for this Committee as the last 60 have been.

Thank you.