106 CONGRESS
2nd Session

SENATE

REPORT
106-255

THE 2000 JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ON THE

2000 ECONOMIC REPORT OF THE PRESIDENT

together with

MINORITY VIEWS

April 5, 2000. — Ordered to be printed

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON: 2000

JOINT ECONOMIC COMMITTEE

[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

LETTER OF TRANSMITTAL

April 5, 2000

HON. TRENT LOTT
Majority Leader, U.S. Senate
Washington, DC

DEAR MR. LEADER:

Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the 2000 Joint Economic Report. The analyses and conclusions of this Report are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

Connie Mack

CONNIE MACK
Chairman

CONTENTS

106TH CONGRESS } SENATE { REPORT
2nd Session } { 106-255

THE 2000 JOINT ECONOMIC REPORT

Mr. MACK, from the Joint Economic Committee, submitted the following

REPORT

together with

MINORITY VIEWS

OVERVIEW OF THE ECONOMY

The United States continues to enjoy the effects of the Great Expansion, a period of economic growth since December 1982 that has been interrupted only by a shallow recession from August 1990 to March 1991. The U.S. economy has spent less time in recession since December 1982 than in any comparable period in history. As of March 2000, economic indicators continue to show favorable conditions. Real (inflation-adjusted) economic growth is approximately 4 percent, above average for the expansion as a whole; unemployment is around 4 percent, its lowest level since the late 1960s; and inflation remains subdued, at 2 to 3 percent a year. Healthy economic growth has contributed to continuing surpluses in the federal budget.

The international economy is improving. Most of our trading partners have better prospects for growth today than during the period of currency crises that affected many developing countries from July 1997 to January 1999. This means that demand for U.S. exports should strengthen. The only cloud in the sky is the big jump in the price of oil, which threatens to reduce economic growth worldwide. However, because of changes in the U.S. economy, we are now in a better position to weather adverse consequences than we were in the 1970s.

The current segment of the Great Expansion, since April 1991, has lasted so long in part because, unlike in most previous expansions, growth in productivity has not fallen; rather, it has accelerated in recent years. This is good news because growth in productivity is vital to long-term improvement in the standard of living. The enormous investment that American businesses and workers have made in new technology, particularly computer technology, is bearing fruit and from all indications will continue to do so for years to come.

Unlike the expansions of the 1960s and 1970s, the Great Expansion is not the result of policies aimed at stimulating demand. In the 1960s and 1970s, policies to stimulate demand often led to inflation, provoking policy makers to depress demand to bring inflation back under control. This stop-go strategy was discarded during the early 1980s. Since then, monetary policy has focused on price stability and fiscal policy has focused on long-run growth.

Expansions do not die of old age. Sometimes they are ended by dramatic change beyond the control of policy-makers such as a natural disaster or financial crisis abroad. In other cases, they end as a result of domestic policy errors such as a monetary shock. For 20 years, the Federal Reserve has avoided sudden changes in inflation and has gradually reduced the rate of inflation to low single digits. The resulting stability has enabled Americans to plan for the near term and the long term with confidence that their efforts would not be derailed by sharp fluctuations in prices and interest rates like those of the 1970s.

Another error is to have tax rates so high that they strongly discourage productive effort. In the early 1980s the United States slashed top rates on income taxes and capital gains taxes to spur economic growth. Since then, tax rates have gradually crept up, though not to their former levels. By avoiding increases that are too large and too sudden, the federal government has generated higher tax revenues without stifling economic growth. Still, the federal government today takes about as much of the nation's income in taxes as it did during the height of World War II. It is appropriate to ask what can be done to reduce the burden of taxes so as to help prolong the current expansion.

The majority report examines the roots of the Great Expansion and makes suggestions to help it continue. Through its hearings and staff reports, the Joint Economic Committee addresses important economic issues facing the United States. Additional information is available on our Web sites (for the office of the chairman, <http://www.jec.senate.gov>; for the office of the vice chairman, <http://www.house.gov/jec>). We hope this report adds to the public's understanding of the U.S. economy.

SENATOR CONNIE MACK
Chairman
REPRESENTATIVE JIM SAXTON
Vice Chairman

MAJORITY STAFF REPORT

INTRODUCTION

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

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

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

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

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

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

1. THE GREAT EXPANSION

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

Former Federal Reserve governor
Lawrence B. Lindsey

I. The Great Change in Policy, 1979-81

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

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

As Exhibit 1 shows, the economic record of the last 17 years is remarkable, particularly when viewed against the backdrop of the 1970s. The United States has experienced two of the longest and strongest expansions in our history back-to-back. They have been interrupted only by a shallow eight-month downturn in 1990-91. The years from 1983 are best viewed as a single expansion, with its roots in the policy changes of the late 1970s and early 1980s. There has never

Exhibit 1: The Great Expansion, 1983-Present

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

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

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

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

been a period of comparable length with so much growth and so little contraction in the history of the United States.[2]

During the last 17 years:

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

II. Factors Underlying the Great Expansion

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

Price stability. Price stability enhances the efficiency of an economy. Low and steady rates of inflation reduce uncertainty in making long-term decisions, such as buying a house or business machinery. When inflation is low, people can spend more time producing and less time trying to protect themselves from inflation. In addition, low inflation avoids imposing the extra tax that in effect falls on earnings if taxes are not indexed for inflation.

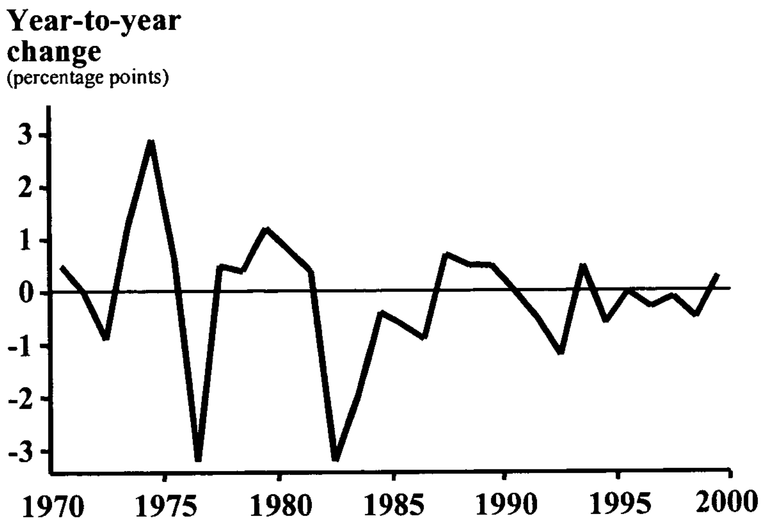
Under the chairmanships of Paul Volcker and Alan Greenspan, the Federal Reserve has successfully focused on price stability. As Exhibit 2 shows, the year-to-year change in the rate of inflation has never exceeded 1.2 percentage points since 1983. Low inflation during the 1980s contributed to the strength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

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

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

Exhibit 2: Inflation Volatility

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



Source: *Economic Report of the President,* 2000, table B-3.
Note: Based on implicit GDP price deflator.

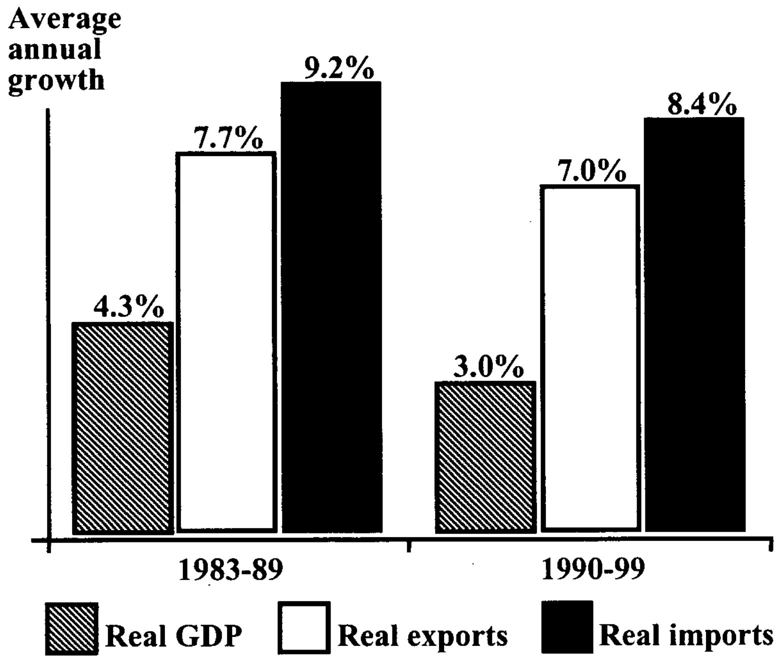
would continue striving for price stability, contributing substantially to the growth of the economy during the 1990s.

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

Increases in the size of the trade sector. Both parties in a trade gain. Buyers, whether consumers or businesses, gain because trade enables them to buy things more cheaply. Sellers gain because trade enables them to sell more goods at better prices. Each party to a trade can focus more on producing those things it does most efficiently. Together, trading partners produce more and achieve higher standards of living than they could do separately. Trade also increases the competitiveness of markets and generates additional gains from economies of scale, the introduction of new products, innovative

Exhibit 3: Growth of Trade

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



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

methods of production, and the spread of technology. All this enhances efficiency and promotes growth.[4]

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

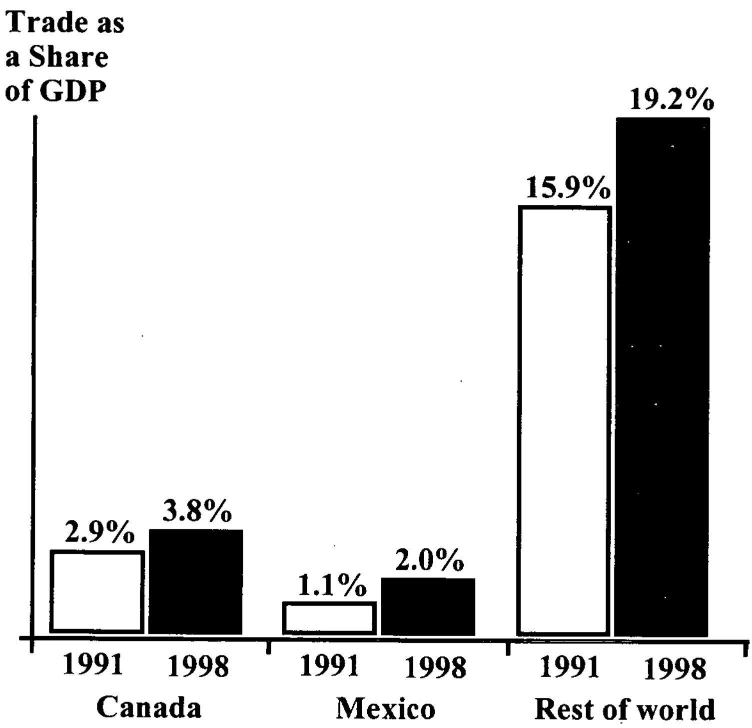
During the Great Expansion, the size of the U.S. trade sector has increased dramatically. Adjusted for inflation, exports more than

---

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

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

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



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

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

tripled from 1983 to 1999; imports expanded even more rapidly. As Exhibit 3 shows, imports and exports alike rose roughly twice as fast as GDP in the 1980s and the 1990s. Exhibit 4 illustrates the growth of U.S. trade in goods and services with Canada, Mexico, and other countries. From 1991 to 1998, trade with Canada rose from 2.9 percent to 3.8 percent of U.S. GDP, while trade with Mexico jumped from 1.1 percent to 2.0 percent. U.S. trade with other countries also expanded, indicating that NAFTA not only expanded U.S. trade with Canada and Mexico, but contributed to an expansion in the overall size of the trade sector.

Economists of almost all persuasions accept that economies open to trade produce more value from their resources and achieve higher levels of income than closed economies.[5] In contrast, protectionists argue that increased openness and expansion in trade creates unemployment, capital flight to low-wage economies, and economic stagnation. The facts support the free trade position. As the U.S. economy has become more open, employment has increased by 35 million and the rate of unemployment has fallen to its lowest level in 30 years. From 1983 to 1998, foreigners invested $1.5 trillion more in the United States than Americans invested abroad. From 1983 to 1999, real GDP per person in the United States rose from $21,102 to $32,439, an increase of 54 percent. Both Congress and the Clinton Administration have generally supported open markets and rejected protectionist calls for trade restraints. Their actions have contributed to the growth and strength of the U.S. economy.

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

---

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

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

[6]For a detailed analysis of how reductions in marginal tax rates during the 1980s helped strengthen the U.S. economy, see Joint Economic Committee, Office of the Chairman, "The Supply-Side Revolution: 20 Years Later," March 2000, available online at <http://www.senate.gov/~jec/ssreport1.htm>. Some claim the Reagan tax cuts were a mistake. But to return to the steeply progressive rate structure that Reagan inherited, with a confiscatory top rate of 70 percent and no adjustments for inflation, would be a severe blow to the American economy. According to estimates by the Joint Committee on

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

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

When governments handle these core activities well, they enhance economic growth. However, if they move beyond these functions and become producers of goods and redistributors of income, they generally do more harm than good. Economies with high government spending usually have sluggish economic growth. For example, in the last four decades, among countries that belong to the Organisation for Economic Co-operation and Development (OECD), a 10 percentage point increase in government spending has been associated with a 1 percent reduction in the long-term rate of annual economic growth.[8]

Federal government spending in the United States persistently rose as a share of GDP between the mid-1960s and the early 1980s. After leveling off during the 1980s, the relative size of government declined during the 1990s. Federal spending has fallen approximately 4 percentage points as a share of GDP in the last seven years. The relationship mentioned in the previous paragraph suggests that the shrinkage of government during the 1990s enhanced growth by

---

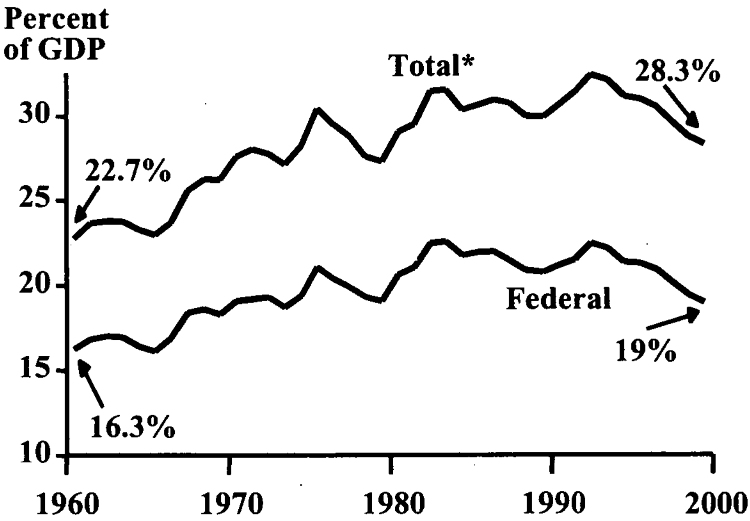
Taxation of the U.S. Congress, under static analysis this would increase the tax burden by $871 billion in 2000 alone, nearly doubling individual income taxes and raising overall taxes 54.7 percent. A middle-class family earning $30,000 would see its taxes increase 45 percent. Because of the economic distortions resulting from such an increase, actual revenue collected would be less than this amount, perhaps even less than under current law.

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

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

Exhibit 5: Government Spending as a Share of GDP

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



Source: *Economic Report of the President,* 2000, table B-80.
Note: * Total government spending includes federal, state, and local.

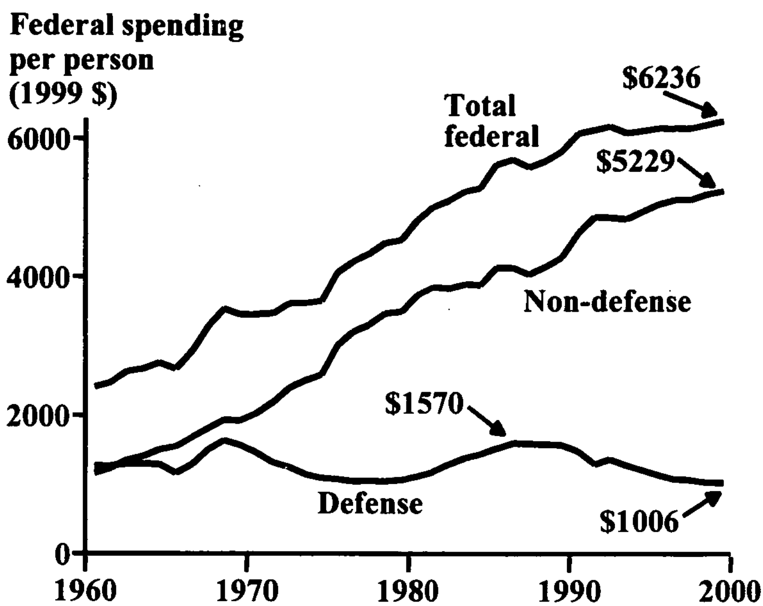
approximately one-tenth this amount, or 0.4 percent a year. The decline in government spending as a share of GDP is shown in Exhibit 5.

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

Demographics. The changing demographics of the workforce has been an overlooked factor facilitating faster economic growth in the Great Expansion. Most people spend their twenties and early

Exhibit 6: Real Federal Spending per Person

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



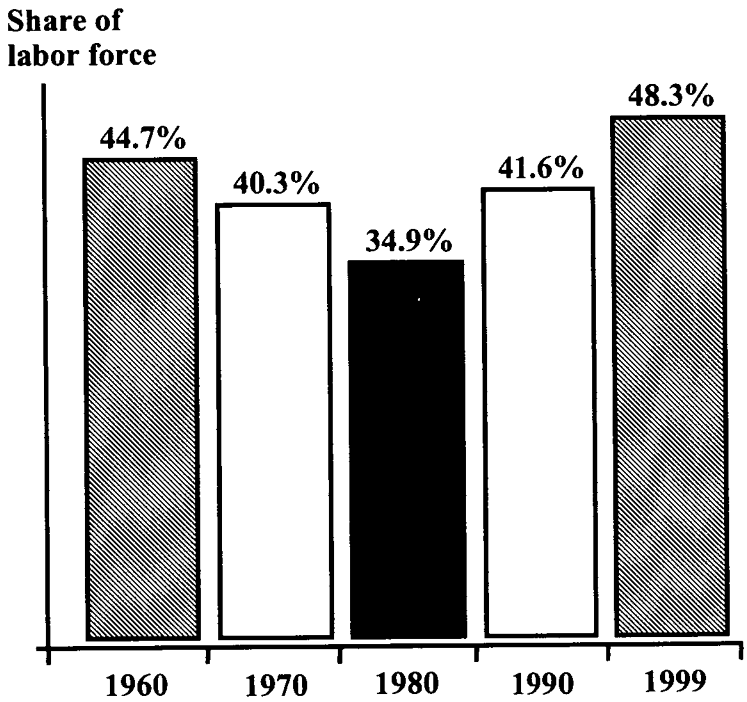
Sources: *Economic Report of the President,* 2000, tables B-1, B-3, B-82; population data from Haver Analytics.

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

thirties developing skills through higher education, training, and job experience. During these years, their productivity and earnings are below average. At the other end of their careers, as they approach retirement their productivity often declines because their health declines and because their job skills may not be as up-to-date as before. Thus, the productivity and earnings of people in their late fifties and over are also below average. People 35 to 54 generally have the combination of education, experience, and health that results in the highest levels of productivity. Therefore, an increase in the share of the population 35 to 54 years old tends to push average productivity and earnings upward.

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

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



Source: Haver Analytics.
Note: For underlying data, see Appendix, table 2.

In the 1980s, the "baby boom" generation began moving into their prime earning years. The share of the labor force in the prime years rose sharply during the 1990s. We estimate that the expansion in prime-age workers increased the total productivity of the labor force by about 0.5 percent a year from 1991 to 1998. Since World War II, labor productivity has grown an average of about 2 percent a year, so an increase of 0.5 percent is substantial. The changing share of the labor force made up by prime-age workers is shown in Exhibit 7.

High technology. The high-technology sector has played a starring role in the dynamic economic climate of the 1980s and 1990s. High-tech industries now account for over 8 percent of U.S. GDP, up from 4.5 percent in 1980. U.S. software, semiconductor, biotechnology, pharmaceutical, and Internet-related companies dominate world markets.

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

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

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

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

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

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

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

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

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

From 1987-89, the federal budget deficit was approximately $150 billion each fiscal year. The deficit rose during the contraction of 1990-91 and fell as the economy began to recover. The Clinton Administration claims that its 1993 tax increase reduced the budget deficit and led to lower interest rates that propelled the expansion of the 1990s.[9] The facts are inconsistent with this view. Interest rates, which had fallen steadily throughout 1992 and the first half of 1993, began rising almost immediately following the Clinton tax increase and passage of the 1993 budget. By July of 1994, the interest rate on 30-

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

year Treasury bonds had risen to 7.6 percent, up from 5.9 percent in October of 1993. Other rates followed a similar path. President Clinton's scenario that his 1993 tax and budgetary policies lowered interest rates and unleashed the current expansion is simply mythology.[10]

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

Higher defense spending in the 1980s enabled spending to be lower in the 1990s. Higher real defense spending in the 1980s proved to be an excellent investment. It led to victory in the Cold War. Following the collapse of the Soviet Union, however, real defense spending declined as the American people asked for a "peace dividend." As the Clinton Administration often highlights, the unemployment rate remained high in 1991 and 1992, the last years of President George Bush's administration, even though the economy was expanding. The transitional movement of resources out of defense and into non-defense industries was a major factor underlying the unusually high unemployment of the period. The United States was able to shift more than 2 million jobs out of defense-related industries between 1989 and 1993. In the short run, this was a major contraction of an important sector, resulting in sluggish growth and upward pressure on the unemployment rate. However, our free market economy created new jobs to use the talents of the displaced defense workers. This exerted a positive impact on the long-run health of the economy.

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

Flow of funds into and out of tax-favored savings accounts. Tax legislation during the 1980s encouraged individuals and families to channel funds into tax-free Individual Retirement Accounts (IRAs) and 401(k) accounts. As funds flowed into these accounts in the 1980s, federal revenues were reduced. Funds began to flow out of these accounts in the late 1990s because federal law requires people to start withdrawing from them by age 70-1/2 or face penalties. The

---

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

withdrawals are taxable. In early 1999, the Congressional Budget Office estimated that withdrawals from taxable IRAs would rise from $93 billion in 1999 to $195 billion by 2008. Currently, 401(k) assets are about 60 percent as large as IRA assets, indicating that withdrawals from them will also generate significant tax revenue in the coming years.

IV. Can the Great Expansion Continue?

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

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

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

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

2. IMPROVING SOCIAL SECURITY, HEALTH CARE, AND EDUCATION

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

I. Social Security

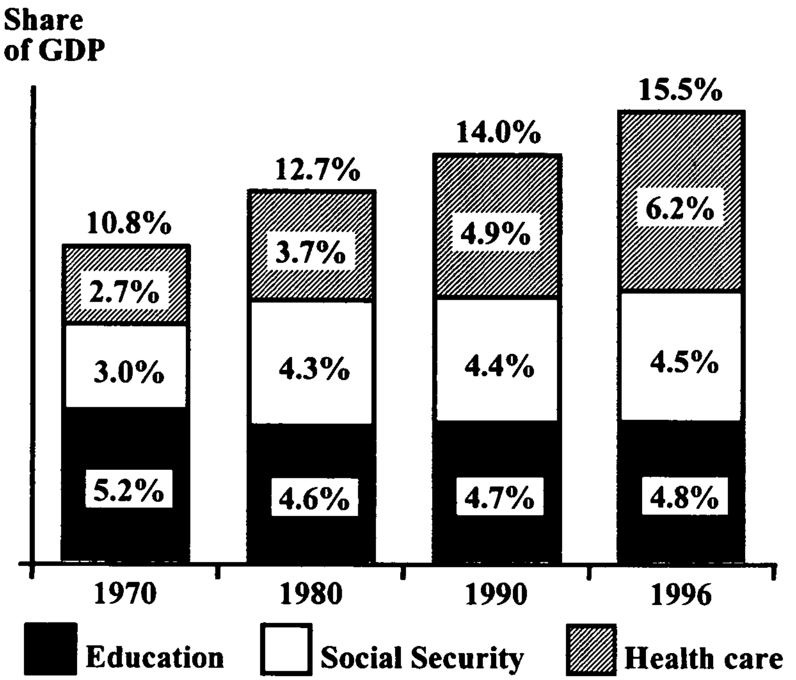
The pay-as-you-go Social Security system was initiated in 1935 in favorable demographic circumstances. The population was growing rapidly, life expectancy past the retirement age of 65 was low, and the number of workers per retiree was consequently high in the system's early years (16 workers per retiree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

The retirement of the baby boom generation will make the Social Security system unsustainable in its present form. According to projections by the system's trustees, by 2037 the trust fund will be exhausted and the current payroll tax rate will be unable to fund promised retirement benefits. Under reasonable population projections, promised benefits will exceed projected revenues by $5 trillion to $11 trillion. The retirement payroll tax already absorbs 10.4 percent of the take-home pay of each worker. Without reform, an even higher rate will be required to keep Social Security solvent.

Life expectancy is difficult to predict. During the last century, the life expectancy of Americans has increased from 47 to 77 years, or approximately 65 percent. As we move into the 21st century, developments in drugs and biogenetics may greatly increase the number of Americans over age 70 and substantially improve their

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

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



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

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

health. Like the retirement of the baby boomers, this will erode the solvency of the current Social Security system.

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

The Lottery-Like Nature of the System

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

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

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

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

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

---

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

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

The Savings-Investment Approach to Retirement

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

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

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

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

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

The Transition to Personal Savings Accounts

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

If action is taken quickly, this potential problem can be overcome. During the next decade, the Social Security system will need only about 80 percent of its projected revenues to fund the benefits of current retirees. The remaining 20 percent will be available to fund PSAs without having to raise the payroll tax. Moreover, the average real rate of return on private investment has been substantially greater than the 2 percent that future retirees can expect from Social Security. For example, the U.S. stock market has yielded an average long-run real return of 7 percent, and the long-run real return of a portfolio comprised 60 percent of bonds and 40 percent of stocks has averaged approximately 5.5 percent a year. Because of the substantially higher real return that can be expected from private investment compared to Social Security, only a portion of the current retirement payroll tax will be required to fund retirement benefits equal to those of Social Security.

Benefits promised under the current system can be maintained while still allowing current workers the option to channel 60 or 70

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

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

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

II. Health Care

The Rising Cost of Health Care

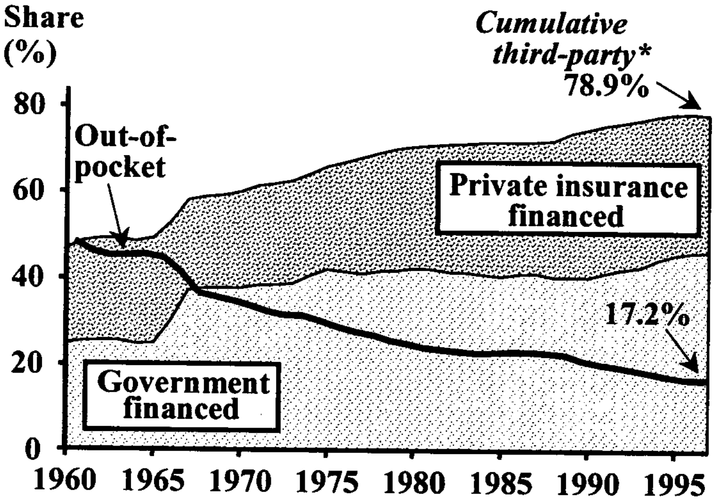
There is considerable dissatisfaction with the cost of health care in the United States. Total spending on health care rose from 5.7 percent of GDP in 1966 to 13.3 percent in 1998. *Government* spending on health care soared from 1.7 percent of GDP in 1966 to 6.2 percent in 1998. The worst is yet to come: there will be a huge increase in the cost of Medicare, the largest government health care program, when the baby boomers retire. Like Social Security, Medicare transfers wealth from workers to retirees. The funds derived from the 2.9 percent payroll tax for Medicare are immediately paid out to current beneficiaries. Presently, Medicare spending accounts for 2.6 percent of GDP and 13 percent of the federal budget. Under current law, these figures are projected to double by 2045.

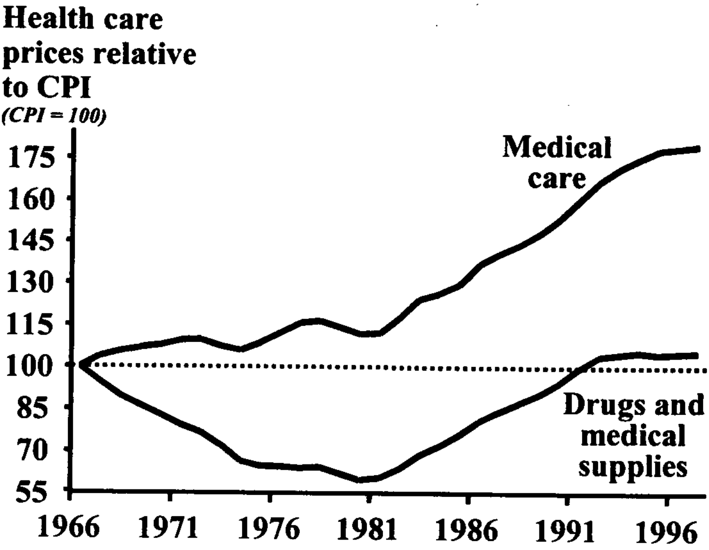
The rapid growth of health care spending to a large extent reflects the nature of the government's involvement. Since 1965, Medicare and Medicaid have subsidized health care for the elderly and the poor. One reason these programs have pushed up prices and spending on health care is that they have increased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

63-597 00 - 2

Exhibit 9: Third-Party Payments and Health Care Inflation

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





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

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

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

As the top panel of Exhibit 9 shows, in 1960 consumers paid directly for about half of all health care spending, while insurance companies and government financed less than a quarter each. The shares changed rapidly after the Medicare and Medicaid programs were established. By the late 1970s, government financed more than 40 percent of all health care spending, and today it finances almost half. Private insurance covers another 31.9 percent, and consumers pay only 17.2 percent directly.

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

The Future of Health Care

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

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

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

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

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

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

---

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

because of rigidities in supply, prices can stay up for a long time.[14] This highlights the need for a more balanced approach to health care policy. Rather than merely increasing demand, it should also focus on the need to expand the supply of medical resources (more doctors and nurses, for example).

III. Education

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

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

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

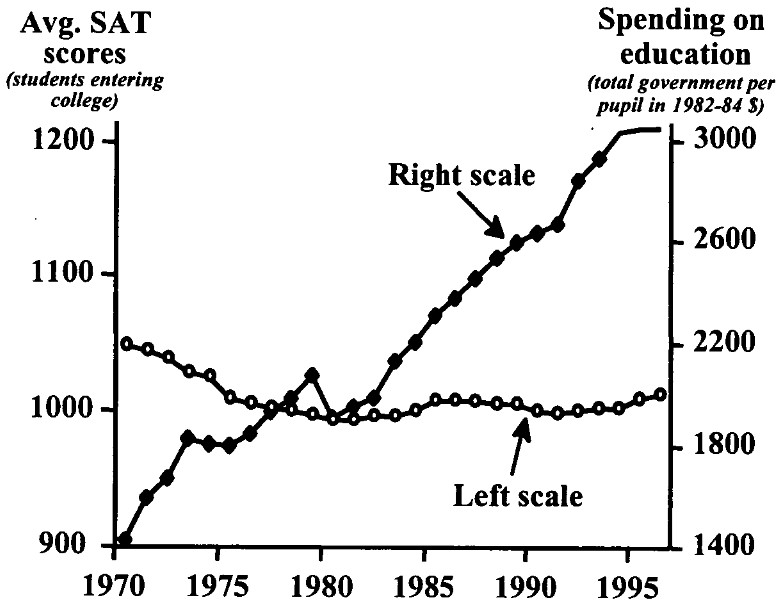
---

[14]Higher prices resulting from Medicare also drive up the health care costs and insurance rates of younger people. As health care insurance becomes more expensive, more households decide that it is unaffordable. Thus, the increase in the number of persons without health care insurance accompanying the expansion in Medicare spending is precisely what one would expect.

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

Exhibit 10: Real Educational Spending and Student Performance

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



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

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

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

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

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

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

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

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

3. PROMOTING A MORE OPEN ECONOMY

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

Economics indicates that residents of a country will be more prosperous when they are permitted to buy from suppliers offering the best deal and sell to purchasers willing to pay the most attractive prices. To test this proposition, the staff of the Joint Economic Committee developed a Trade Openness Index. This index measures the degree to which citizens in various countries are free to exchange goods, services, and capital assets with residents of other countries. The index is based on four factors: (1) tariff rates, (2) presence or absence of a black market for foreign currency, (3) size of the trade sector as a share of the economy, and (4) restrictions on capital movements. High ratings are given to countries with low tariffs, no black market for foreign exchange, a large trade sector (given the country's size and locational characteristics), and few restrictions on the inflow or outflow of capital.[17]

It was possible to derive the index for 97 countries and four time periods during the last two decades (1980-82, 1985-87, 1990-92, and 1995-97). Exhibit 11 illustrates the relationship between openness and economic growth for the countries with the 12 highest and 12 lowest

[17]The four components of the index were weighted equally. The country data on tariffs, black market exchange rate premiums, the actual size of the trade sector relative to the expected size, and a categorical rating indicative of capital market restrictions were all placed on a 0 to 10 scale. For details, see James Gwartney and Robert Lawson, *Economic Freedom of the World: 2000 Annual Report* (Vancouver: Fraser Institute, 2000). The expected size of the trade sector is influenced by both country size and location. Thus, the model used to estimate the expected size of the trade sector is adjusted for size of country (population and geographic area) and locational characteristics (length of coastline and distance from concentrations of demand). The Joint Economic Committee will publish a more comprehensive report on international trade and economic growth later this year.

Exhibit 11: Trade Openness, Income, and Growth

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

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

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

average ratings for openness during these four periods. The 12 most open economies had low tariffs, liberal currency conversion policies, large trade sectors, and few restraints on the inflow and outflow of capital. Hong Kong, Singapore, Belgium, Panama, Luxembourg, and Germany head the list; the United States ranks seventh, tied with the United Kingdom and the Netherlands. In contrast, the least open economies--Myanmar, Bangladesh, Sierra Leone, Burundi, Iran, Uganda, and Syria--persistently followed policies that restricted trade.

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

I. The Trade Record of the Clinton Administration

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

---

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

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

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

(WTO) has, at least for now, undermined the WTO's effectiveness as a force for trade liberalization.

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

Low-income countries resent the imposition of labor and environmental regulations by the United States and other high-income countries.[21] They argue that such regulations are nothing more than a disguised form of protectionism. They have a strong case. Their labor and environmental standards are much like those the United States itself had a century ago, when it had a comparable income level. In 1900, most Americans began their working lives by the time they finished eighth grade. The air in American cities was thick with coal dust from thousands of stoves and furnaces, and drinking water was often infested with disease-causing organisms from raw sewage dumped by cities upstream. In those days, Americans wanted education for their children and a clean environment just as much as they do now; the problem was how to afford them.

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

---

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

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

II. The Future Direction of Trade Policy

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

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

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

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

itself and set an example for the rest of the world to emulate by following this course of action.[23]

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

4. Promoting Sound Monetary Policy at Home and Abroad

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

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

The high credibility the dollar enjoys is rare. Among the world's 150 or so currencies, only the dollar, the euro, the Japanese yen, and a few others such as the Swiss franc and British pound are trusted enough to be internationally acceptable. Most other countries have currencies that are unsound and suffer periodic currency crises as a result. In 1997, East Asian countries were affected; in 1998, Russia; and in 1999, Brazil and Ecuador. The frequency of currency crises in the 1990s has resulted in calls for a "new international financial architecture." The Group of Seven (G-7) nations and other official and unofficial groups have held numerous meetings and issued many

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

papers on various aspects of the subject. So far, proposals for reform have produced few concrete results.

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

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

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

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

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

5. Making the International Monetary Fund More Effective

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

I. Problems with IMF Lending

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

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

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

Cost to U.S. taxpayers. The Clinton Administration has claimed there is no cost associated with U.S. contributions to the IMF. The IMF's base rate for loans, currently less than 5 percent, is comparable to or even below the rates the United States and other highly creditworthy governments pay in open markets. But almost all IMF

---

[26]Paul Blustein, "Suharto Reconsidering Currency Policy; IMF Opposed Indonesian Leader's Plans to Peg Rupiah to Dollar," Washington *Post*, February 22, 1998, p. A24; Steve H. Hanke, "How I Spent My Spring Vacation," *The International Economy*, July-August 1998.

loans are made to less creditworthy governments who would pay much higher rates in open markets. The rates the IMF charges them do not adequately reflect their potential risk, and thereby exacerbate the moral hazard problem discussed above. Subsidized loans are not necessary to assist illiquid borrowers and are counterproductive for insolvent entities.

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

II. Reforming the IMF

The IMF has drifted into areas unrelated to its core mission of financing temporary balance of payments problems. Its far-flung economic development and structural lending projects duplicate the activities of its sister organization, the World Bank. To address these problems, the Congress established a bipartisan International Financial Institution Advisory Commission, which completed its work and presented a report in March 2000.[27] The report contains many suggestions for improving the performance of the IMF and other international financial institutions. Among its findings are these:

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

---

[27]The full text of the report of the commission is available online at <http://phantom-x.gsia.cmu.edu/IFIAC/USMRPTDV.html>. The Treasury has made some highly inaccurate criticisms of the report; see the testimony of Treasury Secretary Lawrence Summers to the House of Representatives Committee on Banking, March 23, 2000, available online at <http://www.house.gov/banking/32300sum.htm>. Representative Jim Saxton (R-New Jersey) introduced the IMF Reform Act of 2000 in February (H.R. 3750) to address some of the same issues covered by the commission. The text of the bill is available online at <http://www.house.gov/jec/imf/2-29-leg.pdf>.

that have more of an emergency character, these reforms are the result of more deliberation and more initiative from indebted countries.

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

The IMF should improve its transparency further. It should disseminate its so-called Article IV reports and other country information that, at the request of some member countries, is now confidential. Also, it should publish minutes of the meetings of its executive board, with a suitable lag, and should reformat its balance sheet to be more understandable. At present, the balance sheet contains no direct information on how much the IMF has lent or how liquid its various assets and liabilities are.

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

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

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

6. Reducing the Burden of Federal Taxes

I. The Size of the Federal Tax Burden

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

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

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

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

II. Who Pays Federal Taxes?

Personal income taxes account for 49 percent of federal revenues; Social Security and Medicare payroll taxes account for 33 percent; corporate income taxes account for 10 percent; and other taxes account for 8 percent. Each source of federal tax revenue imposes a distinct cost on American families in their roles as workers, consumers, savers, and entrepreneurs. The actual burden of a tax may be distinct from the source of collection. Following is a brief description of the burden of each major tax.

---

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

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

Exhibit 12: Individual Income Tax Shares

Over the last two decades, high-income taxpayers have paid an increasing share of federal personal income taxes.

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

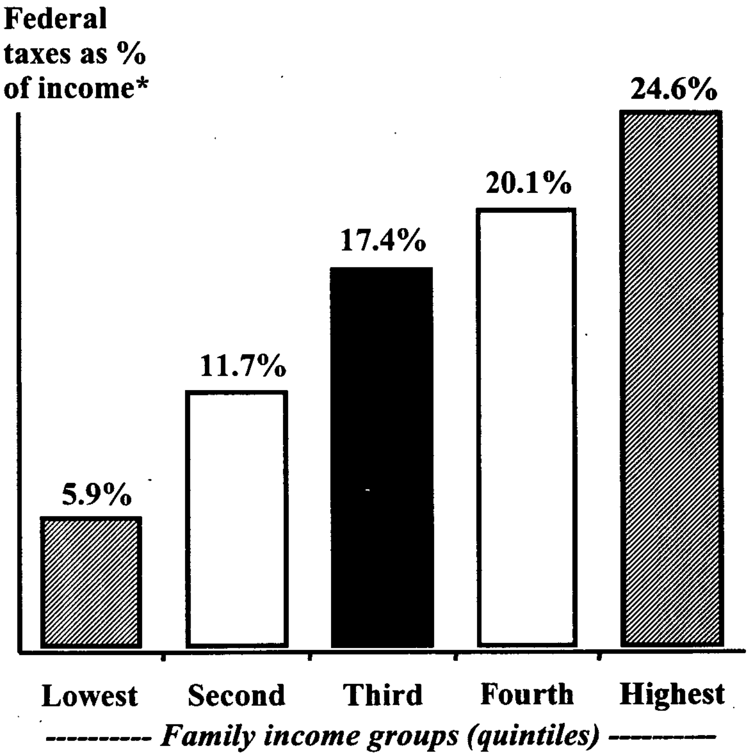
Source: Internal Revenue Service.
Note: For entire series, see Appendix, table 8.

- **Personal income taxes.** The personal income tax burden is highly skewed towards upper-income individuals. As the IRS data of Exhibit 12 show, the top 5 percent of tax-filing families paid 51.9 percent of the federal personal income taxes in 1997, up from 43.6 percent in 1990 and 36.8 percent in 1980.[30] The top 10 percent of earners paid 63.2 percent of the 1997 federal income tax. While the revenue collected from the top group has risen, the share paid by the bottom 90 percent of taxpayers has fallen. Interestingly, this was true during both the 1980s, when marginal rates were reduced, and during the 1990s, when except for the capital gains rate, the top marginal rates were increased. The standard deduction and other provisions exempt millions of lower-income families from taxation, so that just 64 percent of U.S. families are expected to pay income tax in 1999.[31]
- **Payroll taxes.** The combined Social Security and Medicare payroll tax of 15.3 percent imposes a heavy burden on all employed and self-employed families, since it applies to wages from the first

[30] Internal Revenue Service, *SOI Bulletin*, Spring 1999, and electronic data from the IRS for 1997. See Appendix, table 8, for annual data on the shares of personal income taxes paid by various income groups since 1980.
[31] U.S. Congress, Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004," JCS-13-99, December 22, 1999.

Exhibit 13: Total Federal Taxes as a Share of Income

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



Source: Treasury Department. Income is "Family Economic Income."
Note: * Total federal taxes include income, excise, payroll, and estate taxes.

dollar earned. About 80 percent of working families pay more payroll taxes than they do income taxes.[32]

- **Corporate income taxes.** The corporate income tax is passed through businesses to shareholders, debt holders, workers, consumers, or some combination. The tax is highly complex and

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

creates a hidden burden of taxation that many Americans are unaware that they pay.

- **Other taxes.** Consumers pay federal excise taxes on a variety of products including cigarettes, gasoline, alcohol, telephone service, and other items. The federal estate and gift tax, also known as the death tax, can be thought of as falling on either deceased people or their heirs. It is considered unjust by many, and can impede the transfer of family businesses such as farms and shops.

All in all, the federal tax system is highly progressive, meaning that lower-income families pay a smaller share of income in taxes than higher-income families. Exhibit 13 shows Treasury Department estimates of average tax burdens for U.S. families grouped into five income groups for 2000. Families in the highest fifth will pay 24.6 percent of income in federal taxes this year, on average, while families in the lowest fifth will pay 5.9 percent.

III. Problems Created by the High Tax Burden

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

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

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

The Office of Management and Budget estimates that individuals and businesses will spend over 6 billion hours (3 million person-years) filling out tax forms this year, including hours spent record-keeping and learning the tax rules.[34] The tax code has gotten so complicated that more than half of U.S. families now use tax preparation firms to make sure they comply with the complex rules. These firms, such as H&R Block and Jackson Hewitt, have seen their businesses soar. H&R Block's 1999 revenues from tax operations of $1.3 billion are up 30 percent in the past two years.

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

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

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

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

---

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

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

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

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

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

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

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

Other aspects of the income tax system are also investment-unfriendly for U.S. businesses seeking to compete in the global economy. For example, the rapid obsolescence of new technologies is not fully reflected in tax depreciation rules. Semiconductor and printed circuit board manufacturing equipment must be written off over five

---

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

years, but often becomes obsolete in three. A number of other industrial countries have more competitive depreciation treatment for technology equipment.[36]

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

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

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

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

When employees receive health insurance benefits as part of their compensation package, the benefits are generally not taxed at the employer or employee level. By contrast, families and individuals purchasing health insurance directly must generally do so with after-

---

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

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

tax earnings.[38] This difference in tax treatment makes the direct purchase of health insurance more costly, creating an unfair bias against families not receiving benefits through work.

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

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

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

While the tax was originally aimed only at high-income Americans, flaws in its design mean that rising numbers of middle-income taxpayers must also deal with the AMT. In particular, AMT exemption amounts, phase-out thresholds, and the top tax rate threshold are not indexed for inflation, so as incomes grow more families become subject to this tax. Even if they do not owe AMT, more and more taxpayers must perform calculations to see if they are

---

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

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

liable for it, above and beyond their regular tax amount. Taxpayers hit by this add-on tax are projected to jump from about 1 million today to about 9 million by 2009.[40]

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

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

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

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

---

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

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

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

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

I. Is the Trade Deficit a Problem?

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

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

Exports + Net Foreign Investment = Imports[42]

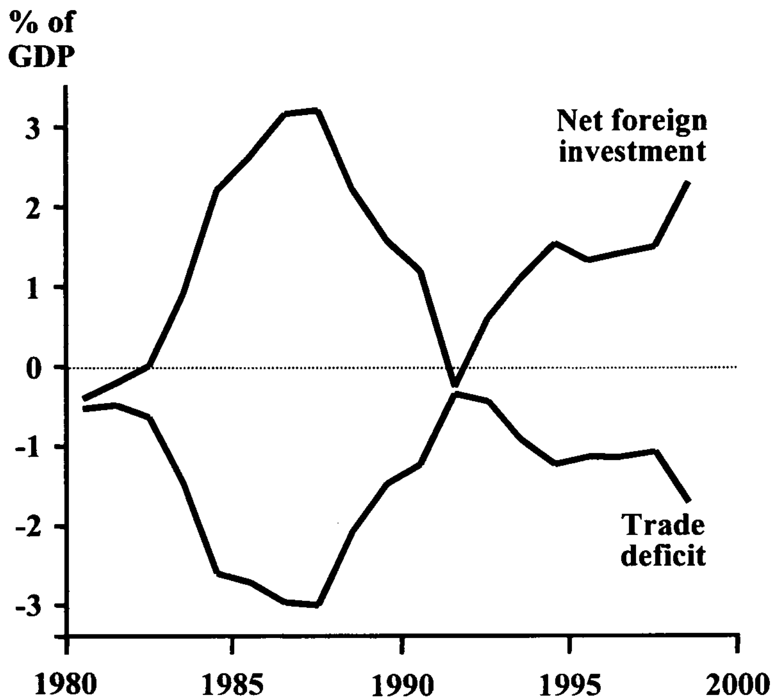
Therefore, when foreigners invest heavily in a country--when there is the net inflow of capital--a trade deficit (current-account deficit) will occur.

During the last two decades, the United States has grown faster than many of its trading partners. At the same time, investment opportunities have been highly attractive in the United States. This combination has undergirded the trade deficits of the last two decades. Why do many people think the trade deficits are bad? Would we have been better off if the U.S. had grown more slowly or if the environment for investment in the United States had been less attractive? These

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

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

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



Sources: *Economic Report of the President,* 2000, table b-22; Haver Analytics.
Note: For underlying data, see Appendix, table 7.

questions answer themselves. Recent trade deficits reflect the strength of the U.S. economy, not its weakness.

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

Doesn't a trade deficit mean greater indebtedness to foreigners? Not necessarily. Much of the foreign investment involves the purchase of stocks and physical assets like buildings and business assets.

Americans benefit because they are able to sell these assets to foreigners at more attractive prices than would otherwise be possible. Foreign investments of this type do not increase American indebtedness to foreigners. Some foreign investments are in the form of loans or the purchase of bonds, which mean lower interest rates for Americans. If the investments are sound, they will generate a future income stream that is more than sufficient to repay the loans. Even in this case, the loans are helpful to the U.S. economy.

Critics of trade often argue that trade deficits mean loss of jobs. Once the link between the inflow of capital and trade deficits is recognized, the error of this view is obvious. The inflow of capital that must accompany a trade deficit will lead to lower interest rates and a higher level of investment. Any loss of jobs accompanying the excess of the imports relative to exports will be offset by higher employment due to the lower interest rates and more investment. The U.S. experience during the Great Expansion illustrates this. Even though imports grew more rapidly than exports and trade deficits were sizeable throughout much of the period, total employment increased by 35 million from 1983 to 1999 and the unemployment rate fell to a 30-year low (see Exhibits 1 and 3 above). Simply put, the protectionist view that trade deficits reduce employment is fallacious. Neither economic theory nor empirical evidence provide support for this position.

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

A trade deficit is quite different from a business loss or even the budget deficit of a government. No legal entity is responsible for the trade deficit.[43] It is not something that one party owes to another; it is

---

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

merely the sum of the buying and selling decisions of millions of people. Suppose an American retailer purchases $500,000 of shoes from a British manufacturer. In turn, the British firm uses the funds to buy stocks or bonds issued by an American corporation. These transactions will increase the size of the trade deficit. But why is there any reason for concern? They reflect the voluntary choices of individuals that will both reap the benefits and bear the costs. This is also true for a nation's trade deficit.

II. Should the Federal Debt Be Fully Paid Off?

At the end of 1999, the federal debt was $5.7 trillion. Of this amount, $2.2 trillion was held by federal agencies and trust funds (primarily the Social Security Administration) and another $500 billion was held by Federal Reserve Banks. Thus, the amount of debt that the federal government owes to someone other than itself is only $3 trillion.

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

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

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

Third, the U.S. dollar is a "reserve currency." Central banks and other monetary authorities around the globe currently hold more than $600 billion of U.S. Treasury securities as reserve assets. If the national debt were paid off and the securities were unavailable to foreigners, the dollar would be less attractive as a worldwide currency. With time, the reduction in the worldwide demand for the dollar could erode its position as the world's leading currency and make financial markets in dollars less extensive. That might make it more costly for Americans to engage in international transactions.

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

63-597 00 - 3

8. CONCLUSION

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

Social Security, health care, and education

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

Trade

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

Domestic and international monetary policy

- Continue to focus the Federal Reserve on price stability. Establish price stability by law as the main long-term goal of the Federal Reserve.
- Encourage official dollarization in interested countries.
- Encourage countries to adopt fixed exchange rates (as dollarization would provide) or fluctuating rates, and avoid pegged rates, which have been at the center of many currency crises.
- Reform the International Monetary Fund, using as a basis some of the recommendations of the International Financial Advisory Commission appointed by the Congress.

Taxes

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

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

APPENDIX

Table 1: Real Federal Spending per Person

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

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

Real Federal Spending per Person *(continued)*

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

Table 2: Civilian Labor Force

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

Source: Haver Analytics.

Table 3: National Health Care Expenditures (NHE)

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

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

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

Table 4: Health Care Price Indexes

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

Source: Haver Analytics.

Table 5: Real Education Spending and Student Performance

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

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

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

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

Source: Constructed by the staff of the Joint Economic Committee.

Table 7: Individual Income Tax Shares

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

Source: Internal Revenue Service.

Table 8: Trade Deficit and Net Foreign Investment

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

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

RANKING MINORITY MEMBER'S VIEWS AND MINORITY STAFF REPORT

Finishing the Job

For the first time in over a generation, an increasing number of Americans are enjoying economic prosperity. Wages for most workers are up, unemployment and inflation are at historic lows. The United States is currently experiencing the longest economic expansion in its history. A lot has been accomplished, but there is still more to achieve.

Accomplishments

- **After 20 years of stagnation, real average weekly earnings are rising once again.**

- **At 4.2 percent, unemployment is at its lowest rate since 1970. The unemployment rate has been at or below 5 percent for the last 3 years.**

- **The economy created more than 20 million jobs between 1992 and 1999, an average of 2½ million jobs per year. By contrast, between 1980 and 1992, employment grew by only an average of less that 1½ million jobs per year.**

- **Core inflation has fallen to its lowest rate since 1965 — despite continued declines in the unemployment rate.**

- **Economic growth has been above 4 percent during each of the last 3 years, well into the current expansion.**

For the first time since the Full Employment and Balanced Growth Act was passed in 1978, the US economy has met the goals set out by Senator Hubert Humphrey and Congressman Gus Hawkins:

- The unemployment rate for individuals over 20 years old is just ½ percentage point above the goal of 3 percent.

- The unemployment rate for individuals over 16 years old has met the stated goal of 4 percent.

- Inflation has remained below the goal of 3 percent since the beginning of the Clinton Administration, 7 years ago.

- All of the above was achieved while balancing the federal budget, for the first time in over 40 years.

The great irony is that Senator Humphrey and Congressman Hawkins saw these goals as part of the path toward achieving full employment and balanced economic growth. Today, 20 years later, Federal Reserve Chairman Alan Greenspan views them as dangerous signs of an overheating economy. On the contrary, low unemployment, low inflation, and rising wages are ***always*** good for an economy.

There is much to celebrate in the current economic expansion. At the same time, there remains a lot more to do. The benefits of the expanding economy have not yet been experienced by all Americans. The current economic prosperity provides a good opportunity to finish the work which has begun on the following agenda, thereby restoring some of the economic losses experienced over the last 2 decades.

Unfinished Agenda

- **Raise the minimum wage by $1 over the next two years.**

- **Encourage more localities to implement Living Wage ordinances, which include a higher minimum wage and pension and health care benefits.**

- **Move toward universal health care.**

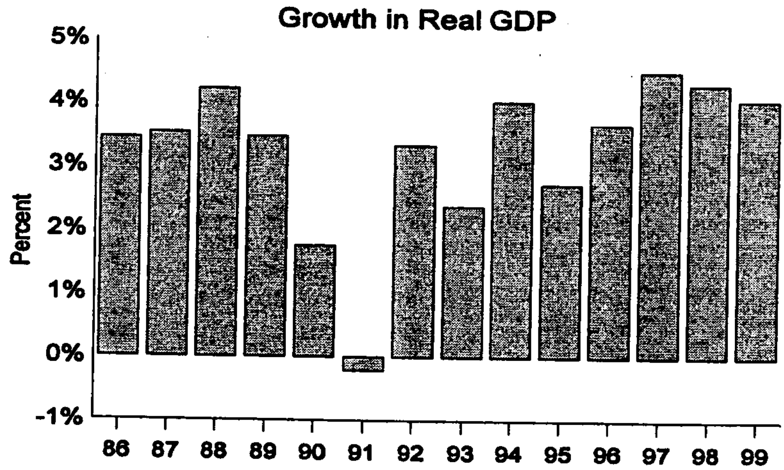
- **Enroll all uninsured children in the Children's Health Insurance Program.**

- **Establish an outpatient prescription drug benefit for all seniors on Medicare.**

- **Ensure that all students have access to computers and to the Internet, and educate children on how to use them to enhance their skills.**

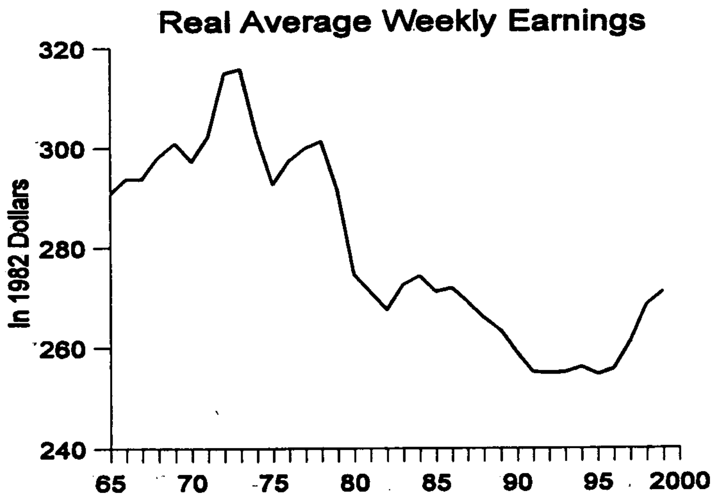
I. The Longest Economic Expansion in US History

The new century begins with the US economy characterized by robust growth, low and stable inflation and low unemployment. By February 2000, the Gross Domestic Product (GDP) had grown for 107 consecutive months, making the current economic expansion the longest on record. Between 1992 and 1999, average real GDP growth was approximately 3 ½ percent a year. During the fourth quarter of 1999, well into the expansion, real GDP growth was almost 7 percent on an annual basis, the highest quarterly growth rate in 3½ years.



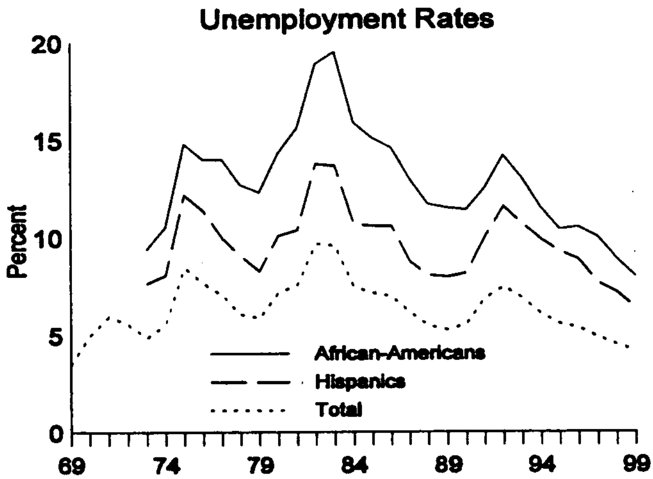
Source: Department of Commerce, Bureau of Economic Analysis

After falling and stagnating for over 20 years, real average weekly earnings have been rising since 1993. Over the last 6 years, real average weekly wages have grown by more than 6 percent. Yet, despite this growth, real average weekly wages have only just returned to levels achieved in 1986 and are still 14 percent ***below*** their 1973 high. Although the stagnation of real average wages has been halted, there is a lot more to do to ***reverse the decline*** experienced since the mid-1970s. Assuming wages continue to rise as fast as they have over the last 6 years, it would take ***another*** 14 years before they would reach their 1973 value.



Source: Department of Labor (BLS).

The average monthly unemployment rate in 1999 was 4.2 percent, its lowest rate in 30 years. The economy created more than 20 million jobs between 1992 and 1999. Most of the new jobs created (18 million) were in the service sector; 1.8 million new jobs were in construction. Manufacturing employment grew by almost 330,000 jobs since 1992, despite a significant loss of jobs over the last two years due to the loss of export markets and the surge in imports resulting from the Asian financial crisis.



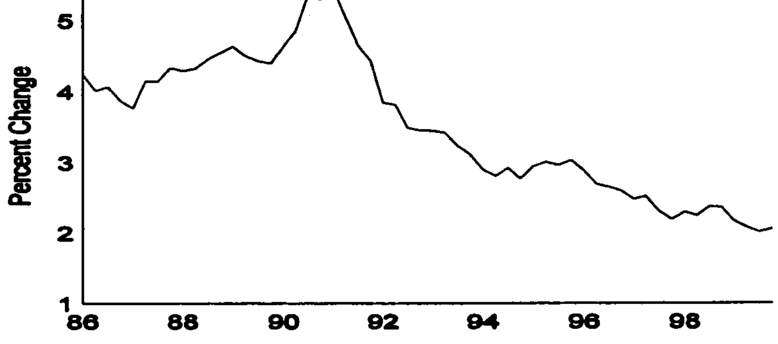
Source: Department of Labor, Bureau of Labor Statistics

Tight labor market conditions have lifted the job prospects for minority workers after years of difficulty. The unemployment rate for African-Americans was 8 percent in 1999, down from a high of more than 14 percent in 1992. Hispanics have also seen their unemployment rate drop from about 11½ percent in 1992 to approximately 6½ percent in 1999. These are the lowest minority unemployment rates since the government began tracking them in 1973.

This performance also extends to other labor market measures. The number of discouraged workers – those who are not actively seeking employment due to pessimism about their job prospects – fell from 7 million in 1994 to 4.3 million in January 2000. Discouraged workers as a percent of all those not in the workforce fell from 10 percent in 1994 to 6 percent in January 2000.

Despite the tight labor market, inflation has remained in check throughout this entire economic expansion. In 1999, core inflation – the change in prices of goods excluding food and energy – was at its lowest rate since 1965. There is little evidence that the strong economy has led to increases in broader price levels during 1999 and early 2000, despite recent increases in energy prices. Energy prices rose at an annual rate of 34 percent for the 3 months ending February 2000, and the core inflation index increased at an annual rate of only 1.8 percent over the same period. For all of 1999, inflation remained low, at less than 3 percent, while consumer spending grew by 5½ percent. To date, there is no evidence that low unemployment, recent wage gains and higher consumer spending have put upward pressure on inflation.

Changes in Consumer Prices



Source: Department of Labor, Bureau of Labor Statistics. Core rate of inflation, calculated year to year.

In recent years, wages have grown faster than the prices of goods and services. This represents a real improvement in living standards. In addition, with all the recent advancements in technology, the ***quality*** of most goods has improved. For example, a 19-inch TV cost $439 in 1973. An average person would have had to work about 2½ weeks in order to afford the TV. Today, a substantially better quality 19-inch TV costs only $270 and an average person only has to work a little less that 2 days in order to afford it. The price of televisions has fallen while their quality has improved, and wage increases have made televisions even more affordable.

There have also been improvements in the affordability of food and other basic commodities. For example, a family of four who lived in San Jose, California paid $100.83 a month in 1983 for a basket of selected goods and commodities.[1] This was equivalent to a little over a day's wages. By contrast, this same basket of goods cost $124.12 in 1997, but because wages grew faster than prices, it took only a little over half a day's work to afford these goods.

Most of the improvement in consumer purchasing power occurred in the 1990s. The current expansion has increased job opportunities for all workers and has halted the slow deterioration in middle class living standards that occurred in the 1970s and 1980s.

Probably the most important economic development of the 1990s has been the elimination of the federal budget deficit. A combination of fiscal discipline and robust economic growth has created two consecutive years of federal budget surpluses after 40 years of continuous deficits. The surplus in 1998 was proof that policies implemented over the previous 6 years were successful in reversing the large budget deficits which resulted from Reaganomics.

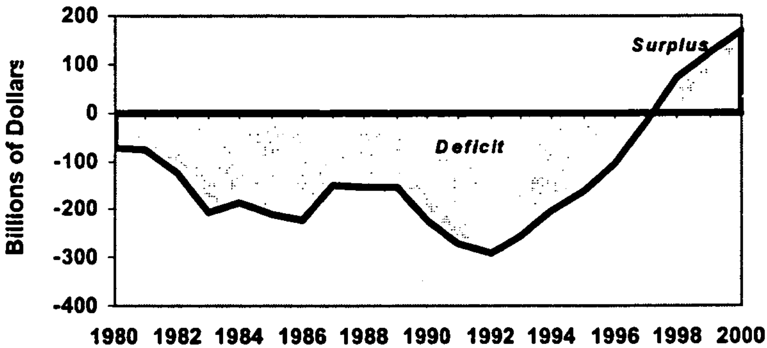
In the early 1980s, large tax breaks for corporations and wealthy Americans, coupled with an increase in defense outlays, resulted in large budget deficits throughout the rest of the 1980s and into the early 1990s. The deficit reached its post-World War II peak in 1983, when it accounted for 6 percent of total output. From the late

---

[1] The basket includes 4 loaves of bread (one for each week), 4-4 pound roasts, 4-4 pound chickens, 4 dozen eggs (one dozen per week), 16 pounds of apples (4 pounds a week), 1 pound of coffee and 24 gallons of gas (12 gallons twice a month).

1980s until 1992, the economy struggled to overcome the burden of deficits in an economically stagnant environment. Presidential leadership and Democratic efforts on the Omnibus Budget Reconciliation Act of 1993, which no Republicans supported, together with sound economic growth during the 1990s, resulted in reducing and finally eliminating the budget deficit by 1998.

Federal Budget Deficits/Surpluses



Source: Office of Management and Budget.

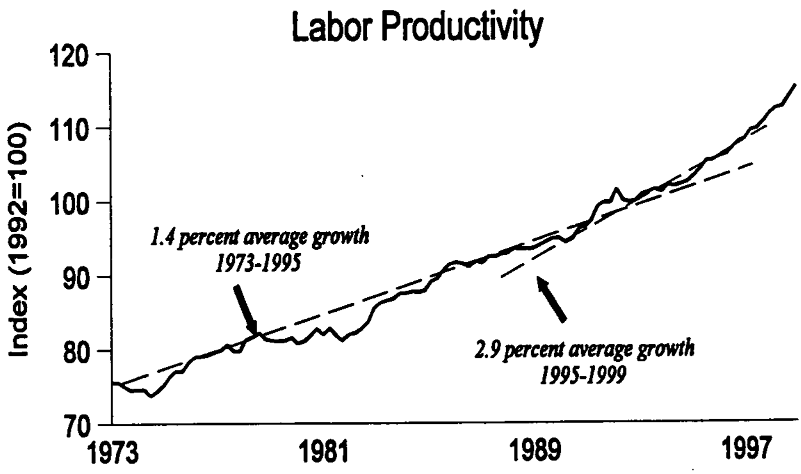
Since 1981, Americans have paid more than $2 trillion in interest payments accrued on the additional debt incurred between 1981 and 1992. This translates into approximately $500 per man, woman, and child each year for the last 19 years. The run-up of the budget deficit during the 1980s placed a heavy burden on Americans, at a time when their wages were stagnant. The challenge for the future is not to repeat the mistakes of the early 1980s, but to maintain fiscal discipline and promote greater investment and economic growth.

What is fueling the expansion?

The most important factor in understanding recent improvements in wages and salaries is the increase in productivity growth rates. Higher productivity growth makes it possible for wages to grow while maintaining low rates of unemployment with little or no inflation. In order to be most beneficial to workers, productivity growth should reflect real improvements in output and wages, not just firms laying off workers. Thus, the challenge is to achieve both high rates of productivity growth and low rates of unemployment simultaneously. This is currently the case in the US economy.

Between 1973 and 1995, the average annual rate of productivity growth was an anemic 1.4 percent per year. At the same time, real average weekly wages ***declined*** by 1 percent a year. In contrast, since 1995, average annual productivity growth has doubled, while the unemployment rate has fallen, and real average wages have ***grown*** by more than 1½ percent per year.

This impressive growth in productivity raises several questions. Most importantly, are we experiencing a long-term shift in



Sources: Department of Commerce (Bureau of Economic Analysis) and Department of Labor (BLS).

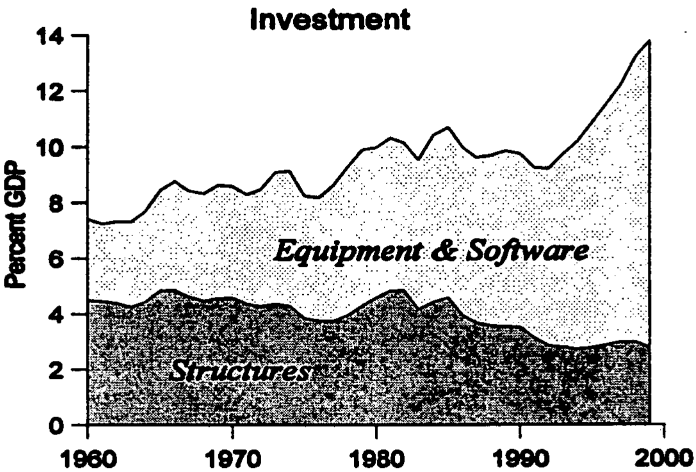
productivity growth rates or is it just a one-time phenomenon? How much of the improvement in productivity is attributable to recent advances in technology? How much of the improvement is due to cyclical factors?

In its recent Annual Report to the President, the Council of Economic Advisors highlights the fact that current productivity growth rates are unusually strong this far into an economic expansion. Historically, productivity tends to surge during an economic slowdown, as firms lay off workers and cut costs, and tends to remain high during the early stages of a recovery, before declining. The continued surge in productivity growth this far into the economic expansion suggests that the recent improvement is not all due to cyclical factors. At the Joint Economic Committee's High-Tech Summit held last summer, Fed Chairman Alan Greenspan, as well as CEOs of IBM, Intel, Microsoft, the President of MIT, and the President of the Communications Workers of America, all testified that recent advancements in technology have contributed to this improvement in productivity. These experts also suggested that we are at the beginning of these technological advances, and that further improvements can be expected for many years to come.

Recent improvements in productivity growth have followed an unprecedented increase in investment in new technologies, especially computers and information technology. Between 1981 and 1993, non-residential fixed investment fell from 13 percent of GDP to less than 10 percent. The last time the rate of investment was that low was in 1964. The fall in investment throughout the 1980s and the early 1990s helps explain the low productivity growth during that period. Between 1993 and 1999, non-residential fixed investment rose from less than 10 percent to almost 14 percent of GDP. Between 1991 and 1998, total investment grew more than 3 times faster than GDP, and more than twice as much as in the 1980s. The steep growth in investment over such a short period of time is unprecedented and is fueling the current economic expansion.

In addition to a significant increase in the amount of productive investment, there has been a shift in the composition of investment. In 1960, investment in structures – such as the bricks and mortar of factories – accounted for 60 percent of non-residential fixed investment, while equipment – such as machinery and computer software – accounted for the remaining 40 percent. The rapid growth of investment in equipment – especially computer software – over the last 40 years has resulted in a reversal of that relationship. Since 1993, investment in information processing equipment and software has grown at an average annual rate of 19 percent. By 1999, equipment and software comprised 80 percent and structures comprised only 20 percent of non-residential fixed investment.

Improvements in the quantity and quality of investment are critical to expanding the productive capacity – or the supply-side – of the economy. This pick-up in investment can be traced to efforts by President Clinton and Democrats in Congress over the last few years to reduce the budget deficit, thereby freeing up capital and making it



Source: Department of Commerce, Bureau of Economic Analysis.

available for productivity-enhancing investments in the economy. The economic expansion of the 1990s has been primarily fueled by increases in investment, rather than by increases in government spending, as in the 1980s. In fact, government spending as a percent of GDP has ***declined*** during the current expansion, and currently stands at less than 18 percent of GDP, its lowest rate since 1967.

Reducing the budget deficit enabled monetary policy to be more accommodating, allowing interest rates to fall. This helped contribute to a positive environment for investment, particularly in information technology (IT) equipment and software. Developments in the IT sector were at a stage where massive inflows of capital could be absorbed. This increase in investment led to major advances in technology, which in turn contributed to a significant improvement in productivity growth. As a consequence, wages and salaries rose after 20 years of decline and stagnation without igniting inflation. This chain of events, which occurred during the 1990s, represents a true expansion of the supply-side of the economy.

There is much to celebrate in the current economic expansion. Today, more people are working at higher wages than anytime in the past 20 years. Low inflation and high productivity growth have contributed to real improvements in living standards for most Americans. But the benefits of this prosperity have not yet been shared equally by everyone. In fact, some Americans have yet to see significant change in their economic situation.

What should be done to maintain the current expansion?

If anything has been learned over the last 7 years in terms of economic policy, it is how important eliminating the budget deficit has been for stimulating private investment, raising wages for American workers and keeping inflation low. Looking forward, it is crucial to maintain the fiscal discipline practiced by the Clinton Administration and the Democrats in Congress since 1993.

The last 20 years provide sufficient evidence to analyze the consequences of economic policies. The key is to learn from our experiences and avoid making the same mistakes we made in the past.

The simple fact is that the Reagan "supply-side revolution" was a complete disaster. While a few got rich, the vast majority of Americans suffered as the country was saddled with an enormous debt, which working families are still paying off.

As a consequence of the 1981 tax cut, tax receipts not only did not rise, as the advocates promised, but rather they fell from 19 percent of GDP in 1980 to approximately 17½ percent between 1983 and 1986. Government outlays, which included draconian cuts in social programs in order to pay for the large build up in defense spending, stood at approximately 22½ percent of GDP throughout the period. The results were budget deficits for "as far as the eye could see."

These ballooning budget deficits placed, and continue to place, a burden on American workers and caused the federal debt to triple between 1981 and 1992. Since 1981, American workers have paid approximately $2 trillion in interest on the additional debt, to finance the so-called "supply-side experiment" of the 1980s.

The great irony is that the Reagan Administration's so-called "supply-side experiment" was nothing more than a Keynesian expansion of consumer demand, without any improvement in investment. In fact, the "supply-side" policies of the 1980s actually ***hurt*** the exact investment they were intended to encourage. Despite these tax cuts, or may be because of them, investment in plant and equipment remained flat, at less than 10 percent of GDP, from 1980 to 1992.

The only difference between the Keynesian expansion in the 1980s and others, was that this one was accompanied by a real ***decline*** in living standards of American workers. Workers watched the purchasing power of their paychecks fall 7 percent between 1980 and 1992. In addition, the 1981 tax cuts – which favored the wealthy – contributed to a considerable worsening in income inequality.

The last 7 years have been an excellent example of how to expand the supply-side of the economy. Consider the record: Since 1992, investment in plant and equipment has grown from less than 9 percent of GDP to almost 14 percent of GDP last year. Productivity growth rates, which averaged 1½ percent annually between 1973 and 1995, have been closer to 3 percent annually since 1995. Recently, the Commerce Department revised upward its estimate of productivity growth in the non-farm sector to 6.4 percent in the fourth quarter of 1999. The size of the revision alone was greater than average productivity growth rates during most of the 1970s and 1980s.

Higher productivity growth enables wages to rise without igniting inflation. As productivity grew over the last 7 years, real average weekly wages rose by 6 percent. The unemployment rate fell and now stands at 4.2 percent. There are no signs of renewed inflation due to the wage gains. There is much to celebrate in this economy, but there is still a lot which needs to be done to make up for the declines in living standards due to the supply-side experiment of the 1980s.

One of the most important lessons of the last 20 years is that the best way to increase tax revenues is simply to grow the supply-side of the economy – as the nation has been doing since 1993, not by drastically cutting tax rates, which was done in the 1980s.

The Republicans in Congress seemed not to have learned that lesson. Their proposed budget for FY 2001 includes a "Bush-lite" tax cut. It only goes half as far as Governor Bush's proposal, but costs more than the bloated Republican tax cut proposal for FY 2000, which the American people clearly rejected.

There are two fundamental things wrong with the Republican's latest tax proposal. First, it benefits the rich and does not help the vast majority of Americans. Second, the tax cuts, together with the rest of the proposed budget package, are certain to take the economy back down the path it took during the 1980s, which caused real economic hardship on workers and their families.

In addition to the large tax cuts, the Republican budget calls for increases in defense spending, and drastic reductions to non-defense discretionary spending. This precise mix of policies brought us the record budget deficits of the 1980s, which contributed to a decline in living standards for the vast majority of Americans.

The Republican budget calls for increasing defense spending by $17½ billion above the caps, which is even more than the Administration's request. According to the Children's Defense Fund, just this additional spending alone would be enough to:

- Provide Head Start to 1.7 million additional children; *and*

- Provide child care to more than 8 million additional children; *and*

- Provide 21st Century After-School programs for close to 35 million additional children.

The Republican budget cuts non-defense discretionary spending by 6 percent or $114 billion over 5 years. If this budget is enacted, it will mean, among other program cuts:

- Dropping 310,000 low-income women off of the Women, Infant and Children program (WIC), just next year;

- Denying child care to over 12,000 children in 2001;

- Eliminating Head Start services for more than 40,000 children and their families by 2005; and

- Cutting off energy assistance to 164,000 low-income families next year, precisely at the same time rising oil prices are hurting families.

The nation should not return to the failed policies of the past, which would certainly jeopardize the recent unprecedented prosperity. Instead, Congress and the President should maintain fiscal discipline, and focus on addressing some of the major economic problems affecting American workers and their families which have been put off for at least 20 years. Now is the time to begin solving these problems.

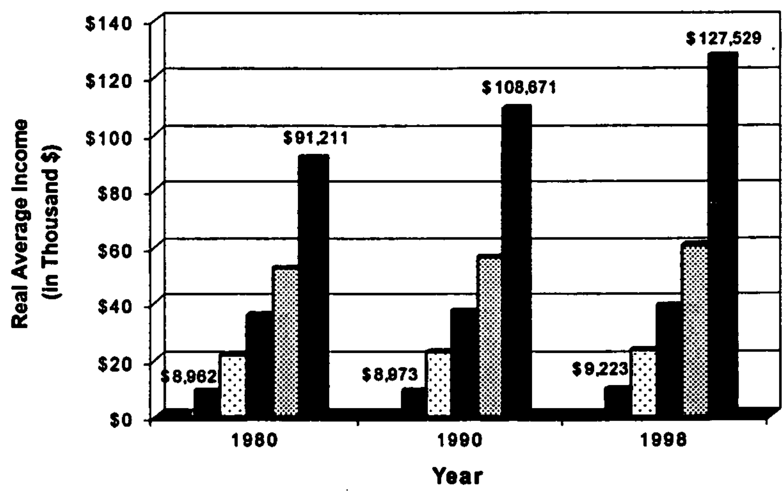
II. The Widening Income Gap

Although it has taken some time to achieve, average before-tax income is now beginning to grow for Americans in ***all*** income groups, not just for the wealthy. Yet after-tax incomes have not performed as well. Overall, the income gap between the wealthy and the rest of Americans continues to widen.

Before-Tax Family Income

Over the past 20 years, real average income for the wealthiest 20 percent of families (the top quintile) grew, while real average income for the poorest 20 percent of families (the lowest quintile) remained fairly flat. Real average income for those in the lowest quintile began rising in 1993 and by 1998 returned to its 1978 level.

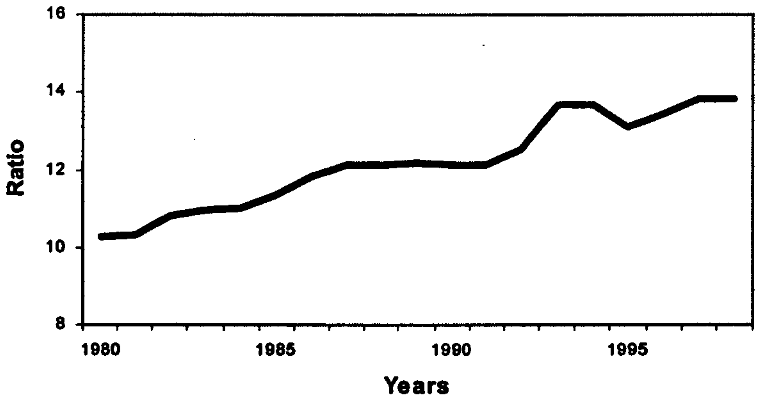
Real Average Income by Quintile



Source: US Census Bureau, Income Statistics Branch, from Detailed Historical Income and Poverty Tables, Table H-3, revised May 24, 1999.

Although it is heartening to see that the current economic expansion has finally begun to raise the incomes of those people in the lowest quintile, they are still trailing the rest of the country in sharing the benefits of the current prosperity. In 1980, the average income of the wealthiest 20 percent of families was 10 times higher than that of the poorest 20 percent. By 1998, the wealthiest families earned *14* times as much as the poorest. The primary reason for this widening gap is the incredible growth in the average income of the wealthy. Although average income in each quintile has improved since 1993, the average income of the wealthiest families has grown much faster. In other words, the income gap continues to widen despite income improvements in each quintile.

Income Ratio of Wealthiest to Poorest Families
1980 to 1998



Source: US Census Bureau, Income and Statistics Branch, from Detailed Historical Income and Poverty Tables, Table H-3, revised May 23, 1999.

After-Tax Household Income

A recent study, based on data from the Congressional Budget Office (CBO), analyzes trends in after-tax income.[2] After adjusting for taxes (and the Earned Income Tax Credit), the top 20 percent of US households experienced a 43 percent increase in average income from 1977 to 1999, while the average income of the lowest 20 percent experienced a 9 percent ***decline***. Recent improvements in income,

---

[2] "The Widening Income Gulf," The Center on Budget and Policy Priorities, Washington, DC: 1999. The CBO data begin in 1977 and end with projections for 1999.

although welcomed, have been too limited to have much impact on narrowing the income gap thus far.

The study also reports that:

- The increase in income of the top one percent of families from 1977 to 1999 equaled the ***total*** income of the lowest 20 percent in 1999.

- The richest one percent of Americans — 2.7 million people — took home as much after-tax income as the lowest 38 percent — or 100 million people — ***combined.***

- In 1977, the top one percent of Americans received a little more than 7 percent of all national after-tax income. By 1999 this concentration had almost doubled, as the top one percent of Americans received almost 13 percent of total national after-tax income.

- On average, the richest one percent of households are expected to pay a smaller percentage of their 1999 income in taxes than they would have under 1977 tax rates. This amounts to an average saving of $40,000 per household.

The foundations for this disparity were laid in the 1980s. Most of the large income growth for the top quintile occurred from 1977 to 1989, when their average after-tax income increased by 33 percent, compared to a 7 percent increase from 1989 to 1999.

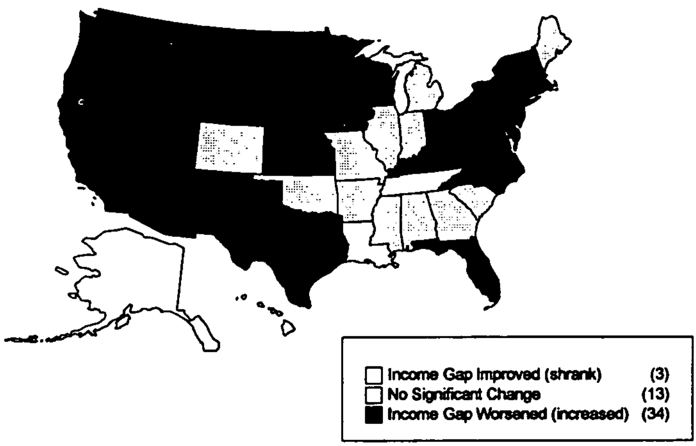
Comparing the increase in income *before* taxes to the increase *after* taxes for the wealthiest Americans illustrates the perverse impact of federal tax policy over the last 20 years. For the top one percent of households, average *after*-tax income grew by 20 percentage points ***more*** than average *before*-tax income between 1977 and 1999. Yet, meanwhile, average after-tax income for the poorest fifth of households ***declined*** over this same period. In contrast to conventional wisdom, the US tax system is redistributing income from the poor to the rich.

State income data reveal that the widening income gap is prevalent across the entire country. One recent study shows that the income gap has widened in almost every state since the 1970s.[3]

Specifically:

- Over the last decade, the gap between the wealthiest 20 percent and the poorest 20 percent of Americans widened in 34 states, and was reduced in only 3 states – Alaska, Louisiana, and Tennessee.

Changes in the Income Gap* by State from 1988-90 to 1996-98



* Defined as the difference between the average income of the poorest and richest 20 percent of families.

Source: "Pulling Apart," Center on Budget and Policy Priorities.

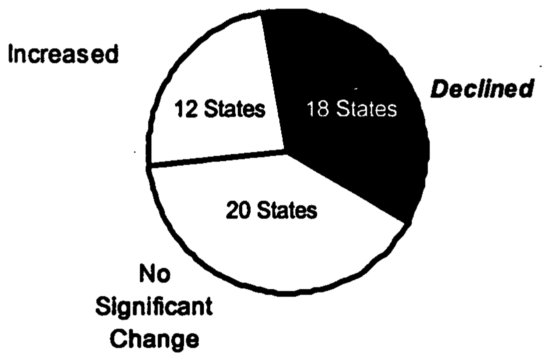
- The real income of the poorest 20 percent of families ***declined*** in 18 states between the late 1970s and the late 1990s. In 6 of those states, the decline was over $2,000 per family (in 1997 dollars).

---

[3] "Pulling Apart: A State by State Analysis of Income Trends", Center on Budget and Policy Priorities and the Economic Policy Institute, Washington, DC: 2000.

- By the late 1990s, the wealthiest 20 percent of families in every state had a larger share of the state's total income than they had in the late 1970s. Meanwhile, in 47 states, the share of total income held by the poorest 20 percent of families *declined* by the late 1990s.

Change in Average Income of the Poorest Families



Source: "Pulling Apart," Center on Budget and Policy Priorities.

- In 24 states, the wealthiest 20 percent of families had more than 9½ times as much income as the poorest 20 percent of families. In the late 1970s, not a single state had such a high "top-to-bottom" ratio.

- The gap between the average income of all middle-income families and the top 20 percent grew in 45 of the 50 states from the late 1970s to the late 1990s.

Between 1991 and 1993 – the "Bush Recovery" – average real income for those families in the 4 out of 5 income groups *declined*. By contrast, between 1993 and 1996 – the "Clinton Recovery" – average real income for all families, regardless of income group, improved.[4]

---

[4] Klein, Bruce, "The 1990s Economic Expansion: Who Gained the Most," Report Prepared for the Democratic Members of the Joint Economic Committee, Washington, DC: 1998.

The widening gap can be explained by strong growth in the upper income group and a weakening in the safety net for the lower income group. Even as the income gap has widened, there has been an erosion in the mechanisms originally designed to help lower income people, particularly as real value of the minimum wage has declined and limitations on assistance resulting from welfare reform have increased.

What should be done to close the income gap?

On the basis of national averages, the US economy is robust. But national averages camouflage how individuals are fairing. It is ironic that the income gap continues to widen as the economy prospers. Federal Reserve Chairman Alan Greenspan has raised the widening income gap as one of the most serious problems currently facing the nation, yet the Federal Reserve's recent decisions to raise interest rates are likely to worsen the situation. Economic policy should be aimed at redistributing income from the wealthy to the less fortunate. These policies should be specifically targeted at raising incomes for the vast majority of Americans, not just for the wealthy. At a minimum, the policies should stem any further erosion in incomes of those at the lower end of the income scale. Policies such as raising the minimum wage, establishing living wages, increasing health insur-ance coverage, providing prescription drug coverage for seniors, and improving education can all contribute to narrowing the income gap.

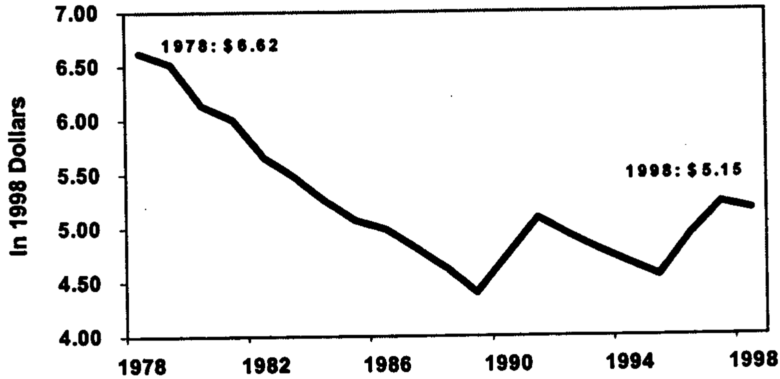
III. The Erosion of the Minimum Wage

One of the most important public policy tools aimed at raising living standards for low-income Americans is the federal minimum wage. Instituted in 1938, the minimum wage was established to help ensure "maintenance of the minimum standard of living necessary for health, efficiency, and general well-being of workers." In 1999, 7.2 million people, or 5½ percent of workers – two-thirds of whom were 25 years and older – worked at the minimum wage, which is currently set at $5.15 an hour.

Most employees receiving the federal minimum wage work in fast food restaurants, retail establishments, and lower-skilled service jobs (such as commercial housekeeping). More than half of those workers earning the minimum wage are employed in retail trade. Another 25 percent of minimum wage workers are employed in agriculture and 6 percent work in the public sector. Women comprise almost two-thirds of minimum wage workers and minorities are disproportionately more likely to earn the minimum wage than others.

Over the last 20 years, the *real* value of the federal minimum wage has been falling, despite moderate increases in overall wages and salaries. Over the last 20 years, the real value of the minimum wage has fallen by 22 percent and is currently ***below*** its real value in the 1960s and 1970s. By contrast, the real average wage for all hourly workers has declined by 10 percent, or less than half that amount. As

Real Value of the Minimum Wage



Source: Bureau of Labor Statistics.

a consequence, workers earning the minimum wage have been experiencing a real decline in their living standards — earning less and less for the same amount of work, and falling further and further behind.

Part of the continuous erosion in the minimum wage can be explained by its legislatively-mandated structure. As currently structured, the minimum wage can only be adjusted by an act of Congress. Thus, the minimum wage, by its very nature, is reactive and is always trying to "catch up" to changes in prices and other wages.

In contrast to earlier times, the minimum wage, at its current level, does *not* guarantee a family income above the poverty level. Despite two increases since 1980, the minimum wage remains ***below*** the level required for a single parent to earn enough to provide the necessities for themselves and a child.

Working full-time at the minimum wage, an individual would earn an after-tax income of $10,912.[5] This figure does not include the cost of health care, pension and other benefits. This annual income is below the national poverty rate for a family of one adult and one child ($11,483), one adult and two children ($13,423) and two adults and two children ($16,895). In order for an adult working full-time to earn enough to meet the federal poverty guideline for a family of two, the minimum wage would need to be set at $5.52. For a single parent with two children, the minimum wage would need to be at least $6.45.

Poverty Income Threshold
1999

	Annual	Hourly Wage
Two people: one parent (under 65) and one child	$11,483	$5.52
Three people: one parent and two children	$13,423	$6.45
Four people: two parents and two children	$16,895	$8.12

[5] After-tax income is obtained by subtracting the payroll tax and adding back the Earned Income Tax Credit.

Critics argue that raising the minimum wage will result in higher unemployment as employers will have to pay more for their workers. This fear has proven to be unfounded. Despite the 1996-1997 increase in the minimum wage, unemployment rates for workers of all ages and demographic groups fell.

Following the 1996 and 1997 increases in the minimum wage, the unemployment rates for teenagers and minorities – those groups most likely affected by the minimum wage – continued to decline. Between 1996 and 1999, the unemployment rate for teenagers fell from nearly 17 to 14 percent, the Africa-American unemployment rate fell from 10½ to 8 percent and the unemployment rate for all minorities fell from approximately 9 to 7 percent. Similar patterns have also occurred in states which have recently raised their minimum wage above the federal level.

Raising the minimum wage during periods of economic expansion is likely to erase any potential adverse effects. Stronger economic growth makes it easier for firms to afford the wage increase. In addition, the number of workers earning the minimum wage should be expected to decline as the labor market tightens.

Raising the minimum wage during a period of tight labor market, which is currently the case, can actually result in ***higher*** employment over the long run. Firms may be more willing to train their workers, including those receiving the minimum wage, which will increase their productivity and expand the economy. With this in mind, President Clinton and the Democrats in Congress strongly support an increase in the minimum wage.

What should be done to restore the value of the Minimum Wage?

Senator Kennedy and 26 co-sponsors have introduced the Fair Minimum Wage Act (S 192) which would raise the minimum wage by $1 over 2 years (from $5.15 to $5.65 and then to $6.15). A companion bill was introduced in the House of Representatives by Congressman Bonior and 151 co-sponsors. This increase would bring the real value of the minimum wage back to its 1979-1980 level. Republicans are conditioning approval of the increase on tax breaks for the wealthy. Although raising the minimum wage will not fix all the problems faced by many lower-income Americans, it does serve as a safety-net.

At the very least, the minimum wage should be tied to, and move with, the federal poverty rate for a family of four. It should also be linked to inflation. This would eliminate the necessity for continuous legislative adjustment to maintain its value.

IV. Living Wages

States and localities are free to set their "minimum wages" above the federal minimum wage. Frustrated by the continued erosion in the real value of the federal minimum wage and the difficulties associated with raising it, a diverse collection of cities and municipalities are spearheading local efforts to guarantee workers a "livable wage" – not an arbitrary wage by one that is calculated to enable workers to afford basic needs. Full-time workers should be paid enough to meet basic needs and government should not subsidize, encourage, or provide incentives to firms to pay below-poverty wages.

The minimum wage, even with the increase currently being considered, does not provide workers with enough income to keep a family above the poverty line. Combined with the arduous manner in which the minimum wage is increased, even to just keep pace with inflation, it no longer fulfills its original purpose and needs to be changed.

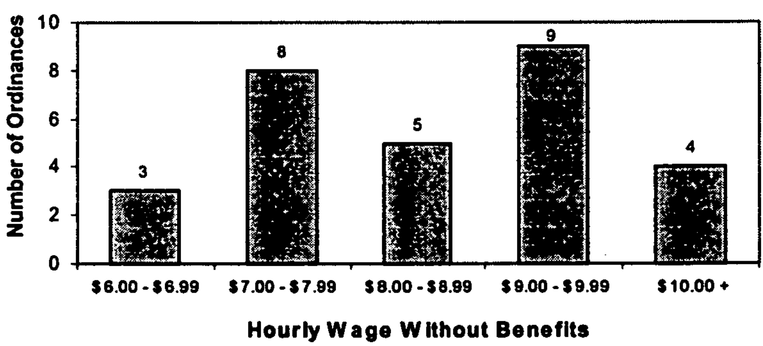
Cities and Counties With Living Wage Ordinances and Year Introduced

Buffalo	NY	1999	Oakland	CA	1998
Cambridge	MA	1999	Pasadena	CA	1998
Corvallis	OR	1999	San Antonio	TX	1998
Dane County	WI	1999	San Jose	CA	1998
Hartford	CT	1999	Boston	MA	1997
Hayward	CA	1999	Duluth	MN	1997
Hudson County	NJ	1999	Los Angles (city)	CA	1997
Kankakee County	IL	1999	Minneapolis	MN	1997
Los Angles County	CA	1999	New Haven	CT	1997
Madison	WI	1999	St. Paul	MN	1997
Miami-Dade County	FL	1999	Jersey City	NJ	1996
Somerville	MA	1999	New York City	NY	1996
Tucson	AZ	1999	Portland	OR	1996
Ypsilanti	MI	1999	Milwaukee	WI	1995
Chicago	IL	1998	Santa Clara County	CA	1995
Cook County	IL	1998	Baltimore	MD	1994
Detroit	MI	1998	Oakland	IN	1991
Durham	NC	1998	Des Moines	IA	1988
Multnomah County	OR	1998			

The Living Wage ordinance which fueled much of the current movement was instituted in Baltimore in 1994. It set a base wage higher than the minimum wage at the time ($6.60 an hour, increased in two stages to $7.70 in 1999) for workers employed under city service contracts. By January 2000, Living Wage ordinances had been enacted in 41 cities or counties nationwide, nearly a third of which (16 cities and 7 counties) had been introduced within the last 2 years.

Most Living Wage ordinances apply to employees working under municipal contracts (similar to the original Baltimore ordinance), though several new ones have been expanded to include businesses that receive subsidies or tax abatements. Each ordinance is unique to each locality, but all variations cluster around 3 themes: (1) who is covered/affected; (2) what is the wage/benefit; and (3) how it is implemented in order to maintain purchasing power. Many ordinances have exemptions, such as for non-profit organizations and summer youth programs. Wages range from $6.25 per hour (Des Moines) to $11.42 per hour in Kankakee County, Illinois (passed in September 1999). Wages under most ordinances are indexed either to a poverty rate, the inflation rate, or another appropriate index.

Distribution of Basic Wage of Living Wage Ordinances 1999



Source: "Living Wage Ordinances as of May 1999," Economic Policy Institute.

Nearly half of the Living Wage ordinances require employers to provide some sort of health benefit or premium. Eleven Living Wage laws require an additional $0.75 to $1.50 an hour if health benefits are not offered (most require an additional $1.25). One (Jersey City) requires $2,000 a year to pay for benefits, and two require that the wage be calculated on a higher percent of the federal

63-597 00 - 5

poverty rate than if benefits were offered. One (Santa Clara County, California) simply mandates that health benefits be offered.

In addition to instituting a higher wage, policymakers are debating other mechanisms for assisting low-wage workers to purchase health coverage as part of Living Wage legislation. These include a local tax credit for health care similar to the Earned Income Tax Credit; mandating that the employer contribute funds into a local or regional health care purchasing entity on behalf of workers; or contributing additional money directly into a medical insurance and/or health care expense account.

Essentially, Living Wage ordinances differ from the minimum wage in that they cover fewer people, mandate wages above the minimum wage, and include some kind of mechanism for automatic increases. Research on ordinances already enacted and analysis of business surveys indicate little adverse affect on employment as a result of living wage programs.[6]

Three comprehensive studies analyzed the impact of a Living Wage ordinance after implementation in Baltimore and Los Angeles. One study found that no company with a Baltimore city service contract reduced its staffing in response to the new law. At the same time, the real cost of city contracts ***decreased*** after the Living Wage went into effect, and although the number of bids on each contract decreased, the decline was statistically insignificant. Another study examining the law's impact after 2 years, found that it helped a small number of workers at little additional cost to Baltimore.[7] Unfortunately, the study also found that many companies did not comply with the ordinance and that many employees did not see a very noticeable increase in income, since their work was part-time or seasonal.

---

[6] In 1999, the Jerome Levy Economics Institute surveyed small businesses to gauge their response to various levels of a minimum wage. More than three-quarters of the respondents replied that their employment practices would not be affected by a minimum wage increase of up to a total of $6.00 per hour. Levin-Waldman, Oren, "The Minimum Wage Can Be Raised: Lessons from the 1999 Levy Institute Survey of Small Business," *Policy Note Number 6*, 1999.

[7] "The Effects of the Living Wage In Baltimore," Economic Policy Institute, 1999.

The cost of Living Wage ordinances is relatively small to business. According to Dr. Robert Pollin, author of *Living Wage* and studies of several ordinances, Los Angeles' living wage ($8.64) raised total costs by up to 1½ percent for the average covered business.

The erosion of the real value of the minimum wage, and the difficulties in raising it, coupled with the increase in the number of workers who do not have health insurance and other basic benefits, make Living Wage ordinances very attractive. These ordinances are a creative way to address a real problem.

What should be done to expand Living Wage ordinances?

Individual cities and counties should be encouraged to adopt Living Wage ordinances. Laws already exist which require firms with federal contracts to pay their employees a wage at least as high as the prevailing wage for that job (as established by the Department of Labor). A better option would be to insist that any employee working on any federal contract be paid at least the minimum required for a family of three to remain above poverty, or the prevailing wage for that position, which ever is higher. The Department of Health and Human Services could also develop a program to facilitate and partially fund regional and local programs for local health cooperatives and other experiments in providing health coverage tied to Living Wage ordinances. Another option is to require employers to devote $1 an hour for health insurance. Best practices learned from these experiments should be communicated to other interested cities.

V. The Aftermath of Welfare Reform

Welfare reform is another factor adversely affecting the average income of the poorest families. A key goal of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 was to "end the dependence of needy parents on government benefits." In January 1993, 14.1 million people were on welfare. By March 1999 that figure had fallen to 7.3 million — a 48 percent drop. An August 1999 report by the Council of Economic Advisors attributes nearly 36 percent of that decline to the unusually strong labor market, and 10 percent to the increase in the minimum wage in 1997. This only explains half of the decline in the welfare rolls. What happened to the others?

A significant minority of those leaving welfare have essentially "disappeared" from the official statistics. The 1999 GAO review of all the broad state studies on former welfare recipients (17 states) found that significant numbers of families could not be located. Even those studies that used 'administrative data' (matching families to other records including employment and other public assistance) missed 8 to 18 percent of families in its count. Researchers are currently not able to comfortably explain this troubling phenomenon.

Overall, the evidence suggests that many of those people leaving welfare are working. The Urban Institute found that 61 percent of former welfare recipients were working in 1997, a rate that was higher than that for similar low-income mothers who were not on welfare.[8]

Yet claims of success may be premature. One of the most troubling early findings is that even among the early group of welfare leavers – whom many researchers felt would be the easiest to employ – staying off public assistance has proven to be difficult. The Urban Institute's survey of those who left welfare during 1995 and 1997 found that 29 percent returned to the welfare rolls. Meanwhile, a significant portion of those who managed to stay off welfare were receiving other benefits, such as food stamps and housing assistance.

[8] Loprest, Pamela, "Families Who Left Welfare: Who Are They and How Are They Doing?" Number 99-01, Urban Institute, Washington, DC: 1999.

Many researchers have cautioned that the most difficult-to-assist welfare recipients remain on welfare rolls and that a notable slow-down in the decline of welfare recipients should be expected over the coming years. A 1997 Urban Institute study found that more than half of welfare recipients in 1991 "experienced a serious form of at least one potential barrier [to employment]." Although the law does allow for 20 percent of a state's welfare population to be exempt from the five year time limit on benefits, this figure can not cover all former welfare recipients with disabilities, low basic skills, substance abuse, and domestic violence.

Additional data show that across the nation, the income of the poorest of the poor is declining again after gains in the mid-1990s – at least partially due to the huge drop in the number of welfare recipients. A recent Center on Budget and Policy Priorities study found that the average income of the poorest 20 percent of single mothers with children improved by almost 14 percent between 1993 and 1995, but ***declined*** by almost 7 percent from 1995 to 1997, during which time welfare reform was being fully implemented.[9]

Many former welfare recipients with jobs earn the minimum wage or slightly more – not enough for a family of four or even three to live above the poverty rate. More than half (57 percent) of the former welfare women surveyed in the Urban Institute study had family incomes ***below*** the federal poverty line. Indeed, 66 percent of children who had been on welfare lived in families with incomes below the poverty line.

Another significant problem facing this group is that many former welfare recipients still can not afford health coverage. The Urban Institute found that 41 percent of adults and 25 percent of children who used to be on welfare did not have public or private health insurance. Understandably, given the high cost of medical care, families without health coverage are unlikely to be able to remain off welfare assistance.

Lack of affordable and accessible health coverage is one of the most significant problems for welfare leavers and low income families. Another analysis by the Urban Institute found that a year or

---

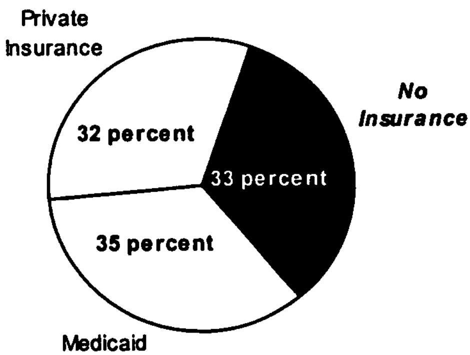
[9] Primus, Wendell, et. al., "The Initial Impacts of Welfare Reform on the Economic Well-Being of Single Mother Families," Center on Budget and Policy Priorities, Washington, DC: 1999.

more after having left welfare, nearly half of the women (49 percent) and a third of the children (30 percent) were without health insurance coverage, despite the fact that the majority of the women were working.[10]

The longer women were off welfare, the more likely they were not to have any health insurance. This was partly due to the fact that transitional health insurance programs for those leaving welfare had expired. The Family Support Act of 1998 required states to provide Transitional Medicaid Assistance for six months to all families who leave welfare because of increased earnings, and another six months of coverage to those whose family income is 185 percent of the federal poverty rate or less (after child care expenses). Surprisingly, of those who left welfare in the preceding six months, 34 percent were uninsured – even though all should have been offered government health coverage. The percent of uninsured rises to 49 percent, after being off welfare for more than a year.

Welfare reform was supposed to encourage economic independence, but an Urban Institute study found that having a job does not alone guarantee adequate health coverage. Although more than half of those who left welfare had a job, one third of these

Health Insurance Coverage for Employed Former Welfare Recipients



Source: Loprest, Urban Institute.

---

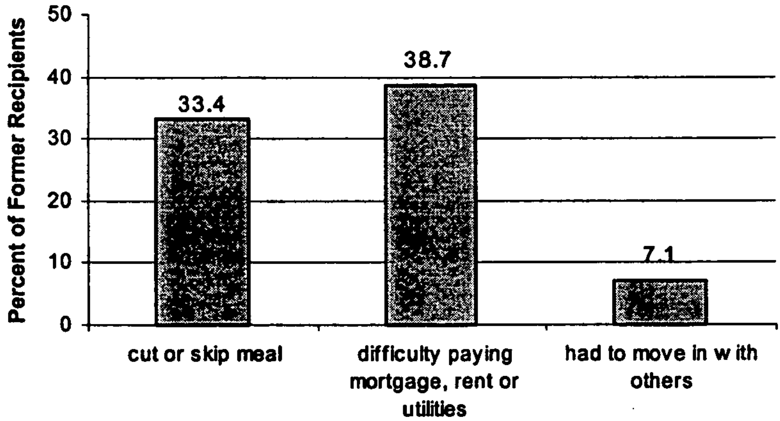
[10] *Health Affairs*, January/February 2000.

working parents remained dependent on Medicaid and another third had no health insurance at all. In fact, according to another recent Urban Institute study, only 23 percent of all ***employed*** former welfare recipients received their health coverage from their employer in 1997. The others, who had some sort of private insurance, were covered by their spouses' health plan.[11]

Of those children whose custodial parent was employed, 45 percent were dependent on Medicaid or state assistance and 23 percent had no health coverage at all. Although this compares favorably with health care coverage for adults, more than 1 in 5 children – whose parent worked – did not have any health coverage. Despite the existence of special health care programs for children formerly on welfare, 41 percent of these children did not have health coverage.[12]

A significant minority of former welfare recipients had more difficulty getting enough food and paying utilities than other families at the same income level. The Urban Institute study of mothers who left welfare during 1995 to 1997 found that one third had to cut the

Measures of Economic Struggle for Former Welfare Recipients



Source: Urban Institute, ***Families Who Left Welfare***, 1999.

---

[11] Loprest, Pamela, 1999.

[12] See further discussion of CHIP below.

size of a meal or skip a meal because they could not afford food, compared to only 25 percent of other mothers with similar income levels. Even more, 39 percent, had difficulty paying mortgage, rent, or utility bills, versus only 29 percent of other mothers with similar income levels.

The "success" of welfare reform should not just be measured by the number of people receiving welfare. Although the number of welfare recipients may have fallen, many former welfare mothers and their children are worse off now than when they were on welfare. Getting people off welfare should not be our sole objective. Welfare-leavers must be able to earn enough to provide a basic standard of living for their families. The apparent loss of health insurance among those leaving welfare is placing an additional heavy burden on those people who are already facing severe economic difficulty and on the hospitals that serve them.

What should be done to assist welfare leavers?

Lack of adequate health coverage is a major problem among the poor and the working-poor, as it is for all middle-income families. Instituting universal health care coverage would be the most effective way to expand coverage to those currently without health insurance. Universal coverage would eliminate the need to worry about such things as welfare leavers and their children. It would also address one of the major factors pushing families into poverty.

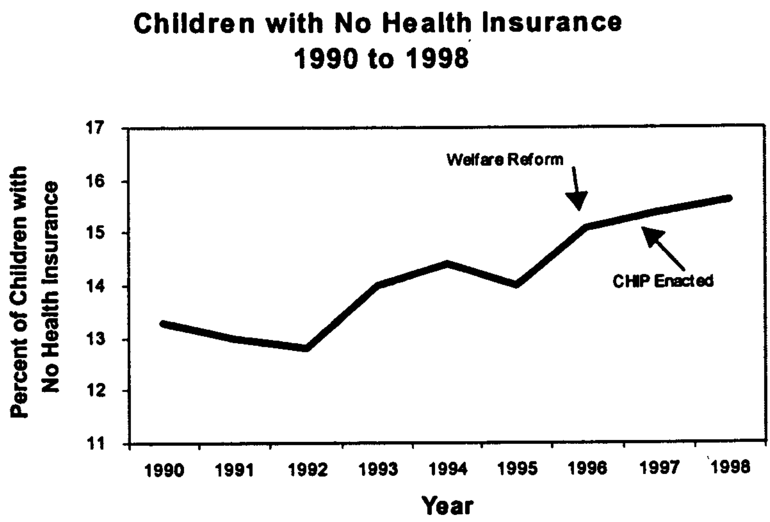
In the absence of universal health coverage, other steps should be taken to ensure adequate coverage for poor families. Enrollment in Medicaid for at least 6 months should be automatic for families leaving welfare, without requiring any additional steps, as is currently the case. Vice-President Gore has proposed extending Medicaid coverage to parents of children enrolled in the Children's Health Insurance Program (CHIP).

Additional assistance needs to be provided to those families who have left welfare, found jobs and are still experiencing economic hardship. A variety of existing programs can help, along with some changes in the way welfare is administered. For example, expand the Earned Income Tax Credit; do not count time spent in training programs toward the 6 month time limit; increase funds available for subsidized child care and transportation to work programs; increase the income limits on welfare enrollment; and expand vocational training opportunities. Other options include, encouraging states to be more effective in increasing the actual economic well-being of welfare and former welfare recipients; and expanding the High Performance Bonus. The Bonus should also include a measure of the rate of Food Stamp and Medicaid participation as a percent of all those who were eligible, to ensure that states do not continue to underutilize other support programs.

For the currently unemployed and former welfare recipients, programs to improve their employment prospects need to be expanded to include health care, food stamps, and housing assistance. Programs should be extended to address the significant barriers to employment faced by many poor adults, such as alcoholism, domestic violence, poor education and work skills. Adequate funds should be provided for outreach. The Children's Defense Fund calls for all parents who are unable to find a job after the expiration of their welfare benefits, to be provided with a public job (subject to verification of the unavailability of private employment).

VI. Children's Health Insurance Program

The proportion of children without any health coverage has been rising since 1992, with the exception of a small decline in 1995. In 1992, more than 13 percent of all children under 19 had no health coverage and by 1996 – the year welfare reform was enacted – the uninsured rate had risen to more than 15 percent. At the same time, the proportion of children covered by private plans steadily declined from 71½ percent in 1990 to approximately 67 percent in 1995.

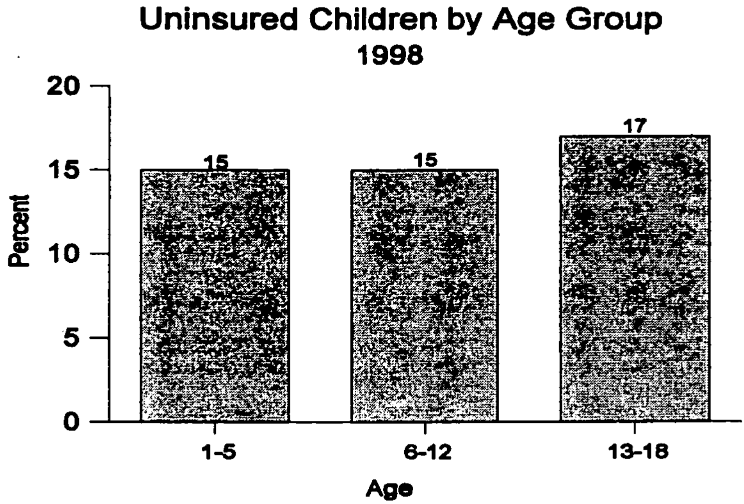


Source: Smith, "Health Insurance Coverage of Children," CRS, January 12, 2000.

In 1998, almost 12 million children had no health insurance. Teenagers now make up a disproportionately high percentage of all uninsured children. Seventeen percent of teenagers under the age of 19 are uninsured, and 15 percent of children between the age of 1 and 12 are uninsured. About 80 percent of those uninsured kids had a parent that worked at least part-time. Fifty-eight percent had a parent that worked full-time year-round but were still without health coverage.[13]

---

[13] Smith, Madeleine, "Health Insurance Coverage of Children," Congressional Research Service, January 12, 2000.



Source: Kaiser Commission, *1998 Health Insurance Coverage.*

One of the main criticisms of welfare reform concerns its potential negative impact on children in low-income families. Since income assistance and Medicaid enrollment often occur togther, many members of Congress were concerned that millions of children would be without health insurance due to welfare reform. To address this problem, Congress enacted the State Children's Health Insurance Program in 1997, referred to as CHIP or S-CHIP.

CHIP is a combined federal-state program, with the federal government contributing at a higher rate in each state than it does for Medicaid. CHIP does not guarantee coverage, but encourages states to expand their Medicaid coverage to include uninsured children. The program was originally funded for only 5 years, with the goal of enrolling 5 million kids by FY 2002. By June 1999 only about a million children had enrolled in the program.

CHIP is considerably short of meeting its five-year goal; only one-fourth of funds allocated for the program were spent in 1999. Outreach has been hampered by the fact that only 10 percent of disbursed funds can be used for administrative costs, which could be used to promote the program and increase enrollment. There is still a significant lack of awareness of the program among individuals moving off welfare to a job with no health insurance. Nonetheless, more must also be done to get individuals discouraged from going on welfare rolls to enroll their kids in CHIP.

What should be done to expand CHIP participation?

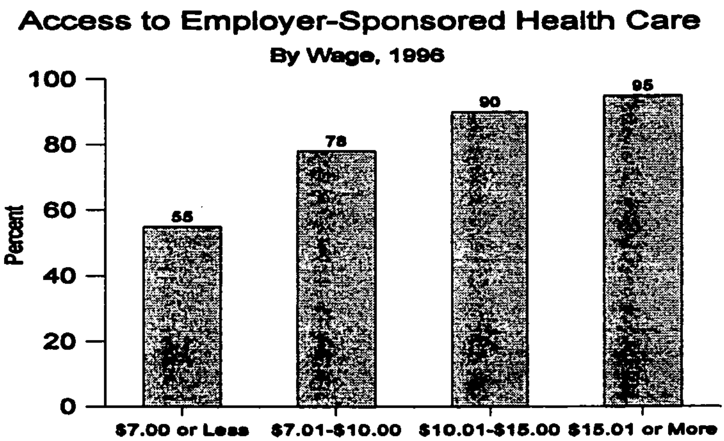
There are a variety of things which should be done to expand health care coverage of children. First, further improvements are necessary for CHIP to meet its objectives. Increased administrative funds need to be allocated so that all states can begin significant outreach and improved training for providers. Congress should appropriate additional funds specifically for outreach and staff training. Alternatively, Congress should expand the portion of state grants that can be used for this function. States should also continue to be tracked on their success rates in ensuring that all children are covered 6 months after leaving welfare. In addition, states should be encouraged to increase their program coverage. This will likely require additional federal funds. In February, the Administration proposed several actions aimed at improving CHIP's implementation, including allowing school lunch programs to share information with Medicaid so that a higher proportion of eligible children are enrolled in both Medicaid and CHIP; expanding the sites authorized to enroll children; and requiring states to simplify enrollment procedures.

The Medikids program, initially proposed by Representative Sabo, would address the needs of middle income families who do not have health coverage for their children. The program would cover children in families living at up to 3 times the federal poverty level. With a federal matching grant (75 percent federal share/25 percent state share) these children would be eligible for an expanded state-sponsored Medicaid package or would receive assistance in purchasing private insurance (most likely at a sliding-scale).

VII. The Growing Number of Adults Without Health Insurance[14]

Forty-four million non-elderly Americans lacked health insurance in 1998, 6 million *more* than in 1992, when the current economic expansion began. Health care coverage continues to decline, despite economic prosperity.

The US system of health insurance is one of the few in the world that is structured around the workplace. In recent years, small businesses have accounted for more than three-quarters of the job expansion. Yet, between 1996 and 1998, the percentage of small business employees with employer-sponsored health coverage dropped from 52 percent to 47 percent. In 1998, only 54 percent of small firms offered health coverage, down from 59 percent in 1996. Currently, 70 percent of the uninsured are full-time workers or dependents of full-time workers.



Source: Cooper and Schone, "More Offers, Fewer Takers for Employment Based Health Insurance: 1987-1996", *Health Affairs* (Nov/Dec, 1997)

---

[14] This section relies heavily on three sources: Hewitt Associates for The Henry J. Kaiser Foundation, "Retiree Health Coverage: Recent Trends and Employer Perspectives on Future Benefits," October, 1999; The Kaiser Commission on Medicaid and the Uninsured, "Uninsured in America, A Chart Book," June 1998; The Kaiser Commission on Medicaid and the Uninsured, "Health Insurance Coverage of Low Wage Workers, " June 1998.

A deterioration in health care coverage of low income workers has further widened the gap between the rich and the poor. Between 1987 and 1996, health insurance coverage rates for low-wage workers fell from 54 percent to 42 percent while coverage for the highest paid workers increased from 87 percent to 90 percent. Most recent data (1996) suggest that only 55 percent of low-wage workers ($7 per hour or less) have access to job-based coverage, compared to 95 percent of high-wage workers (earning more than $15 an hour).

In addition, many who have stopped working are dependent on health coverage received under previous jobs. Employer-provided health benefits are the leading source of supplemental coverage for Medicare beneficiaries and the largest source for supplemental prescription drug coverage. However, employer-based coverage for retirees is on the decline, with many large companies dropping coverage and fewer new companies adding it. A number of trends have surfaced in recent years: fewer large companies offer post-retirement health benefits; financial caps are being placed on employers' contributions; eligibility requirements are being tightened; and more employers are offering managed care Medicare plans. A recent study shows that between 1991 and 1998, health coverage provided by large employers for retirees above the age of 65 declined by 13 percentage points. For those retirees younger than 65, coverage declined by 12 percentage points. In addition, the percent of companies that require retiree contributions rose from 73 percent in 1991 to 92 percent in 1998.[15]

What should be done to improve health care coverage for adults?

The United States is the only advanced industrial society that does not provide some sort of universal healthcare. In the last year a number of legislative bills have been introduced in Congress to move the United States more towards such a system. One bill (HR 2227) extends COBRA coverage until the age of Medicare eligibility for individuals who are age 55 or older. Another bill (HR 2228) would allow middle-income workers aged 55 to 60 to buy into Medicare. If enacted, this legislation would reduce the number of uninsured by 400,000 Americans. Both of these approaches improve Americans'

[15] Hewitt Associates for The Henry J. Kaiser Foundation, "Retiree Health Coverage: Recent Trends and Employer Perspectives on Future Benefits," October, 1999.

access to healthcare by either extending government-sponsored plans, like Medicare, or expanding employer-sponsored plans. Both types of coverage should be expanded to give all Americans the peace of mind of knowing that they would be covered should they fall ill.

VIII. Prescription Drug Coverage and the High Cost of Medication

The decline in health care coverage is only part of the problem facing Americans. Another part of the problem is rising health care costs. Prescription drug costs are the single largest out-of-pocket medical expense for seniors, many of whom have moderate incomes. In 1994 and 1995, 76 percent of seniors had incomes below $30,000 and the average senior paid $558 for prescriptions. This compared to an average of $355 spent by 55 to 64 year-olds during the same period. By 1999, spending on outpatient pharmaceuticals had ballooned to roughly $1,000 per Medicare beneficiary.[16]

Medicare provides health insurance for 34 million seniors and 5 million disabled persons – virtually everyone 65 and older is insured by Medicare. Although Medicare provides a broad range of basic health care services, it does not include coverage of outpatient prescription drugs. Only one-third of all Medicare beneficiaries in 2000 are estimated to have a consistent prescription drug benefit through a supplemental plan. Over 13 million of Medicare beneficiaries do not have prescription drug coverage at all.[17]

Medicare beneficiaries with no supplemental drug coverage are the hardest hit. They fill one fourth fewer prescriptions than those with full-time coverage, yet face higher total out-of pocket costs during the year. In fact, seniors without prescription drug coverage pay higher prices for medications than any other group. A 1993 survey found that 1 in 8 seniors reported having to choose between medicine and food at some point during the year.[18]

---

[16] Gluck, Michael, "A Medicare Prescription Drug Benefit," The National Academy of Social Insurance, April 1999.

[17] Actuarial Research Corporation for the US Department of Health and Human Services.

[18] *American Pharmacy*, October, 1992; HCFA Office of Strategic Planning, Data from the Current Beneficiary Survey, cited in staff documents, Medicare Commission; Department of Health and Human Services, unpublished data; Committee on Government Reform and Oversight, US House of Representatives, Minority Staff Report, "Prescription Drug Pricing in the United States: Drug Companies Profit at the Expense of Older Americans," October 20, 1998.

Since 1980, drug expenditures have grown by double digits, far more than total health care expenditures. In 1998, drug expenditures grew by more than 15 percent, almost three times the growth of total national health care expenditures. Most of the growth in drug expenditures can be traced to a significant increase in volume, mix and availability. However, as prescription drugs have become more important to overall health care and new, effective medicines have become available, people who rely most on prescription drugs – the elderly and the disabled – have found their access increasingly denied.

The proportion of firms offering retiree health coverage declined by 25 percent from 1994 to 1998. Medigap premiums for drugs remain high and increase with age; the value of Medicare managed care benefits keeps declining; and participation of Medicaid eligible populations remains low.

At the same time that prescription drug costs are rising and less people are covered by any kind of insurance, profit rates – calculated after expenditures for R&D are removed – for the drug industry have reached close to 20 percent, four times larger than the average profit rates for other industries. According to *Fortune*, the pharmaceutical industry was the most profitable industry in 1998. The stock prices of the top pharmaceuticals achieved average annual gains of 24 percent since 1984, versus almost 15 percent for the S&P 500 as a whole.

Concerns about rising prescription drug costs, the desire to enable more seniors to take advantage of new, effective medications, and arguments that proper use of medications can decrease the reliance on other, more expensive treatments have led to various Congressional proposals to incorporate a universal prescription drug benefit into Medicare. It is difficult to precisely predict all the potential impacts of the various prescription drug proposals. However, studies have shown that drugs can be used as effective substitutes for other kinds of treatment, potentially reducing total health care costs.[19] For example, proper use of medications can be expected to decrease hospital and nursing home costs.[20] Also, a Medicare drug benefit provides a means for tracking drug use, thereby reducing adverse drug interactions. According to the General Accounting Office, Medicaid's

---

19 See for example, the Employee Benefit Research Institute.

20 See *New England Journal of Medicine*, March 4, 1999.

automated drug utilization system reduced adverse drug reactions and saved more than $30 million in 5 states.

What should be done to help people afford prescription drugs?

Twenty-five million Medicare beneficiaries do not have dependable and affordable outpatient prescription drug coverage. Americans of all ages look to Medicare for guaranteed coverage as part of the foundation of their retirement planning.

Accordingly, Representative Stark introduced the "Access to Prescription Medications in Medicare Act." This legislation meets the needs of present and future Medicare beneficiaries by offering a comprehensive drug benefit that restrains ballooning prescription drug prices. By giving beneficiaries the same marketplace power as others already insured, the bill tackles the glaring price discrimination that seniors now are forced to face. It provides a universal Medicare drug benefit with a $200 deductible and 20 percent coinsurance for seniors and disabled persons up to $1,700 per year. Medicare beneficiaries with very high drug expenses will get all of their drug costs paid by Medicare after $3,000 in annual out-of-pocket spending. This plan merges cost containment with a voluntary benefit that is universal, affordable, and also covers catastrophic care.

It appears that the Republicans do not intend to go forward with ***meaningful*** prescription drug legislation this year. On February 16, 2000, Representatives Stark and Shows filed discharge petitions on the "Access to Prescription Medications in Medicare Act" (HR 1495) and the "Prescription Drug Fairness for Seniors Act" (HR 664). These petitions were the only means of forcing the House to address the crucial issue of affordable access to prescription drugs for seniors and the disabled. Both petitions call for bringing each of these bills to the House floor for consideration as soon as possible, without conditions.

Both the Republicans and the pharmaceutical industry are stalling due to their concern for industry profits. However, a number of Wall Street analysts have stated that a Medicare drug benefit could be positive for the pharmaceutical industry, with incremental volume gains more than offsetting any price pressures. Studies have suggested that drug utilization increases dramatically when coverage is provide to the uninsured. In the end, a prescription drug benefit will result in healthier seniors, higher quality care, a curb in overall medical costs, and a more profitable pharmaceutical industry.

IX. The Social Consequences of Globalization

The US economy has become much more integrated into the world economy over the last 20 years. Once it was rare for a US firm to have operations in other countries. Now, these same firms are probably owned by a group of US and international investors. It is difficult to determine what constitutes an "American company."

The flow of all goods and services traded between the United States and the rest of the world currently amounts to more than $2 trillion, double what it was just 10 years ago. More firms are trading in more countries than ever before. Although there are benefits to this increased trade, there are also significant social consequences. The challenge facing the nation is how to participate in this process of globalization, without hurting workers and the environment, here at home and abroad.

International trade accents the differences in domestic policies and practices. One nation's labor and environmental standards can be considered excessive by some of its trading partners and inadequate by others. Except for the major industrialized countries, very few other countries adhere to universally-accepted basic standards on labor practices, like the prohibition against slave and child labor. Even fewer countries provide workers the right to organize for independent trade unions. This raises many questions when two countries, with different labor standards begin trading with one another.

People and firms in countries with high labor standards may find it cheaper to import goods from countries with lower labor standards, rather than produce them at home. In addition, consumers may not know the labor and environmental conditions under which the products they buy were made. The net result is that the country with the higher labor standards loses production and jobs, and there is an implicit endorsement of the lower labor standards of the other country. Policies should be pursued which have the opposite outcome – increase production and employment here at home and encourage higher labor standards around the world.

Much of the recent increases in trade, primarily imports into the United States, come from countries that have low labor standards, and in fact do not even provide their workers with basic fundamental rights. As the major promoter of democracy and individual freedom around the world, the United States should do all that it can to encourage the adoption of higher labor standards abroad, and certainly should not be engaged in trade that endorses low standards abroad and displaces good paying jobs in the United States. Trade with low income countries should not merely exploit their lower wages.

A similar, but more intractable challenge exists concerning the environment. The production of goods and services depletes resources – everything from non-renewable resources like oil and coal to renewable resources like trees. As in the case of labor standards, all countries have different environmental laws and protections. The challenge is for the United States to protect its environment, without jeopardizing the environment in other parts of the world. Currently, the United States avoids domestic production in order to save its environment, only to import goods from abroad, thereby harming another country's environment. The United States should not be encouraging the abuse of the environment either at home or abroad. Instead, it should encourage all nations to adhere to high standards to protect the environment.

What should be done to protect workers and the environment?

As a first step, all countries should be encouraged to adopt the four internationally-recognized "core" labor standards developed by the International Labor Organization (ILO) – freedom from forced labor, freedom of association and the right to organize and bargain collectively, the effective abolition of child labor, and nondiscrimination in employment. Fair and decent labor standards do not inhibit trade or global economic growth. The growth of the industrialized economies over the last 50 years is testament to that.

The gains from trade must be better shared with the workers who make the goods and services which are traded. All firms should pay their workers fair compensation. A firm's success should be shared with its workers, thereby encouraging them to be more productive. Trade should not be a "race toward the bottom" that forces countries to compete on the basis of low wages, poor working conditions, and disregard for the environment. Work should raise people out of poverty and provide them with a standard of living which enables them to provide for the health and welfare of their families.

It will be more difficult to achieve high and internationally agreed-upon environmental standards. First, there is no international organization, similar to the ILO, as in the case of labor, to provide a forum for countries to develop environmental standards and to help countries meet those standards. Although there are a lot of commonalities in terms of environmental protection, each country also has its unique environmental concerns.

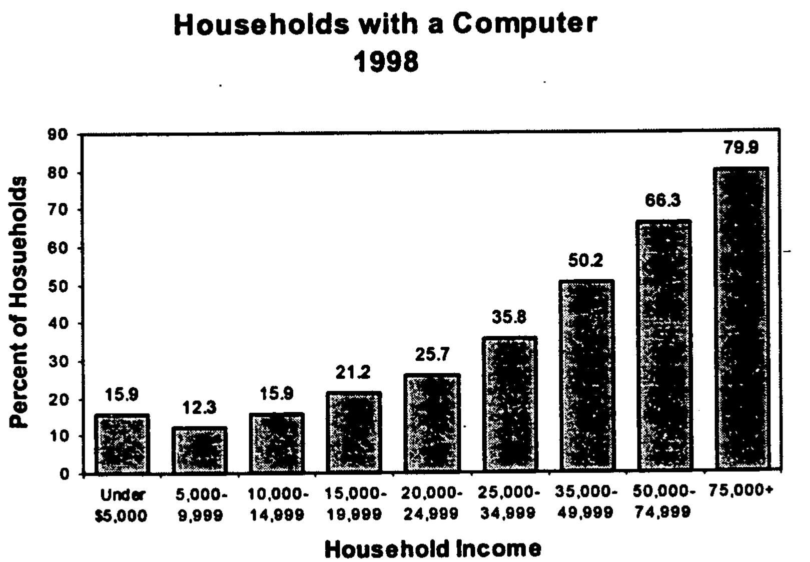
The first thing that needs to be done is to improve international awareness of the impact of trade on the environment, and the spill-over of environmental impact in one country on others. The only way to avoid exploitation of the environment is to develop some form of internationally-agreed upon standards. It is very important that these international standards not be the lowest common denominator. It should be the responsibility of the industrialized countries – those with the highest standards – to ensure that the internationally-accepted standards be meaningful in protecting the environment from further exploitation. In both cases of labor and the environment, technical assistance should be provided to countries in need and there needs to be strict monitoring of adherence to the internationally agreed-upon standards.

International trade should benefit everyone involved and should not be just a means toward avoiding laws and practices put in place to protect workers and the environment. In order to meet this objective, further efforts toward trade liberalization should be conditioned on the adoption of internationally-recognized labor standards and environmental protections.

X. Digital Divide

Technological advances, which are at the core of the current economic expansion, have the potential of further widening the gap between the haves and the have-nots. Most jobs already require that workers be comfortable using computers and the Internet. As with the development of other skills, the sooner a person begins learning them, the higher the probability that he or she will succeed in the workplace.

Recent studies find that computer use and Internet access correlate very strongly with income and education. According to the Department of Education, in 1998, 80 percent of households with incomes above $75,000 had a computer, versus 26 percent for households earning between $20,000 and $25,000. At the same time, 59 percent of those households with incomes above $75,000 used the Internet compared to only 20 percent of those households earning between $20,000 and $25,000.[21]

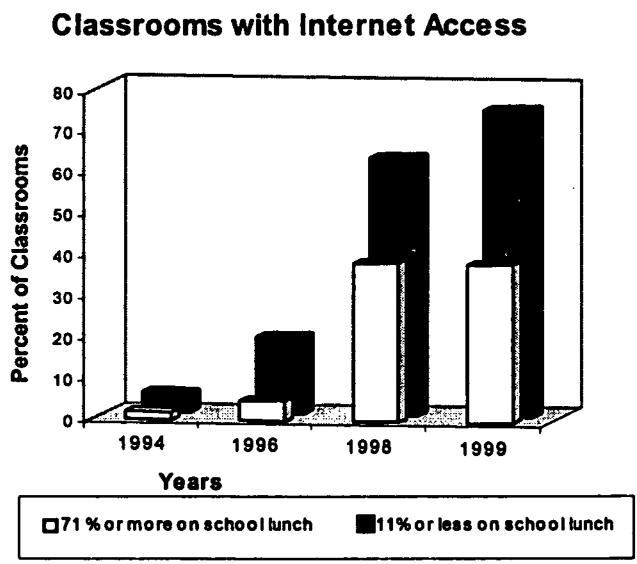


Source: National Telecommunications and Information Administration: 1999.

[21] National Telecommunications and Information Administration, <u>Falling Through the Net: Defining the Digital Divide</u>, Washington, DC: 1999.

Computer and Internet use are significantly lower for minorities, even after controlling for income and education.[22] African Americans, Native Americans, Pacific Islanders, and Hispanics are all more likely to access the Internet outside their home, if at all.
The digital divide closes for minorities as their incomes rise over time. Between 1984 and 1998, African Americans at the highest income level measured (above $75,000) narrowed the difference between them and whites in home computer ownership by three-fourths.[23]

Although nearly all (over 90 percent) schools have some Internet access with little difference by income and geography, there are still substantial differences in the quality of Internet accessibility for students. Schools with a higher proportion of low-income students have significantly ***fewer*** proportion of classrooms with Internet access.



Source: US Department of Education, National Center for Education Statistics, Internet Access in US Public Schools and Classrooms: 1994-199," Washington, DC: 2000.

According to the Department of Education's survey, schools with higher concentrations of poverty are more dependent on state and

[22] National Telecommunications and Information Administration (NTIA) "Factsheet: Racial Divide Continues to Growth," 1999.

[23] "Factsheet," NTIA.

federal support for Internet access than private resources. Forty-eight percent of schools with the highest concentration of students below poverty list the state or federal government as primary support instead of the local school district, compared to 14 percent of the schools with the lowest poverty rates.

What should be done to increase access to computers and the Internet?

In addition to improving computer access and learning at school, it is vital that ***all adults*** have improved access to computers and the Internet. The Commerce Department finds that Community Access Centers (CACs), which are schools, community centers and other places with broad public access, are vitally important to those who do not have home access to computers.[24] CACs have been particularly valuable in rural areas and inner city neighborhoods. The Department also finds that those people with lower incomes and education, and many unemployed are using the Internet to search for jobs and take courses. Public access to technology for these groups may be vital to helping them advance economically, which may also help narrow the broader income gap.

---

[24] 1998 Census Bureau data.

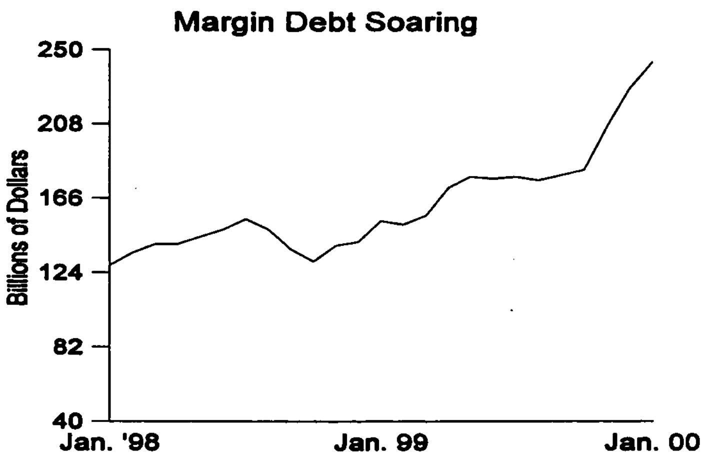
XI. Vulnerabilities

The current prosperity is not free of potential complications. The economy faces a number of external and internal factors which might make it vulnerable to economic slowdown or inflation in the future. The following section discusses some of those vulnerabilities.

The Stock Market

US financial markets have experienced a considerable run-up over the last 20 years. In addition, there has been a shift in the kinds of stocks attracting capital in the private market. The Dow Jones Industrial index grew by 334 percent between 1980 and 1989, and by 418 percent between 1989 and 1999. The NASDAQ index grew three-fold between 1980 and 1989 and ***nine-fold*** between 1989 and 1999. The sustained growth in both markets is unprecedented. There has also been a shift in investor preference from the traditional companies listed on the New York Stock Exchange to the young, technology companies listed on the NASDAQ.

At the same time that stock prices have been soaring, margin debt has been growing. Margin debt grew by 60 percent -- or almost $90 billion in 1999. Between September 1999 and February 2000 alone, it jumped by an average of $20 billion per month. Until recently, the growth of margin debt remained proportional to market capitalization, but this is no longer the case. Margin debt is running well ahead of gains in the stock market – a sign that speculation is



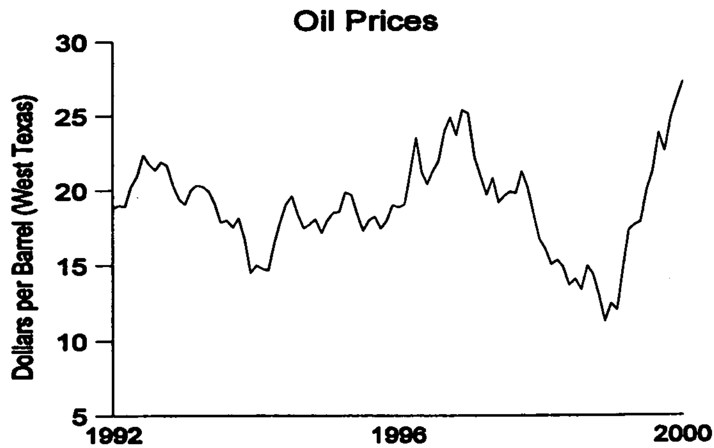
Source: Federal Reserve Board.

picking up. Heavily-indebted investors are more vulnerable to a market downturn because they may be forced by margin calls to unload portions of their portfolio. This, in turn, could further fuel a downturn, setting off a self-feeding downward spiral. The Federal Reserve has not responded to these early signs of excess speculation, but could consider raising margin requirements in order to stem a further build-up in debt.

Oil Prices

In recent months, there has been a significant increase in oil prices. An improving worldwide economy and output cuts by members of the Organization of Petroleum Exporting Countries (OPEC) in 1999 have sent prices soaring. Oil prices have almost tripled in the last year, fueling fears of inflation for the overall economy. Heating bills have escalated, especially in the northeastern part of the United States, and average gas prices have increased 40 percent in the last year around the country.

The current oil price, although high, remains considerably



Source: Bureau of Labor Statistics.

lower than its price of $38 a barrel in 1980. However, oil inventories are extremely low. As oil inventories have decreased, the world market has become more vulnerable to supply shocks, such as a break in oil exports from Iraq. In addition, world demand for oil is projected to increase in 2000, since the world economy is expected to begin growing once again. This will make it difficult for OPEC to gauge the fine line between maintaining oil inventories and starving the world economy. The International Energy Agency estimates that OPEC would need to increase output by nearly 10 percent in order to keep pace with world demand.

Fortunately, the US economy is no longer as dependent on oil as it was during the oil shocks of the 1970s. Overall, oil comprised 3 percent of GNP in 1998, down considerably from nearly 9 percent in 1980. However, oil can still be a powerful drag on the industrialized economies. The Organization of Economic Cooperation and Development estimates that every $10 rise in the price of a barrel of oil lifts inflation by half a percentage point and reduces economic growth by a quarter percentage point. Although a return to the 1970s era of stagflation is unlikely, any unanticipated supply shock could fuel inflationary pressures and simultaneously act as a drag on the economy. In the final analysis, low and stable oil prices are best for the long-run prospects of the economy.

Cyclical Factors

It has long been understood that economies follow a business cycle, based on firm profitability. As firms' expectations of the economy improve, they tend to invest more. The economy consequently grows, unemployment falls, and wages increase, squeezing firms' profits. This "profit squeeze" compels firms to cut back their investments because of lower expected future profits. Less investment drags down economic growth and chokes off the amount of capital available to develop new technologies. The economy then enters a period of economic stagnation.

The US economy has followed this business cycle pretty closely over the last century. More recently, however, people have argued that changes in the structure of the US economy have made it less susceptible to the traditional business cycle. For example, recent advances in technology have made it possible for firms to maintain "just-in-time" inventories, thereby avoiding any serious build-up of inventories, one of the main consequences of the business cycle.

In addition, after 9 years of expanding, the US economy does not exhibit many of the trends which might indicate a pending slow-down. Productivity growth rates have accelerated during the last several years, rather than stagnate as in other mature expansions. Inflation has been falling, not rising, as expected given the long period of low unemployment. While these trends suggest that an economic down-turn is not imminent, they do not necessarily signal the demise of the business cycle.

Technological advances, particularly in the area of information technology, have been at the center of the current economic expansion. The revolution in information technology has been compared to the invention of electricity more than 100 years ago. It remains unclear how long the current technology-induced investment will continue. In the case of electricity, the subsequent investment wave began to level off, bringing about an economic slowdown. It remains too early to know if investment in information technology will follow that course, or set out a course of its own.

Monetary policy also plays an important role in understanding the path an economy takes. In the past, as unemployment rates fell, wages began to rise, igniting fears of inflation. To address these fears, the Federal Reserve has typically raised interest rates, thereby tightening the supply of money. Although a restrictive monetary policy might contain inflation, it can also pull the economy into recession. Once that occurs, the Federal Reserve might ease monetary policy in order to get the economy moving again.

The economic expansion of the last 9 years has been challenging to Chairman Alan Greenspan and his colleagues at the Federal Reserve. In contrast to previous expansions, there has been no evidence that wages have grown as a consequence of the historic low rates of unemployment. This has caused Mr. Greenspan, always vigilant of inflation lurking around the corner, to call for pre-emptive increases in interest rates in order to cut-off even the prospect of inflation. These pre-emptive moves, in and of themselves, risk causing the economy to slow down even though there are no signs of inflation.

There are many reasons why the economy might experience a downturn and, there is no evidence that the current expansion is immune from some of the internal dynamics that have characterized similar expansions in the past. Speculation about the death of the business cycle may be greatly exaggerated. The real risk to continued prosperity may be the overzealous implementation of monetary policy.

International Economic Environment

The strength of the US economy over the last several years has not been matched in the other industrialized countries. At above 4 percent, the US economy in 1999 grew almost 3 times faster than the average growth rates in France, Germany, Italy, Japan and the United Kingdom. Economic growth in Canada was a little less than 4 percent. Japan, once thought to be the "model economy" grew at less than 1½ percent in 1999, as it continued to recover from the East Asian financial crisis of 1997-1998.

Comparing growth rates is not just a contest of economic superiority. As the US economy becomes more open to the international economy, growth rates abroad take on increased significance at home. Exports and imports combined currently account for about a quarter of the US economy, and are a key factor in contributing to US economic growth. As foreign economies grow faster, they tend to buy more imports, providing US exporters with an opportunity to expand sales in those markets. Conversely, the US economy has been growing faster than the economies of our major trading partners, causing US imports from abroad to grow faster than US exports to foreign markets. This has contributed to the growing US trade deficit.

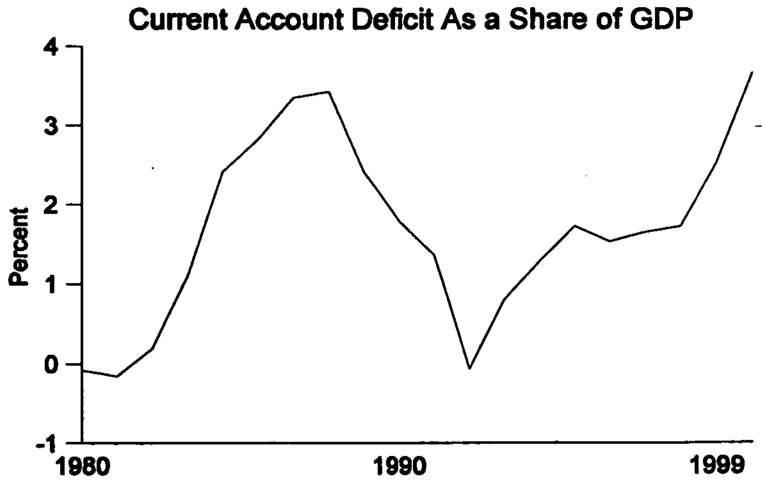
The East Asian financial crisis hurt the prospects of US exports and placed additional pressure on import-competing industries in the United States. In 1996, prior to the outbreak of the crisis, Japan, Korea, Singapore and Taiwan together accounted for approximately one-fifth of all US exports and imports. As a result of the financial crisis – which caused these economies to slow down and their currencies to depreciate – US exports to these four countries stagnated and US imports from them jumped considerably. Between 1996 and 1999, US exports to the four countries fell by 4 percent and US imports from them grew by 17 percent.

Differential growth rates and the East Asian financial crisis are just two examples of how important developments in the world economy are to the strength of the US economy. Over the next several years, growth rates in Europe and East Asia are expected to recover, thereby expanding markets for US goods and services. But as these major economies grow, so too might their exports to the United States. Thus although international economic conditions may improve, if US imports continue to grow faster than exports, the trade deficit will continue to worsen.

The ideal is for the international economy to grow at a healthy but steady pace. In order to achieve this goal, it is important to avoid economic shocks, such as increases in oil prices mentioned above, or minimize their impact on the international economy as soon as possible. Although countries have agreed in principle to meeting this objective, action has proven more difficult than words.

The Current Account Deficit

In 1999, the US current account deficit, the broadest measure of US trade in good and services, grew by 54 percent from the previous year, and reached $339 billion or almost 4 percent of GDP. The booming US economy, a strong dollar and weak overseas economies have contributed to a surge in imports and only a moderate increase in exports. These developments have placed pressure on the US manufacturing sector in particular. As a result, net manufacturing employment has fallen by close to a half million jobs since 1997, even though output has remained stable.



Source: Bureau of Economic Analysis.

The Current Account reflects the gap between domestic saving and investment. In recent years, US investment has been booming and domestic saving has been relatively flat. Despite the elimination of the federal budget deficit, national saving – traditionally low in the United States – has not improved, primarily because private saving has continued to fall. The United States needs to make up this "saving gap" by borrowing from abroad. Over the last decade foreign governments, firms and individuals have invested hundreds of billions of dollars a year in US securities to finance this gap.

During the 1980s, when the federal budget deficit began ballooning, the United States went from being the world's largest creditor to the world's largest debtor. Such a dependency on foreign borrowing makes US financial markets vulnerable to changes in foreign investor preferences. If foreign investors decide not to continue to buy dollar-denominated assets, the value of the dollar could depreciate significantly, making US imports more expensive, pushing up inflation, and possibly contracting the domestic economy.

In the long-run, the large current account deficit makes the US economy more vulnerable to external shocks. In the short-run, the deficit reflects real economic hardship for US workers and their families. Increased imports and slow export growth have contributed to further shifts in employment out of high-paying manufacturing jobs and into service jobs which may be lower-paying and frequently do not provide benefits. Although the expanding economy makes it somewhat easier for workers to find new jobs, the adjustment process still places severe burdens on individuals and their families. Dislocated workers are sometimes forced to accept permanent income losses in order to get re-employed. This transition may also entail the need to move, retrain, lose health care, and pension coverage. Policies should be implemented to ease the adjustment burden being felt by these workers, who, by no fault of their own, find themselves under severe economic pressure.

XII. Conclusion

The economy is in its best shape in years, yet some Americans are still not sharing in the prosperity. There remains quite a lot of unfinished business to attend to in order to raise living standards of all Americans, not just for the lucky few.

Despite recent improvements in all income groups, the gap between the rich and the poor continues to widen. Stemming any further widening in the income gap, let alone reducing it, does not necessarily have to mean taking wealth away from the rich. It can be done by devoting more of the recent economic gains to those people whose incomes have not been growing as much.

One immediate way to narrow this gap is to strengthen the safety net for those in lower income groups. First and foremost, the minimum wage should be raised in order to correct for the 20 year erosion in its value. The next step is to encourage the adoption of Living Wage ordinances throughout the country.

Losing or not having health care coverage can be very costly, and can throw families into poverty. Health care coverage should be extended to all those who need it, and the delivery of health care services should be improved. In particular, more needs to be done to insure that all children are covered by health care insurance.

Prescription medication is becoming one of the most expensive elements of health care, and its cost is expected to continue rising in the future. Congress should expand Medicare to include prescription drug coverage for all seniors and disabled people, those who face the heaviest burden of rising medication costs.

The United States is experiencing an unprecedented period of economic prosperity. Unemployment is at a historic low and there are no signs of a resurgence of inflation. But as good as this story is, it is not complete. Economic prosperity has not yet come to millions in our society, and for most it has come following a period of prolonged economic stagnation. The challenge before the nation is to both ensure the continuation of this economic prosperity and to aim at sharing its benefits more widely with all Americans.