

Withdrawal/Redaction Sheet

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	orszagg to Janet L. Yellen at 03:55:46.00. Subject: A few things. (partial) (1 page)	02/02/1999	b(6)
002. email	Michele Jolin to Janet L. Yellen at 08:56:47.00. Subject: 2 things. (partial) (1 page)	02/09/1999	b(6)
003. email	Douglas W. Elmendorf to Jeff Liebman and Janet L. Yellen at 15:54:46.00. Subject: today's Social Security hearing. (partial) (1 page)	02/09/1999	b(6)
004. email	t.srinivasan to Janet L. Yellen at 14:11:04.00. Subject: Department of Economics Reunion. (2 pages)	02/15/1999	Personal Misfile

COLLECTION:

Clinton Presidential Records
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[02/02/1999 - 02/15/1999]

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RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

Freedom of Information Act - [5 U.S.C. 552(b)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
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P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

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RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 15:52:03.00

SUBJECT: Social Security

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

One other thing -- It turns out that the amount being transferred to Social Security (\$2.8 trillion) is almost exactly equal to the off-budget surpluses for the next 15 years (\$2.7 trillion). This has the unfortunate effect of reinforcing the impression that we're just going to count twice money that would have belonged to Social Security anyway.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 13:02:26.00

SUBJECT: CNP speech from last year

TO: Sandra F. Daigle (CN=Sandra F. Daigle/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D61]MAIL48400743B.036 to ASCII,
The following is a HEX DUMP:

The 1998 Economic Report of the President

Dr. Janet Yellen
Chairman, President's Council of Economic Advisers
Center for National Policy
February 10, 1998

Thank you. It is a pleasure to be here. I want to thank the Center for National Policy for again hosting the release of the annual *Economic Report of the President*. In particular, I want to thank Mo Steinbruner and Mike Pietro all of their help in arranging this event.

I would also like to thank my colleagues--Jeff Frankel and Rebecca Blank--for all their hard work and dedication in producing this year's *Report*.

Finally, I want to thank the staff of the Council, many of whom are here with us today. During the past several months, the staff have been working long nights and weekends to produce the *Economic Report*. And, because the other work of the Council doesn't disappear, they are in effect working two jobs with two shifts. I appreciate all of their hard work, their thoughtful insights and their good spirits. Their dedication and professionalism deserve special recognition.

As you probably know, the Employment Act of 1946, which created the Council of Economic Advisers, requires the President to submit an *Economic Report* to the Congress each year. This Act, together with its later amendments, gave the Federal government responsibility for stabilizing short-run economic fluctuations, promoting balanced and noninflationary economic growth, and fostering low unemployment. One purpose of the *Economic Report* is to tell Congress whether we have met those responsibilities. I am happy to say, in this the

fifty-second year after the Act, that the state of the economy is truly extraordinary.

I will elaborate on this point in a moment, but I would also like to note that the *Report of the Council of Economic Advisers*, has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains a chapter on the economic well-being of families and children, and a chapter on racial and ethnic inequality--two central concerns of this Administration. The report also contains two chapters on microeconomic topics, one focusing on improving economic efficiency in the areas of health and environmental policy, and one discussing recent trends in antitrust policy. Finally, the international chapter focuses on the benefits of opening international markets.

In the remainder of my remarks I will touch briefly on the current state of the economy, and then discuss the broad and lasting benefits of a "high-employment economy" -- which is one of the key themes of this year's *Economic Report*. I will then talk about some of the key challenges that still face our nation as we move into the 21st Century.

STATE OF THE ECONOMY

Our Nation's economy is the strongest it has been in a generation. In 1997, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent, and employment rose by 3.2 million, for an average rate of 267,000 jobs per month. The unemployment rate dropped below 5 percent for the first time in 24 years, yet core inflation rose just 2.2 percent. And, this occurred during a period of historic deficit reduction: the Federal budget deficit, which reached \$290 billion in the 1992 fiscal year, declined to only \$22 billion in fiscal 1997. And, as you know, the President recently submitted to Congress a budget for fiscal

1999 that projects a balanced budget for the first time since 1969.

As 1998 begins, the prospects for continued growth with high employment and low inflation are excellent. The economy is remarkably free of the symptoms that often presage an economic downturn -- that is, inflationary pressures remain well under control; inventories are lean in comparison with sales; and there is no evidence of any financial imbalance that could disrupt the expansion. Economic turmoil in East Asia, assuming that stability is restored, may work to permit continued U.S. growth and job creation with a more moderate outlook for interest rates. Our economy is in fundamentally sound shape and well-equipped to handle any unexpected bouts of rougher weather.

THE BENEFITS OF A HIGH EMPLOYMENT ECONOMY

The exceptionally strong economy that we are enjoying today is due in part to the sound and credible economic strategy put in place by the Clinton Administration. The Administration's strategy has focused on getting the fundamentals right -- reducing the budget deficit, investing in the American people, and opening markets at home and abroad. These were the right policies to stimulate the job creation needed to move the economy to full employment. And, they are the right policies for attacking the longer term problems of sluggish productivity growth and widening income inequality that have afflicted our nation's economy since the early 1970s.

The *Report* underscores the enormous economic and social benefits to a "high-employment economy." An economy with strong job creation and low unemployment can make a broad and lasting contribution to the well-being of the American people. Let me talk briefly about some of these benefits:

First, a high employment economy produces certain *direct and measurable benefits*.

Returning the economy to full employment yields a direct and measurable benefit to our nation by ensuring that the economy's resources--human and material--are not squandered by needless cyclical unemployment. On average, reducing the unemployment rate by a percentage point raises output by approximately 2 percent; in 1997, 2 percent of GDP was \$160 billion, or roughly \$600 for every American man, woman, and child. Wasted resources from not producing at potential, together with the human cost of unemployment, are intolerable; the elimination of this waste is the principal benefit of a sustained return to full employment.

Second, a high-employment economy can *reduce long-term joblessness*. A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less skilled or younger and more inexperienced workers into the labor force. These new labor market entrants gain much-needed job experience, building the skills they will need to hold down a job in the future. The experience of some European countries illustrates this point: in Europe, the prolonged stagnation or recession may have led to a permanent increase in unemployment there, as the unemployed and the never-employed have seen their skills atrophy or become obsolete. For this reason, running a high-employment economy, may be one of the surest ways to ensure that an unacceptably large fraction of our citizens are not consigned to long-term joblessness and economic marginalization.

Third, it will *help move welfare recipients into the workforce*. Keeping the unemployment rate low and job growth high is necessary if we are to move current welfare recipients into the work force. Early, indirect evidence on this point is encouraging: employment and labor force participation rates among single women who maintain families--about two-thirds

of whom have children under 18--have increased in the past few years. This is probably in part the result of recent welfare reform: the greatest acceleration in employment rates has occurred among those single women most likely to be affected by welfare reform, namely, those with young children. Nevertheless, it is obvious that fostering an economy in which job opportunities are plentiful plays a crucial part in aiding the transition from welfare to work.

Fourth, it *enhances personal economic security*. Knowing that work is available to those who seek it, at wages sufficient to keep them and their families out of poverty, is a key to personal economic security. A tight labor market increases the confidence of job losers that they will be able to return to work, lures discouraged workers back into the labor force, enhances the prospects of those already at work to get ahead, enables those who want or need to switch jobs to do so without a long period of joblessness, and lowers the duration of a typical unemployment spell.

And, finally, a high-employment economy *may help reverse the trend toward greater economic inequality*. From the 1980s until the early 1990s, the economy's ability to reduce poverty through growth alone was hampered by a strong headwind: for the poorest Americans, the benefits of an expanding economy were offset by the sustained declines in wages at the low end of the earnings distribution. Since 1993, living standards for all Americans are on the rise, especially for those at the bottom of the income distribution. The poverty rate fell to 13.7 percent in 1996, from 15.1 percent in 1993; the poverty rate for black Americans is at a historical low, and in 1997 unemployment among blacks fell to its lowest rate since 1973. Since 1993, household income has grown in each quintile of the income distribution, with the largest percentage increase going to the poorest members of our society. Maintaining a

full-employment economy is essential if this progress is to continue.

CHALLENGES IN A CHANGING ECONOMY

Although our economy is strong and Americans are working in record numbers, our Nation still faces other, broader challenges as we move into the 21st century. In many ways the U.S. economy today is very different from that in which our parents and grandparents lived and worked. Today, 24 percent of families are headed by a single parent, compared with 14 percent 25 years ago. Three in five married mothers with children under 6 are in the work force--twice as large a share as in 1970. And the U.S. population is aging-- in the next century there will be fewer workers for every retiree, making issues related to retirement security more and more important. The nature of the workplace also has changed significantly: few American workers expect to be working for the same employer--or even to be in the same career--when they retire. Information technology is dominating industry: in the 1950s the information technology industry barely existed; today it employs a larger share of the labor force than the automobile industry did in the 1950s and 1960s. Because information and technology and global commerce are leading the transformation of the global economy, the new strength of a nation will be found in the skills, knowledge and imagination of its people.

The Clinton Administration's agenda is designed to deal with these changes and the challenges they pose. It is designed to equip the American people with the strength, the skills, the security and the flexibility needed to reap the rewards of our growing, changing economy. The President recently laid out this broad agenda in his State of the Union and again in his FY1999 budget. In the remainder of my remarks, I will focus on 3 of the key agenda areas: retirement security, the challenges of childcare and racial and ethnic economic inequality.

First, let me talk about issues related to the aging of the population, which we address in Chapter 1 of the *Economic Report* -- reforming Social Security.

For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. A large share of elderly Americans, particularly those with low incomes, rely on Social Security as their primary source of pension income in retirement. The system has enjoyed dramatic success in reducing poverty rates among older Americans.

Today, however, many Americans fear that Social Security will not be there for them when they are ready to retire. This concern reflects the widespread recognition that, under current “intermediate” projections of the Social Security trustees, the system faces a long-term funding gap: beginning in 2012, unless the system is reformed by then, the government will be unable to pay current Social Security benefits in full out of current payroll taxes; it will then have to draw down the system's trust fund, and by 2029 those funds will be exhausted. If still nothing has been done, the government would then face several options which it could adopt singly or in combination: it could reduce benefits until they are in line with collections, raise payroll taxes to cover an unchanged level of benefits, or finance the shortfall from other parts of the budget, by raising other taxes, cutting expenditures on other programs, or borrowing and allowing the budget deficit to increase. One or more of these measures will have to be taken so long as no changes are made to the present system.

Although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is

taken. For example, even if nothing is done and the trust fund is exhausted, payroll taxes will still be sufficient to permanently finance roughly 75 percent of benefits. Put another way, the difference between the anticipated income and the anticipated expenditures of the OASDI (Old Age, Survivors', and Disability Insurance) program over the next 75 years amounts to around 2¼ percentage points of taxable payroll, or approximately 1 percent of GDP. These facts suggest that the problem of placing Social Security on a sound financial footing can admit of eventual resolution.

The President is committed to Saving Social Security First. He has proposed reserving 100 percent of any budget surplus until steps have been taken to reform Social Security. He has also proposed a process to devise an appropriate solution over the next 2 years.

A second major policy challenge involves children and issues related to childcare.

Chapter 3 of this year's *Report* documents that there have been notable improvements in children's well-being over the past three years, although an unacceptable fraction of America's children still live in poverty. Children have shared in the benefits of the recent economic expansion: the official child poverty rate has fallen by 2.2 percentage points since 1993. And, under a broader measure of poverty which includes both taxes (like the EITC) and non-medical in-kind benefits, the poverty rate for children has decreased by 4.7 percentage points from 1993 to 1996, and is now below its level in 1989. The primary reason for this drop is because more families were able to earn enough money to bring their incomes above the poverty line. Child poverty has also declined due to an expansion of the Earned Income Tax Credit.

Other measures of children's well-being have also improved. The share of children

living in households without enough to eat has fallen since the early 1990s, and the share of households with children living in housing in poor physical condition has also declined since the late 1970s. There have also been increases in low-income children's utilization of basic health care services, and continued improvements in mortality rates of infants and young children during the 1990s.

Despite these improvements, many children remain economically vulnerable. One in five children, and nearly one in two children in female-headed families, had incomes below the poverty level in 1996. Adequacy of family income is a critical predictor of both the present and future well-being of children. Children who grow up in low-income families score lower on standardized tests, complete fewer years of school and tend to have lower earnings. With respect to medical care, one in seven children did not have access to health insurance in 1996, despite substantial increases in Medicaid coverage since 1989, due to a concurrent decline in children's private health insurance coverage; one in nine children lived in households which paid more than half their income for housing in 1995. Finally, a large share of children are not attaining even a basic levels of proficiency in science, mathematics, and reading. Thus, too many children are at risk of current and future hardship.

For this reason, the President has developed a number of initiatives to strengthen the economic and social supports for America's children. This year, the Administration has begun to implement the Children's Health Insurance Program, which offers \$24 billion over five years to States to expand health insurance for uninsured children. For fiscal 1999, the President has proposed to expand the supply of affordable housing for low-income families, through a 40% increase in the low-income housing tax credit, and through continued expansions in the HOME

Investments Partnership Program. The President has also proposed two major new initiatives to improve the quality of elementary and secondary education. The first would invest \$12.4 billion over 7 years to bring down class sizes in public schools in grades 1 to 3 from a nationwide average of 22 pupils in to an average of 18. The second would provide tax credits to pay interest on nearly in \$22 billion in bonds to support new construction and renovation of public school buildings.

Today, more American workers are faced with the need to juggle the demands of the workplace with the demands of family and home. In 1997, over 60 percent of married mothers with a child under six were working--compared to 30 percent twenty years ago. For most of these families, it is difficult to afford high quality day care. In 1993, child care expenditures represented 25 percent of annual income for those families with annual incomes below \$14,400 with employed mothers and preschool children in paid care. Comparable families with annual incomes above \$54,000 spent only 6 percent of their income on child care. There is also reason to be concerned about the quality of child care: A recent study of regulated child care providers found that 86 percent of child care centers surveyed provided mediocre or poor care when judged from the perspective of child development, and 12 percent were of such poor quality that the children's health and safety needs were only partly met.

The President's 1999 budget includes a \$21 billion increase in funding for child care, to make it accessible to more families and to raise its quality. An important part of this proposal is increased tax credits for 3 million working families to help them pay for child care, as well as an increase in block grants to States that will directly subsidize child care for low-income families. In addition, the proposal calls for a new Early Learning Fund, along with support for the

enforcement of State child care health and safety standards, scholarships for up to 50,000 child care providers per year, and funding for research and consumer education. Finally, the proposal includes \$3.8 billion in additional funding over 5 years to help to reach the goal of expanding participation in Head Start to 1 million children in 2002.

Finally, I'd like to talk about issues related to the progress of different racial and ethnic groups. Chapter 4 of the *Economic Report* reviews trends in racial and ethnic economic inequality and concludes that this country's longstanding goal of achieving racial equality has not yet been attained. Although there has been progress in narrowing economic gaps among racial and ethnic groups in the postwar period, it has been very uneven, with rapid progress in the 1960s and early 1970s, followed by 20 years of stagnation between the early to mid-1970s to the early 1990s.

The current expansion has brought signs of renewed progress: since 1993, for example, the median income of black families has risen more rapidly than that of non-Hispanic whites; in 1996, black family income reached a new high, and the poverty rate for blacks fell to a new low. Data compiled under the Home Mortgage Disclosure Act show that between 1993 and 1996, conventional home mortgage lending to blacks rose 67% and to Hispanics, 49%--much larger than the percentage increase in conventional home mortgage lending overall during this period. Such developments raise hope for renewed and sustained progress toward economic equality.

Nevertheless, substantial disparities in economic status across racial and ethnic groups persist. For example, income gaps between black and white families are as large today as they were 30 years ago. The median wealth of white families is by some estimates 10 times that of black and Hispanic families. Poverty rates of blacks and Hispanics are almost triple those of non

Hispanic whites; and differences in child poverty rates across racial and ethnic groups are stark, with about 40 percent of black and Hispanic children in poverty in comparison with about 16% for whites.

Because the largest share of most families' income is derived from earnings, labor market outcomes across racial groups are important determinants of economic inequality across racial groups. After increasing rapidly between 1965 and the mid 1970s, the wages of black and Hispanic men and women relative to those of non-Hispanic whites have stagnated or declined between the mid 1970s and early 1990s. Part of this erosion of relative pay reflects a society wide trend toward rising income inequality, due to an increase in the demand for more educated workers and an increase in the skilled-unskilled earnings differential. Because blacks, Hispanics and American Indians are less likely to hold a college degree than whites and Asians, these groups have been hurt disproportionately by changes in the economy that have raised the demand for college educated workers. Over the last 30 years, educational attainment has increased for all groups and blacks largely closed the high school attainment gap with whites; however, the college completion gap widened in the 1980s, as the reward to college educated workers rose.

Although differences in education across racial groups explain a portion of the trend toward rising earnings inequality since the mid-1970s, racial earnings gaps have also increased among individuals with similar educational levels, suggesting that other factors may also be at work. For example, since the mid-1970s the wages of young black college graduates have fallen relative to those of their white counterparts. Researchers debate whether this trend reflects unmeasured skill differences potentially related to school quality, to discrimination in the labor market, or to other factors.

Clearly, more needs to be done to promote equality of opportunity for all Americans. Many of the Administration's current and proposed policies, such as those that encourage community empowerment and those that promote improved quality and accessibility of education at all levels are intended to address these disparities. Furthermore, the Administration's 1999 budget proposal signals a renewed federal commitment to strong and effective enforcement of the Nation's civil rights laws. It increases funding for federal civil rights enforcement agencies by more than 16 percent. And, this January, in a Martin Luther King Day address, Vice President Gore announced the Administration's package of proposed civil rights enforcement initiatives. In addition to increasing funding, these initiatives place greater emphasis on the nonlitigation and prevention remedies for discrimination, and provide for better coordination across Federal agencies and offices. The President has also initiated and devoted great energy and resources to his Initiative on Race, an effort to further a national dialogue on race in America.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been extraordinary: strong growth and low unemployment combined with low and stable inflation. And there are enormous social and economic benefits to our high-employment economy. But that success--and the economy's present strength--cannot be taken for granted. Moreover, there are still long-term changes and challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era. We must finish the job of balancing the budget while investing in

people and opening markets at home and abroad. At the same time, we must ensure that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 18:46:03.00

SUBJECT: draft of fiscal section of cnp speech

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

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The following is a HEX DUMP:

Draft 2/2/99

Fiscal Policy

Let me turn now to a subject that is one of the Administration's greatest accomplishments in economic policy and also one of our Nation's greatest challenges for the future.

Before President Clinton took office in 1993, the Congressional Budget Office projected that the budget deficit would top \$350 billion in 1998 and continue climbing. Publicly held debt had increased from 26 percent of GDP in 1981 to 50 percent in 1993, and it too was expected to increase rapidly during the rest of the 1990s. Instead, the budget outlook has improved dramatically: in 1998 we enjoyed the first budget surplus since 1969 and the largest surplus as a share of GDP since 1957. The ratio of debt-to-GDP has fallen to 44 percent. More important, the Administration now projects substantial surpluses in the unified Federal budget and a further decline in debt well into the future.

This remarkable reversal in our fiscal fortunes owes to several factors. The first was a set of tough policy decisions made by the President and Congress. In 1993 and again in 1997, the budget deficit was reduced by slowing the growth of entitlements and imposing stringent caps on discretionary spending. A second factor reducing the deficit was strong economic growth, which boosted tax revenue considerably and dampened spending a little. Finally, technical factors boosted receipts and depressed outlays over and above what policy changes and macroeconomic conditions can account for. [On the receipts side, higher-than-anticipated capital gains realizations and changes in the distribution of income among taxpayers boosted individual income tax revenue beyond expectations. On the outlays side, spending for Federal health programs--primarily Medicare and Medicaid--has been lower than expected, most likely

reflecting slower growth in health care costs economy-wide.]

Achieving a surplus in the Federal budget has provided the foundation for tackling longer term problems. The most important of these problems is posed by the aging of the population, with its implications for future imbalances in Social Security and Medicare and for the strength of the economy as a whole.

[The most commonly used yardstick to measure the financial soundness of the Social Security system is its 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits. By 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline. And by 2032, the Trust Fund is expected to be depleted, after which time contributions would still be sufficient to pay about three-quarters of current law benefits. Of course, future taxes and benefits will depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe.]

With respect to Social Security, the primary factors that will push benefits above payroll tax receipts are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retiree. When the Social Security Act was passed in 1935, the life expectancy of a 65-year-old American was about 13 years. Today, life expectancy for a 65-year-old is 18 years and rising. At the same time, people are retiring earlier. In 1950 the average age for first receiving Social Security retirement benefits was 68; today it is 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years

[Automated Records Management System Hex-Dump Conversion]

time, it will be just 2 to 1 and still falling. With respect to Medicare, these same demographic effects combine with the rising cost of medical care to pose an even greater threat to the finances of that program.

For the Nation as a whole, the central problem is how to provide a high standard of living for both workers and retirees, even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can increase the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers.

The key to accomplishing this goal is to increase national saving. Net national saving has increased from 3.1 percent of GDP in 1992 to 6.7 percent of GDP today, an increase that is accounted for entirely by an increase in government saving. Fiscal discipline has been a centerpiece of this Administration's economic policy, and the President is now trying to ensure that this discipline continues into the first decades of the 21st century.

In his State of the Union address a year ago, the President proposed to reserve the budget surplus until agreement had been reached on a plan to secure the viability of Social Security. With this commitment to "save Social Security first," a yearlong process of public education and bipartisan discussion followed. In his State of the Union address last week, the President put forward a comprehensive framework for Social Security reform that also addresses several other critical objectives for this Nation. Let me first discuss the various pieces of this plan, and then return to the plan's overall macroeconomic impact.

Regarding Social Security, the President proposed to transfer 62 percent of the projected unified budget surpluses over the next 15 years to Social Security, amounting to about \$2.8

trillion. About a quarter of those transfers would be invested in corporate equities, with the remainder invested in special Treasury securities like the current balance in the trust fund. Investing in a mixture of bonds and equities is, of course, standard for private or state and local government pension plans, and the President intends to limit the trust fund's holdings of equities to only 15percent of its total assets, which is more conservative than most pension plans.

I should emphasize that we are very sensitive to the possible dangers associated with government ownership of private firms, so we intend to work with Congress to devise a mechanism to ensure that the investments are made independently, without political interference, and with low administrative costs by the most efficient private-sector managers. Under this plan, only 4 percent of the overall stock market would be owned by Social Security, about equal to the share controlled by Fidelity Investments, and much less than the share owned by state and local pension plans. It is worth noting that, as an approach for investing in the stock market, equity investment through the trust fund has at least two key advantages over investing through individual accounts: substantially lower administrative expenses, and much greater risk sharing of market fluctuations both within and across generations.

According to the independent Social Security actuaries, the transfers and equity investments would ensure the solvency of Social Security through 2055, 33 years beyond the expected exhaustion date of the trust fund under current law. However, 75-year actuarial balance is the usual measure of solvency, and the President has emphasized his desire to make the hard-headed, painful, but sensible choices needed to extend the trust fund through 2075. Many possibilities have been suggested by policy analysts, including increasing the normal or early retirement age, raising the maximum level of taxable earnings, enrolling state and local government workers in Social Security, and so forth. None of these changes would be easy, and all would require

bipartisan support to succeed. Nevertheless, 75-year balance can be achieved without excessive pain, and any changes that are implemented could be phased in very gradually.

The President also proposed two specific changes in Social Security rules. One is to eliminate the “earnings test,” whereby workers who earn more than a base amount lose between 30 and 50 cents of Social Security benefits for each extra dollar they earn. This is the worst form of tax: in present value sense, it is hardly a tax at all, because the benefit reduction while earning is made up by increased benefits later, but it appears to be a tax and is confusing and burdensome, so it probably discourages work. It is probably one of the factors contributing to early retirement.

The President also wants to reform Social Security to reduce poverty among elderly women who are widows. The poverty rate for *all* elderly women was 13 percent in 1997, but for widowed elderly women it was 18 percent. In contrast, the poverty rate of married women was about 5 percent and for widowed men about 12 percent. Currently, widow benefits vary from 50 to 67 percent of benefits for a married couple when both were alive. However, using the official poverty thresholds, a widow needs 79 percent of a couple’s income to maintain her pre-widowhood consumption. This is a key reason why widow poverty is so much higher than overall elderly poverty.

The President has stated clearly that his foremost priority is securing the future of the Social Security system. If that goal is reached, then the President stated that the remaining projected surpluses over the next 15 years should be dedicated to three purposes. First, 15 percent of the projected surpluses would be transferred to the Medicare trust fund. The Administration, the Congress, and the Medicare commission should work to use these funds as part of broader reforms. Even without such reforms, however, the transfers would extend the projected solvency of the Medicare trust fund to 2020. Second, 12 percent

of the projected surpluses would be used to create Universal Savings Accounts, which would help people save more for their retirement needs. One possible structure for these accounts would have the government provide a fixed contribution for most working Americans and an additional matching portion, with a higher matching rate for lower income workers. These accounts would not be part of the Social Security system but would provide additional retirement resources. The remainder of the projected surpluses over the next 15 years would be reserved to improve military readiness and to meet pressing domestic priorities in such areas as education and research.

This framework for Social Security reform dramatically extends the Administration's commitment to fiscal discipline and saving for our Nation's future. Evaluated from a macroeconomic perspective--from the perspective of national savings--this plan saves, in essence, between 77 and 89 percent of the projected surpluses, depending on one's evaluation of the saving impact of the USA accounts. The transfers to Social Security and Medicare amount to 77 percent of the federal budget and about 2 percent of GDP, and they are pure additions to national saving. In addition, the USA accounts amount to 12 percent of the budget and could be viewed as a tax cut that is highly likely to add to personal saving. Only 11 percent of the surpluses are devoted to additional government spending.

Dedicating the surpluses to Social Security and Medicare serves two purposes. First, it helps to lock in the surpluses so they are not used for tax cuts or wasteful spending. Second, it gives these critical programs a "first call" on the benefits of our fiscal discipline. And these benefits will be large.

This is a fiscally conservative, pro-growth plan that comes close to a plan of simply paying off debt. Publicly held debt is projected to fall from 44 percent of GDP today to about 7 percent in 2014. That would represent the smallest burden of government debt on the economy since the United States entered World

War I in 1917. In addition, some of the surpluses will be used to purchase equities, which will represent an asset of the government. The dramatic decline in national debt would increase private capital investment, raise future national income, and free up government resources by reducing debt servicing costs.

[this probably needs more of a wrap-up]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 16:33:49.00

SUBJECT: Draft of statement for press conf

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Attached.

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D20]MAIL42266353M.036 to ASCII,
The following is a HEX DUMP:

STATEMENT OF JANET YELLEN
Release of the 1999 *Economic Report of the President*

Thank you all for coming in today to hear about the 1999 *Economic Report of the President*. Each year, one of the most closely watched aspects of the Report's release is the color of the cover. And, as you can see, unlike this year's budget document, the Economic Report is in red -- symbolizing our Nation's "red hot economy." [Or, as one of our economists suggested "After so many years of Republic red ink, the Government Printing Office had a surplus of red -- and the CEA is helping them out."]

In any case, as you all know, the President is required to submit to Congress each year a Report that describes the state of the US economy. But, the Report has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains: a chapter on the benefits of a strong labor market; a chapter on the aging American population; a chapter on regulation and innovation; and, two chapters on international issues -- one discussing the recent world-wide financial turmoil and one describing reform of the international financial architecture.

Let me first talk briefly about the current state of our economy, and then talk about the direct and measurable benefits that American workers are enjoying from our strong and healthy economy. Finally, I will touch briefly on the challenges that remain as we move into the 21st Century.

STATE OF THE ECONOMY

Our Nation's economy is healthy and strong. As Chapter 2 of the Report details, our Nation is currently enjoying the longest peacetime expansion in history. In 1998, the US economy remained strong, despite a serious weakening in the international economy. Unemployment remained at historically low levels -- staying below 5% for the past xx months. Job creation was vigorous -- with xxxx million jobs created in 1998 and almost 18 million since 1993. Growth has been strong -- with our economy growing at 3.9% in both 1998 and 1997. And inflation remained at historically low levels.

And the President just released his budget that projects a surplus of \$79 billion. Last year, for the first time since 1969, our nation enjoyed a budget surplus of almost \$70 billion -- the largest dollar surplus on record and the largest as a share of our economy since the 1950s.

As 1999 begins, our economy is fundamentally sound and I am confident that we will continue to experience solid economic growth with high employment and low inflation. There is no evidence of domestic imbalances that would threaten the outlook for continued growth.

The exceptionally strong economy that we are enjoying today is due in part to the sound and credible economic strategy put in place by the Clinton Administration. The

Administration's strategy has focused on getting the fundamentals right -- that is, fiscal discipline, investing in education and technology, and opening markets abroad. These were the right policies to stimulate the job creation needed to move the economy to full employment.

THE BENEFITS TO AMERICAN WORKERS OF A STRONG ECONOMY

Because of our Nation's strong and healthy economy, American workers are enjoying direct and measurable progress. In the *Report*, we describe work done by the CEA on real wage growth. Let me talk briefly about some of these findings:

[[Becky -- Do you want to add here paragraphs on the Chapter 3 findings on wages?]]

In addition to these direct and measurable benefits, American workers are benefiting from our strong economy in other ways. An economy with strong job creation and low unemployment makes broad and lasting changes in our labor market and in the well-being of the American people.

A high-employment economy can *reduce long-term joblessness*. A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less skilled or younger and more inexperienced workers into the labor force. These new labor market entrants gain much-needed job experience, building the skills they will need to hold down a job in the future.

A strong, high-employment economy will *help move welfare recipients into the workforce*. Keeping the unemployment rate low and job growth high is necessary if we are to move current welfare recipients into the work force. Early evidence on this point is encouraging: employment and labor force participation rates among single women who maintain families--about two-thirds of whom have children under 18--have increased in the past few years. This is probably in part the result of recent welfare reform: the greatest acceleration in employment rates has occurred among those single women most likely to be affected by welfare reform, namely, those with young children. Nevertheless, it is obvious that fostering an economy in which job opportunities are plentiful plays a crucial part in aiding the transition from welfare to work.

A high-employment economy *enhances personal economic security*. Knowing that work is available to those who seek it, at wages sufficient to keep them and their families out of poverty, is a key to personal economic security. A tight labor market increases the confidence of job losers that they will be able to return to work, lures discouraged workers back into the labor force, enhances the prospects of those already at work to get ahead, enables those who want or need to switch jobs to do so without a long period of joblessness, and lowers the duration of a typical unemployment spell.

And, finally, a high-employment economy *may help reverse the trend toward greater economic inequality*. From the 1980s until the early 1990s, the benefits of an expanding economy were offset by the sustained declines in wages at the low end of the earnings distribution. Since 1993, living standards for all Americans are on the rise, especially for those at the bottom of the income distribution. The poverty rate fell to xxx percent in 1997, from 15.1 percent in 1993; the poverty rate for black Americans is at a historical low, and in 1998 unemployment among blacks fell to its lowest rate since 1973. Maintaining a full-employment economy is essential if this progress is to continue.

CHALLENGES IN A CHANGING ECONOMY

Yes, our economy is strong and Americans are working in record numbers. And there are broad and lasting benefits to sustaining a healthy economy with strong job creation and low unemployment.

But our Nation still faces other, broader challenges as we move into the 21st century. The Clinton Administration's agenda is designed to deal with these changes and the challenges they pose. It is designed to equip the American people with the strength, the skills, the security and the flexibility needed to reap the rewards of our growing, changing economy. The President recently laid out this broad agenda in his State of the Union and again in his FY2000 budget.

First, we must maintain fiscal discipline by saving Social Security for the 21st Century--thereby laying the foundations for future economic growth. By the year 2030, the number of elderly Americans will double, a seismic demographic shift with great consequences for our nation. That is why the President proposed in the State of the Union Address that we commit 62% percent of the budget surplus for the next 15 years to Social Security, with a small portion invested in the private sector. This will allow the Trust Fund to earn a higher return and keep Social Security sound until 2055. But, we must also work on a bipartisan basis to put Social Security on a sound footing for the next 75 years. And, we must work to reduce poverty among elderly women, and to eliminate the limits on what Seniors on Social Security can earn.

Once we have saved Social Security, we must fulfill our obligation to save and improve Medicare, and invest in long-term medical care.

By saving the money we will need to save Social Security and Medicare, over the next 15 years we will achieve the lowest level of publicly-held debt since 1917. This debt reduction will help keep future interest rates low or drive them even lower, thus fueling economic growth well into the 21st Century.

To spur future growth, we must also encourage savings. In the State of the Union address, the President proposed that we use 11 percent of the surplus to establish new Universal Savings Accounts--USA Accounts--to give all Americans the means to save. With these accounts, Americans can invest as they choose, and receive funds from the Federal government to match a portion of the savings. This is the right way to provide tax relief to the American people.

Education is also key to our nation's future prosperity. That is why the President proposed in the State of the Union

address a plan to create 21st Century schools through greater investment and more accountability. Among other things, the President proposed that states and school districts that accept federal resources will be required to end social promotion, turn around or close failing schools, support high-quality teachers, and promote innovation, competition and discipline.

Finally, at this time of continued turmoil in the international economy, we must do more to help create stability and open markets around the world. We must press forward with open trade. At this time of economic fragility in so many regions, the United States must not build new walls of protectionism, that could set off a chain reaction around the world that would imperil the world's growth. We must also continue to work to strengthen the architecture of our international financial system. The United States must continue to lead in stabilizing the world financial system.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been strong -- we have enjoyed solid growth, strong job creation, low unemployment and low and stable inflation. And there are broad and lasting benefits that American workers are enjoying as a result of strong economy. Even so, there are still long-term challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Robert F. Schoeni (CN=Robert F. Schoeni/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 14:37:40.00

SUBJECT: McClellan Memo

TO: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP [CEA])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Mark wanted me to make sure that you knew that his memo should not be distributed to anyone other than CEA staff.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 15:41:54.00

SUBJECT: Social Security

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

At the technical meeting today, Larry Summers pushed the view that you have emphasized, namely that "the biggest substantive and political risk to our plan is that the transfers do not reduce the reported surplus" -- or that people will later create a "super-unified budget" to put all the pieces back together again. The process of legislation drafting is finally giving this issue some prominence. I expect there will be a principals meeting on scoring and legislation next week.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 15:27:53.00

SUBJECT: rough draft of cnp speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

this is a rough draft with a hole for the social security/fiscal
discipline part (Doug, could you send it directly to Janet). Janet, have
a look and we can talk about how to put it in shape tomorrow so it will be
ready to go on Thursday.===== ATTACHMENT 1 =====
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D90]MAIL45665253C.036 to ASCII,
The following is a HEX DUMP:

The 1998 Economic Report of the President

Dr. Janet Yellen
Chairman, President's Council of Economic Advisers
Center for National Policy
February 4, 1999

Thank you. It is a pleasure to be here. I want to thank the Center for National Policy for again hosting the release of the annual *Economic Report of the President*. In particular, I want to thank Mo Steinbruner and [Mike Pietro?] for all of their help in arranging this event.

I would also like to thank my colleagues--Jeff Frankel and Rebecca Blank--for all their hard work and dedication in producing this year's *Report*.

Finally, I want to thank the staff of the Council, many of whom are here with us today. During the past several months, the staff have been working long nights and weekends to produce the *Economic Report*. And, what is truly remarkable is that they have also continued to do the other work of the Council, which does not stop just because it is time to produce the *Economic Report*. I appreciate all of their hard work, their thoughtful insights and their good spirits. Their dedication and professionalism deserve special recognition.

As you probably know, the Employment Act of 1946, which created the Council of Economic Advisers, requires the President to submit an *Economic Report* to the Congress each year. This Act, together with its later amendments, gave the Federal government responsibility for stabilizing short-run economic fluctuations, promoting balanced and noninflationary economic growth, and fostering low unemployment. One purpose of the *Economic Report* is to tell Congress whether we have met those responsibilities. I am happy to say, in this the fifty-third year after the Act, that the state of the economy is truly extraordinary. Last year was a year for baseball home-run records, and it was also a year for economic records as we achieved the longest peacetime economic expansion on record—and the records go back to 1854.

I will elaborate on this point in a moment, but I would also like to note that the *Report of the Council of Economic Advisers* has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains a chapter on the benefits of a strong labor market and one on work, retirement, and the economic well-being of the elderly. This year's microeconomics chapter focuses on regulation and innovation. It examines this Administration efforts in three areas—antitrust, the environment, and electric power restructuring—to ensure that regulation not only does not interfere with innovation, but indeed fosters beneficial technological change and adapts itself to such change as well. Finally, the Report devotes two chapters to the crisis in the international economy. The first analyzes capital flows in the global economy and discusses both the emergence of the crisis and policy responses to the crisis. The second focuses on the evolution and reform of the international monetary system with an eye to understanding how such crises can be avoided in the future.

In the remainder of my remarks I will touch briefly on the current state of the economy

and the characteristics of this expansion. Then I want to discuss three themes: 1) the benefits of the strong economy and a strong labor market—especially for groups that had not seen much economic progress for a long time; 2) the importance of addressing challenges in the world economy in a way that preserves the benefits of outward-looking trade and investment policies; and 3) the achievement of restoring fiscal discipline and the challenge of preserving that fiscal discipline while saving Social Security and meeting the other challenges of the coming century.

STATE OF THE ECONOMY

Our Nation's economy is the strongest it has been in a generation. In 1998, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent. Nonagricultural jobs increased by about 2.9 million during the year, and the average unemployment rate for the year dropped to 4.5 percent, its lowest level since 1969. The consumer price index rose by only 1.6 percent, its smallest increase since 1964, and other measures of inflation were even more muted.

As you all know, this year the Federal budget moved strongly into surplus. In the 1992 fiscal year the budget deficit was \$290 billion and expected to rise further with no change in policy. But beginning in 1993, the deficit began to decline steadily. In 1998, the budget *surplus* was \$69 billion, and surpluses are projected well into the future. I will return to the budget and Social Security in a few minutes.

The current economic expansion is only the third on record that has lasted at least 7 years and this year's report puts the expansion in its historical context by comparing it with the other two long expansions--the 106-month long expansion of the 1960s (the longest in peace or war) and the 92-month long expansion of the 1980s. Judged in terms of overall economic performance this expansion has been not only long but excellent--especially with respect to inflation and unemployment. By this time in the expansion of the 1960s, for example, inflation was rising sharply and was much higher than now, at about 5%. In the 80s expansion, inflation was also rising at this stage and had reached 5%. By contrast, Inflation now is much lower and has been coming down. Since the need to combat high or rising inflation is what typically brings an expansion to an end, this greatly raises the prospects for a continuing expansion. The combination of low inflation and low unemployment is particularly remarkable and shatters long held views and simple textbook theories about the possibility of combining low unemployment and inflation. In fact, the misery index, which is the sum of inflation and unemployment, is lower at this stage of the current expansion than in either the expansion of the 60s or the 80s.

This is also an expansion which is investment driven--to a far greater extent than in either of the other two long expansions. This investment is a contribution to future growth and it is working to hold inflation down.

The continuing strong economic performance in 1998 is all the more remarkable because it took place at a time of considerable stress to the world economy. And the United States did not entirely escape the turmoil in foreign economies. Net exports declined sharply during 1998, as a result of slow or negative economic growth in a number of our trading partners and a substantial rise in the foreign exchange value of the dollar since early 1997. Moreover, during the late summer and early fall domestic financial conditions, which had been highly conducive to economic growth for several years, became much less favorable. However, a series of interest rate cuts by the Federal Reserve and other favorable developments relieved this financial stress

and left the economy on a relatively even keel by year-end. We are not out of the woods, of course, as ongoing concerns about Brazil remind us. But the U.S. economy has entered 1999 on course to continue growing and the chances are good that next year at this time we will be on the verge of marking the longest economic expansion—whether in peace or war—ever.

THE BENEFITS OF A STRONG LABOR MARKET

The Clinton Administration laid a strong policy foundation for growth in 1993 when the President put in place an economic strategy grounded in deficit reduction, targeted investments, and opening markets abroad. These were not only the right policies to stimulate the job creation needed to move the economy to full employment. They were also the right policies for attacking the longer term problems of sluggish productivity growth and widening income inequality that have afflicted our nation's economy since the early 1970s. I am happy to say that in this year's *Report* we are able to report some encouraging evidence of improvements for low-wage and minority workers associated with the strong labor market created in this expansion.

It was once commonly accepted that an economic expansion is a rising tide that lifts all boats, so that the most surefire way to alleviate poverty and help disadvantaged groups was to keep the economy expanding. However, in the late 1970s, a new, long-term trend toward widening inequality began to afflict the economy, most likely as a consequence of pervasive technological changes raising the demand for skilled labor and lowering the demand for unskilled workers. In addition, productivity growth declined substantially, for reasons that are still not well understood. During the expansion of the 1980's, real wages declined. Men were disproportionately impacted. During this expansion, we saw real wages stagnate for the first five years of the expansion. However, this has finally become an expansion in which a rising tide is lifting all boats.

Real wages have grown very strongly over the last two years and have are now up about five and a half percent on average over the expansion.

The long term slide in the real wages of men (over 11 percent in median earnings between 1979 and 1996) has finally been checked with strong increases in the last two years.

Low wage workers have finally seen gains. Real hourly wages for the lowest two tenths of the distribution of men and women have increased 5-6 percent since 1993.

Median real wages of blacks and Hispanics, both men and women, have risen especially rapidly in the past two years.

Employment gains have been substantial for high school dropouts, immigrants, blacks and Hispanics and of course for women with young who head households, suggesting that a good share of those who have left the welfare rolls have found jobs.

There is also good news on the job displacement front. Job losses due to layoffs skyrocketed in the last recession and remained unusually high even in 1993-95, during the recovery. However, the most recent evidence, covering the 95-97 period shows that displacement has declined substantially since 1993-95 and among those who have been displaced the share that have found new work increased and wage losses are the smallest on record.

It is too early to declare victory in reversing adverse long-term trends in income distribution. In particular, it remains hard to know how much of this turnaround is due to particularly favorable business cycle conditions. Nor is this Administration taking the improvements for granted. First, it is committed to maintaining the macroeconomic stability

that is a necessary condition for ensuring that all Americans participate in the country's growing prosperity. Second, the Administration continues to stress the importance of education and training policies that address the challenges of a changing economy and a changing society.

MAINTAINING FISCAL DISCIPLINE

[Doug]

MEETING THE INTERNATIONAL CHALLENGE

I would like to say a few words about the challenges we face on the international economic front. The last year has been an extraordinarily tumultuous one for the world economy. As you know, what seemed like currency crisis confined to developing Southeast Asia in the summer of 1997, erupted during 1998 into a deep, global economic crisis.

A third of all world economies were in recession or experiencing markedly slower growth by late 1998. World economic growth is estimated by the International Monetary Fund (IMF) at only 2.2 percent in 1998 and is projected to remain at this low level in 1999, after robust growth of 4.2 percent in 1997. Projected world growth has almost declined to levels registered during the pronounced world slowdowns of 1974-75, 1980-83, and 1990-91. Japan's hopes for recovery from a long-standing slump have been dashed. And the U.S. and other industrial countries have not escaped without impacts. The financial market turbulence led to a general flight from risky assets raising spreads and interest rates on riskier debt, in the United States and effectively tightening monetary conditions. In addition, our trade deficit has burgeoned, with our exports falling absolutely in real terms as a consequence of reduced demand from impacted Asian economies.

The United States has been focused since the outset of the crisis on the need to take steps to spur growth throughout the industrial world, to contain the crisis through IMF-lending cum reform programs in crisis countries; to provide precautionary loans to countries like Brazil that have implemented serious reform programs but are nevertheless threatened by capital outflows; and on the need to take steps to alleviate suffering in crisis afflicted countries through safety net spending and also through lending to help countries recapitalize their banking systems and emerge from debt.

Beyond that, the Administration is focused on the need for an ongoing, serious program of reform to strengthen the international financial system to make it less crisis prone and to improve the mechanisms available for dealing with any crises that may nevertheless occur. Unfortunately, it turns out that there is just no silver bullet--no simple solution that would guarantee countries the benefits of global capital flows while eliminating the risk that a crisis of confidence could once again result in the painful withdrawal of that access. Even so, international agreement is finally emerging on the steps that can and should be taken to strengthen the architecture of the financial system so that it is less crisis-prone going forward. Last fall, the central bank governors and finance ministers from a group of industrial and key emerging market countries, informally dubbed the G-22, formed three working groups, which issued reports on aspects of international financial reform. One report focuses on measures to increase transparency and accountability in the operations of individual countries, of financial and corporate institutions and of the international financial institutions themselves. The purpose

is to enhance the availability, relevance and reliability of information available for evaluating risk in lending. A second working group proposed a series of reforms to strengthen domestic financial institutions: improvements in prudential supervision and regulation are particularly needed in order to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis. A final report sought to identify policies to make the system less crisis prone--for example, through reducing implicit and explicit government guarantees which create moral hazard and exacerbate risktaking. For example, deposit insurance, the implicit promise of bailouts of corporations considered too big to fail, and semi-fixed exchange rate regimes which reduced the perceived riskiness of foreign currency exposure--all increased the exposure of crisis countries and created fragility. Finally, the reports identify policies which could improve creditor coordination in crises and promote the orderly, cooperative and equitable resolution of international financial crises that may occur in the future. The reform agenda will be advanced at the next G-7 summit and in a variety of international fora. **CONCLUSION**

Let me conclude by saying that over the past year the performance of the U.S. economy has been extraordinary: strong growth and low unemployment combined with low and stable inflation. And there are enormous social and economic benefits to our high-employment economy. But that success--and the economy's present strength--cannot be taken for granted. Moreover, there are still long-term changes and challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era. We must preserve our hard-won fiscal discipline while investing in people and opening markets at home and abroad. At the same time, we must ensure that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 2-FEB-1999 15:07:57.00

SUBJECT:

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Larry has agreed to write the op-ed piece with you. David and I discussed an outline over lunch, and I'm working on a draft now. Hope to have something by COB.

Withdrawal/Redaction Marker

Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
001. email	orszagp to Janet L. Yellen at 03:55:46.00. Subject: A few things. (partial) (1 page)	02/02/1999	b(6)

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
CEA ([Yellen])
OA/Box Number: 950000

FOLDER TITLE:

[02/02/1999 - 02/15/1999]

2013-0723-F
ab1294

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

Freedom of Information Act - [5 U.S.C. 552(b)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: orszagp@sbgo.com@INET@LNGTWY (orszagp@sbgo.com@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME: 2-FEB-1999 03:55:46.00

SUBJECT: A few things

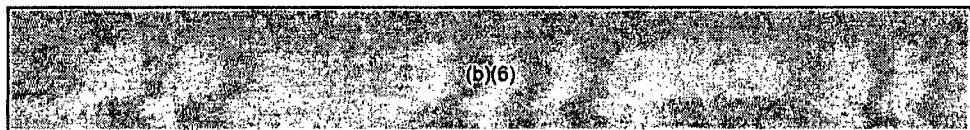
TO: Janet L. Yellen@eop (Janet L. Yellen@eop [CEA])

READ:UNKNOWN

TEXT:

Janet:

1. I hope all is well (or at least bearable) in Washington. I find the uproar over "double counting" quite frustrating and misleading, but perhaps unavoidable given the lack of understanding about how the unified budget system works...



[001]

3. I will be in Washington on February 11 and 12 (I'm testifying before Ways and Means on the 11th on SS), and will try to swing by the CEA if I have a chance.

4. Best of luck in the ERP roll-out.

5. I am attaching two draft papers. I am working with Bob Greenstein to put out a series of "primers" on different Social Security topics. The first paper -- on the "simple" rate of return comparison between the cohort rate of return on SS contributions and the return on equity investments -- falls into this category. (I also have a draft of a primer on the earnings test, but that one needs some serious work.) The second paper comes out of a project on administrative costs in UK personal pensions (individual accounts) I am doing with a woman from the World Bank and my older brother. Our findings there are quite striking -- accounting for accumulation costs, transfer costs (which most people exclude, but which are crucial given that about 40 percent of accounts are transferred within 4 years), and annuitization costs, charges erode the value of an account by almost 50 percent. Previous estimates had neglected one of the three sources of costs -- usually the transfer one. Anyway, I am also attaching a summary paper on those findings. If you or Doug have any comments, I would really appreciate them.

Take good care,
Peter

--

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**Administrative Costs and
Individual Accounts:
Lessons from the U.K. Experience**

February 1999

Mamta Murthi, J. Michael Orszag, and Peter R. Orszag

Administrative Costs and Individual Accounts: Lessons from the U.K. Experience

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Dr. Mamta Murthi¹
Dr. J. Michael Orszag²
Dr. Peter R. Orszag³

INTRODUCTION

Individual accounts are perhaps the most controversial issue in the current debate over Social Security reform in the United States. The administrative costs associated with such accounts are particularly contentious, with proponents claiming that the costs will be relatively low and opponents claiming the opposite.

Any cost projections for individual accounts in the United States are necessarily hypothetical, since we have had no direct experience with such accounts here. Research has therefore focused on costs under related systems, from Chile's individual accounts to the Thrift Savings Plan and private 401(k)'s in the United States.⁴ This paper examines the costs of privately managed individual accounts in the United Kingdom, in the hope that the experience there may inform the debate in the United States. Since Britain is the only G-7 economy to experiment with these accounts, its experience provides a unique laboratory in which to investigate both their opportunities and their drawbacks.

Our conclusion from an examination of the data from the U.K. is that the costs of administering privately managed individual accounts are surprisingly high -- significantly higher than most previous estimates have suggested. Over a typical career and retirement, the current market level of charges in the U.K. would reduce the value of an individual account by nearly half relative to its value with no charges. In other words, almost 50 percent of an account's value is dissipated through fees and charges. This figure is based on actual market data, and reflects a comprehensive treatment of all the costs associated with individual accounts. As discussed below, previous studies have found lower costs for the U.K. because they excluded the costs of transferring funds among different providers, or the cost of annuitizing an account upon retirement, or both.

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⁴ See, for example, Olivia Mitchell, "Administrative Costs in Public and Private Retirement Systems," in M. Feldstein, ed., *Privatizing Social Security* (National Bureau of Economic Research: Chicago, 1998).

The high costs in the U.K. should serve as a warning for the debate in the United States. But it is crucial to recognize that costs depend on the structure of individual accounts, and that a system of individual accounts in the United States could be designed so that costs would be lower than in the United Kingdom:

- The U.K. system involves *privately managed, decentralized* accounts and annuities. The U.K. system of individual accounts is privately managed and highly decentralized. Most analysts agree that such a system is substantially more expensive than a publicly managed, centralized system (such as the Thrift Savings Plan for Federal government employees in the United States).⁵
- The U.K. system of individual accounts and annuities is *voluntary*. In the U.K., individuals can choose whether to participate in the system of individual accounts and annuities. Mandatory accounts and annuities might lead to more economies of scale, reduced adverse selection effects, and less complexity.
- Other institutional differences may affect costs. Any comparison between experiences in two countries -- even ones as similar as the United States and the United Kingdom -- inevitably ignores at least some institutional differences.

It is therefore not straightforward to extrapolate from the voluntary, privately managed individual accounts in the U.K. to a possible system of individual accounts in the United States, especially if that system were mandatory and publicly managed.⁶ Nonetheless, our conclusion is that the U.K. figures vividly warn us that if individual accounts are adopted in the United States, we must pay careful attention to the design of those accounts to ensure that administrative and other costs are not unduly high.

This paper explains these results in more detail. It comprises four sections:

- Background on the U.K. Social Security System, which outlines the structure of U.K. Social Security program and thus provides the context for the rest of the paper.
- A Taxonomy for Evaluating Fees, which presents a framework for evaluating charges both during a working career and during retirement.

⁵ See, for example, Estelle James, Gary Ferrier, James Smalhout, and Dimitri Vittas, "Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in a Social Security System?" presented at NBER Conference on Social Security, December 4, 1998; and National Academy of Social Insurance, "Evaluating Issues in Privatizing Social Security, Report of the Panel on Privatization of Social Security," Washington 1998, available at www.nasi.org.

⁶ For a more extensive discussion of the different methods of organizing individual accounts in the United States, see Advisory Council on Social Security, *1994-1996 Advisory Council on Social Security: Findings and Recommendations*, available at www.ssa.gov; National Academy of Social Insurance, "Evaluating Issues in Privatizing Social Security, Report of the Panel on Privatization of Social Security," Washington 1998, available at www.nasi.org; and Estelle James, Gary Ferrier, James Smalhout, and Dimitri Vittas, "Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in a Social Security System?" presented at NBER Conference on Social Security, December 4, 1998.

- Cost Ratios in the U.K. Social Security System, which applies that framework to data from the U.K. and estimates how much of an individual account's value is dissipated through various costs.
- Summary and Conclusions, which summarizes and discusses the implications of our results.

The paper is intended to be a general summary of the costs associated with individual accounts in the U.K., and is part of an ongoing effort sponsored by the World Bank to examine such costs in more detail. As part of that effort, we have constructed a comprehensive firm-specific database of administrative costs in the U.K. Using this database, we are currently completing a detailed econometric analysis of costs in the U.K. pension and annuities markets. This more detailed work, conducted in collaboration with World Bank officials, is intended to explain more fully the underlying causes of the costs of individual accounts and annuities in the U.K., and thereby further inform the ongoing debate in the United States and elsewhere.

I. BACKGROUND ON THE U.K. SOCIAL SECURITY SYSTEM

The Social Security system in the United Kingdom is complicated. This section therefore provides a brief introduction to the system, as background for our subsequent examination of administrative and other costs associated with its individual account component.⁷

The U.K. Social Security system consists of two tiers: a flat-rate basic state pension, and an earnings-related pension. The first tier is provided through the government, and payments depend on marital status and the number of years an individual worker contributed to the system. The second tier, which can be managed by an individual, his or her employer, or the government, depends on an individual's earnings history. For a majority of workers in Britain, this second tier is *not* managed by the government. Instead, it comprises either employer-based or individual-based private pensions. In this sense, the U.K. Social Security system is at least partially privatized, one of the few such examples in the industrialized world and the only example in the G-7.

Basic State Pension

The first tier of the U.K. Social Security program is called the basic state retirement pension (BSP). The BSP is a pay-as-you-go system. Under the BSP, a portion of the National Insurance Contribution (NIC) payroll tax finances a flat-rate benefit for retirees. In other words, this basic benefit is the same for all qualified retirees, rather than varying with an individual's earnings history.⁸ The benefit payments amount to about \$105 per week per person.⁹ Currently, about

⁷ For more complete descriptions of the U.K. system, see Alan Budd and Nigel Campbell, "The Roles of the Public and Private Sectors in the U.K. Pension System" in M. Feldstein, ed., *Privatizing Social Security* (National Bureau of Economic Research: Cambridge, 1998); David Blake, *Pension Schemes and Pension Funds in the United Kingdom* (Clarendon Press: Oxford, 1995); and David Blake and J. Michael Orszag, "Towards a Universal Funded Second Pension," October 1997 (available at <ftp://www.econ.bbk.ac.uk/pub/review.ps>).

⁸ To be eligible for such payments, men must have paid NIC contributions for 44 years and women for 39 years.

10.6 million pensioners (or virtually the entire population of retirees) receive a basic state pension.¹⁰ Such pensions provide about one-third of total income for retirees.¹¹

The State Earnings-Related Pension Scheme

The second tier of the U.K. system offers three different alternatives to workers. Roughly one-quarter of British workers currently choose the most basic option, the State Earnings-Related Pension Scheme (SERPS). SERPS is similar to the U.S. Social Security system: it is a publicly funded pay-as-you-go system, with benefits based on earnings history and funding provided by the NIC payroll tax.

When it was first introduced in 1978, SERPS was relatively generous. Over time, however, reforms have made the program less attractive, especially to middle- and upper-income workers (many of the reforms, especially in the 1980s, were explicitly designed to encourage movement to either employer- or individual-based pension systems). The maximum SERPS benefit is currently about \$200 per week, and the average benefit is under \$30 per week. The majority of Britons who remain enrolled in SERPS today earn less than \$15,000 annually.

Contracting Out of SERPS

Workers who opt out of SERPS have two other options available to them: an individual-based account or an employer-based account. Those who choose either of these options do not accrue SERPS benefits, and therefore pay lower payroll taxes: Since their subsequent pensions are in effect not financed out of NIC taxes, the government provides a payroll tax rebate to reflect reduced future SERPS payments. In this sense, the system is similar to some of the voluntary opt-out proposals -- including the Moynihan-Kerrey bill -- for individual accounts in the United States. The two opt-out options are:

- **Personal Pension.** Since 1988, one way to achieve contracted-out status is through a personal pension, which is similar to an Individual Retirement Account in the United States. Since these personal pensions are similar to the individual accounts being debated in the United States, we refer to "personal pensions" and "individual accounts" interchangeably. About 25 percent of workers in the U.K. are currently enrolled in personal pensions.
- **Employer-Based Pension.** About half of all workers participate in an employer-sponsored pension plan (often referred to as an "occupational pension"), and are thereby contracted out of SERPS. Occupational pensions can be either defined-benefit (DB) or defined-contributions (DC) plans. Relative to the United States, DB plans are much more common in

⁹ A spouse's pension of about \$65 per week is available for those who wish to claim benefits based on their spouse's contribution record instead of their own.

¹⁰ Roughly 1.4 million pensioners are on income support, since the level of means-tested income support is above that of a full Basic State Pension.

¹¹ This figure will change significantly over time, because occupational pension income of retirees is projected to increase in the future while state pension entitlements are expected to decline. The fraction of income attributed to the Basic State Pension is expected to decline, while income support among pensioners will increase in the absence of reform.

the U.K., especially among larger employers. They amount to about 85 percent of all employer pension arrangements.¹²

To summarize the results for the second (earnings-related) tier in the U.K., roughly one-quarter of workers belong to SERPS, one-quarter opt out of SERPS and into personal pensions, and one-half opt out of SERPS and into employer-based pensions.

Individual accounts in the U.K.

Appendix I provides more detail on the system of individual accounts in the U.K. This section provides a few of the relevant highlights.

- The government's payroll tax rebate finances contributions into individual accounts equivalent to roughly 3 percent of average (mean) annual earnings for workers covered by the U.S. Social Security system.¹³ Roughly half of account holders also contribute an additional amount on top of the government rebate. Thus, the contributions being deposited into individual accounts in the U.K. are at least as large as those being considered for individual account plans in the United States.
- Personal pensions in the U.K. are offered by a variety of firms, but the market is dominated by insurance firms. Although the personal pension market is open to all providers, only insurers can offer certain types of related products.¹⁴
- The U.K. pensions market is very competitive, with numerous personal pension plans. The competitiveness of the market is underscored by the withdrawal of several high-profile firms from the market in the face of keen competition. For example, Fidelity withdrew from the personal pension market in 1993 and transferred its plans to another provider. Citibank also pulled out of the market. Despite these prominent withdrawals, the overall number of providers has not changed much over time.
- Competition in the U.K. pensions market has sometimes been taken to extremes, as evidenced by the "misselling" controversy arising from misleading advice provided about personal pensions by some financial firms (see box). The misleading advice was motivated, at least in part, by a desire to gain additional customers.

¹² In the past few years, Group Personal Pensions (GPPs) have grown rapidly. GPPs are typically arranged for an entire company or industry and thus share some elements of both personal pensions and employer-based pensions. They tend to have lower costs than individual personal pensions.

¹³ In 1996, mean earnings (including earnings above the maximum taxable cap) in the United States were \$24,928. Mean earnings including only taxable payroll were \$21,254. Median earnings were \$15,243 in 1994. See Tables 4.B1 and 4.B3 in Social Security Administration, *Annual Statistical Supplement 1997*.

¹⁴ For example, only insurance firms can offer annuities, waiver premia for disability insurance, and tax-advantaged life insurance policies. Partly in response to the misselling controversy (see box), however, the historical dominance of insurance companies may be slowly changing. Non-traditional providers such as Virgin Direct, supermarkets, and the retail chain Marks & Spencer have recently entered the market. It is also worth noting that foreign providers from Europe, Australia, and Canada and their subsidiaries have a significant presence in the market.

- The pressures induced by strong competition have not resulted in low costs. A number of features of the U.K. system make it expensive for providers. For example, retirees are allowed to purchase annuities from any provider (not necessarily the provider of their personal pension), but the actual annuity payment must be made by the original personal pension provider. The designated annuity provider must thus pay the pension provider before the payment is forwarded to the individual annuitant -- adding to administrative burdens and raising costs.¹⁵ Furthermore, providers are required to undertake tax compliance checks. As part of our larger World Bank research project on the U.K. system, we are examining these detailed administrative requirements, and their associated regulatory compliance costs. For the purposes of this paper, which is intended merely to document the level of costs, it is important to note only that the system is quite complex, as any privately managed system of individual accounts is likely to be. The key point is that a high level of fees and other charges need not imply excess profitability. In the U.K. case, we do not believe that it does.

Annuity markets in the U.K.

The Social Security system in the United States, and the SERPS program in the U.K., automatically provide an inflation-adjusted annuity to beneficiaries. Holders of individual accounts, however, must purchase an annuity if they want to ensure that they don't outlive their savings. And they must purchase a real (inflation-indexed) annuity if they want to ensure that those savings are not eroded by inflation.

The regulations governing when an annuity must be purchased in the U.K. are complicated. When a holder of a personal pension retires, he or she can withdraw up to 25 percent of the accumulated balance from the individual account tax-free. If the account holder retires before the age of 75, the rest of the account can be distributed in one of three ways:

- An annuity purchased from a life insurance company,
- An annuity purchased from the provider of the individual account, or
- An income drawdown facility, under which the retiree withdraws specific amounts of money while most of the balance continues to earn market returns.

At 75, regardless of which option is initially chosen, the balance of the account must be converted into an annuity.¹⁶ Individuals with more than one personal pension plan may annuitize or commence income drawdown at different times.

¹⁵ The situation is yet more complex for specific types of individual accounts. For example, workers can use individual accounts to add additional contributions on top of their employer pensions. In particular, all employers offering occupational schemes are required to provide an in-house account for Additional Voluntary Contributions, as well as a facility for individuals to contribute to a Free Standing Additional Voluntary Contribution scheme.

¹⁶ There are a wide variety of annuity types, including level annuities, which pay the same amount in pounds for the term of the annuity; unit-linked annuities, which pay an amount linked to stock prices for the term of the annuity; index-linked annuities, which pay an amount linked to the retail price index for the term of the annuity; and with-profits annuities, which pay an amount linked to the profits of the provider. Other choices include whether the annuity is single life or joint; minimum guarantee or not; and the frequency of payment (monthly, quarterly, annual, etc.). The annuities market thus presents a wide variety -- perhaps a bewildering variety -- of choices for retirees.

THE MISSELLING CONTROVERSY

In 1988, new regulations allowed investors in private pensions to contract out of SERPS. At the time, few analysts thought that these individual accounts would present regulatory difficulties. After all, the U.K. financial services industry was, by and large, a reasonably safe place to invest and the 1986 Financial Services Act had established a system of self-regulation combined with heavy penalties for conducting investment business without authorization.

As it turned out, the U.K. experienced substantial difficulties with the movement to personal pensions. In what has become known as the "misselling" controversy, high-pressure sales tactics were used to persuade members of good occupational pension schemes (especially older, long-serving members) to switch into unsuitable personal pension schemes. Sales agents had often sought too little information from potential clients to provide proper advice, and their firms did not keep adequate records to defend themselves against subsequent misselling claims.

In December 1993, the Securities and Investments Board announced that it would undertake a general review of the personal pensions schemes of the 560,000 individuals who had transferred £7 billion (roughly \$10 billion) out of occupational pension schemes since 1988. After conducting this review, the Securities and Investment Board concluded that a large fraction had been given inappropriate advice. Miners, teachers, and nurses with relatively generous occupational pensions were among the main targets of sales agents. Many of these people switched from a good occupational scheme into an inappropriate individual account.

As a result, the following steps were taken by the U.K. government:

- Tighter regulation. In 1994, the government imposed stricter rules for providing advice on the transfer of funds from occupational to personal pensions.
- Disclosure. Since January 1995, providers have been required to disclose their fees and commissions.
- Compensation. Investors who had been given bad advice to transfer to a personal pension had to be compensated. Total compensation is projected to amount to £11 billion (\$18 billion) or more. Independent financial advisers (IFAs) have been particularly hard hit by the compensation costs. Unlike insurers, IFAs often lack the financial strength to pay compensation.

Despite these steps, there is some evidence of continuing problems. For example, an undercover investigation by the *Guardian* newspaper in London recently discovered that, "Britain's biggest life assurer, the Prudential, was at the centre of a new controversy last night after a *Guardian* investigation revealed it is continuing to attempt to mis-sell pensions...When approached by *Guardian* investigators, Prudential agents: Attempted to sell policies that maximised earnings for both the salespeople and the company; Recommended poor value pensions; Quoted future growth figures banned by the Financial Services Act; and Showed potential customers deliberately misleading competitor statistics...."¹⁷

¹⁷ The *Guardian*, August 10, 1998

II. A TAXONOMY FOR EVALUATING FEES

This section presents a taxonomy for analyzing costs in a system of individual accounts. We define and decompose the charge ratio. We then use the decomposition to study costs in the U.K. system.

The Charge Ratio

We define the **charge ratio** as a measure of how much of an individual account's value is dissipated due to administrative charges and other costs. In particular:

$$\text{Charge ratio} = 1 - \frac{IA_c}{IA_{nc}}$$

where IA_c is the value of the individual account with charges and other costs, and IA_{nc} is the value of individual accounts without charges and other costs.

The charge ratio is designed to show how much of a pension's value is reduced by charges and other costs. Since the account with charges is lower than the account without charges, the charge ratio varies between zero and one, with higher costs corresponding to higher values of the charge ratio. At one extreme -- no fees of any form -- the charge ratio takes the value zero. At the other extreme, where charges are so high that they consume the entire value of the pension, the charge ratio is equal to one. In practice, we would expect to observe values between the two extremes.

It is important to note that the charge ratio does not necessarily measure the provider's profitability: charges can be high because underlying costs are high, or because profits are high. The competitiveness of the personal pension market, noted above, suggests that the market is not excessively profitable.¹⁸ It is thus likely that the charge ratio in the U.K. primarily reflects underlying costs, rather than excess profits by providers.

It may be helpful to provide some examples of the underlying costs affecting the charge ratio:

- *Customer acquisition.* Acquiring customers through sales and advertising can be very expensive. The costs of training and paying salespeople and advertising are reflected in lower pension entitlements.
- *Fund management charges.* Pension providers pay fund managers to oversee their investments. Usually, fund management charges are not a substantial fraction of total personal pension costs -- especially in the U.K., where fund managers typically earn lower salaries than their counterparts in the U.S. Nonetheless, charges for fund management, especially active fund management, can erode the value of a pension.

¹⁸ It is difficult to measure the profitability of this specific line of business, since providers also offer many other types of financial products.

- *Regulatory and Compliance Costs.* Ensuring that accounts are sold properly can be expensive for both the private sector and regulators. Penalty fees for failing to observe regulatory requirements can also be significant. For example, it is estimated that about \$18 billion in compensation will need to be paid by U.K. insurers and independent advisers to cover missold individual accounts (see above box).
- *Business Maintenance Costs.* Record-keeping and administration of accounts require resources.
- *Adverse selection effects.* In a voluntary account system, individuals who choose to have individual accounts will likely have different characteristics from the rest of the population. As many analysts have noted, this "adverse selection" is particularly important in the annuity market: those choosing to annuitize tend to have longer life expectancies than the population as a whole. Such adverse selection may result in significantly lower annuity rates, even if the insurance companies are not earning profits given the characteristics of those choosing to annuitize. A lower annuity rate will show up in the charge ratio through the annuity ratio (see description below).

Decomposing the Charge Ratio

The charge ratio can be broken down into three components, corresponding to the losses from administrative and other costs during a working life, assuming no fund switching (accumulation ratio); losses from switching funds during one's working life (transfer ratio); and losses upon retirement from converting the account into an annuity (annuity ratio).

1. The **accumulation ratio** (ACR) captures fund management and administrative costs while the worker is contributing funds to an individual account throughout her career. It does not include any costs from switching providers (which are instead captured by the transfer ratio).
2. The **transfer ratio** (TR) measures the costs from switching funds during a working career. It is computed as the ratio of funds received at retirement by an individual switching providers during a working career to the funds that would have been received at retirement by the same individual if she had not switched providers at all. It does not include the ongoing costs of holding an account with a specific provider (which are captured by the accumulation ratio). Most previous analyses have ignored the costs of transferring funds, and thus implicitly assumed a transfer ratio of 1.0.
3. The **annuity ratio** (ANR) reflects the losses from annuitizing an account upon retirement. It measures the ratio of private annuity yields to theoretical yields from population mortality tables, and captures both adverse selection and cost loadings on private annuities.

The charge ratio can be expressed as a function of these three ratios and the percentage of the account that is withdrawn as a lump sum (LS) upon retirement:

$$\text{Charge ratio} = 1 - \frac{IA_c}{IA_{nc}} = 1 - ACR \times TR \times ((1 - LS) ANR + LS)$$

where ACR is the accumulation ratio, TR is the transfer ratio, ANR is the annuity ratio, and LS is the fraction of the accumulated account taken as a lump sum upon retirement. (An appendix provides more mathematical detail on the three component ratios.)

With this framework, we can see that almost half of an individual account's value could be lost through charges. As explained in more detail below, reasonable figures for the U.K. are an accumulation ratio of 0.75, a transfer ratio of 0.80, and an annuity ratio of 0.90. If 25 percent is taken as a lump sum, the charge ratio is:

$$\text{Charge ratio} = 1 - 0.75 \times 0.80 \times (0.75 \times 0.90 + 0.25) = 0.45$$

The total charge ratio is thus 0.45, so that over a worker's career and retirement, 45 percent -- or nearly half -- of an individual account's value is dissipated by charges and other costs.¹⁹

Previous estimates of costs for the U.K. have not included all three components of the charge ratio. They have therefore estimated lower charges. For example, it is often noted that accumulation costs of 100 basis points per year reduce the value of an individual account by 20 or 25 percent over a typical career.²⁰ Such figures, however, do not incorporate the effects of transfer costs and annuitization costs.²¹

Before exploring the U.K. data in more detail, it is worth emphasizing again that the charge ratio is equal to one minus the product of the three component ratios. Therefore, higher costs will be associated with a higher charge ratio, but *lower* accumulation, transfer, and annuity ratios. For example, substantial accumulation costs will generate a *low* accumulation ratio (closer to zero) and therefore a *high* overall charge ratio.

¹⁹ It is important to note that these calculations are direct charge calculations, and as such do not correct for tax offsets provided by the government. For example, part of the reduction in annuity yields from adverse selection may be corrected for an individual by reduced taxation of part of the annuity payments. In addition, 25 percent of the value of individual accounts can be taken as a tax-free lump sum, and individuals are given flexibility over how and when they annuitize, which in itself has an option value. We do not correct for tax offsets because our focus is the costs associated with individual accounts. The government's decision to subsidize some of those costs are a distinct issue.

²⁰ See, for example, the discussion in National Academy of Social Insurance, "Evaluating Issues in Privatizing Social Security, Report of the Panel on Privatization of Social Security," Washington 1998, available at www.nasi.org.

²¹ One counter-example is Peter Diamond's discussion at the New Mexico regional conference held on July 27, 1998. During that conference, he noted: "We talked earlier about the cost in the accumulation process. And I talked about 20 percent decrease in benefits from the cost of accumulating. There's an extra cost in paying the insurance companies over and above what they will pay back for buying annuities. The current best estimates of that cost are an additional 10 to 20 percent on top of the 20 percent cost of the accumulation." The full transcript is available at www.concordcoalition.org.

III. COST RATIOS IN THE U.K. INDIVIDUAL ACCOUNT SYSTEM

This section provides evidence on each of the three cost ratios outlined in the taxonomy above. For each of the three component ratios, we use actual data from 1988 (when personal pensions were introduced) to 1998, whenever available. But our task is complicated by the multiple ways in which costs are imposed on consumers. As one analyst of the U.K. market noted, "Pension plans have a bewildering array of charges, including bid/offer spreads, reduced allocations of premiums, capital units and levies, annual fund charges, policy fees and penalties on transfers, early retirement, and other events."²²

Our approach is designed to provide a comprehensive metric capturing all these various methods of passing along costs to the holders of individual accounts.

Accumulation ratio

The accumulation ratio reflects what most commentators mean by "administrative costs." It measures the ratio of an individual account's value immediately prior to retirement to its value if no charges had been incurred throughout the worker's career. It assumes that the worker does not change providers (i.e., that the worker holds her individual account with the same provider throughout her entire career).

The accumulation ratio measures the losses in the value of an individual account from charges such as annual management fees (as a percent of the account's balance), and fixed charges (pounds or dollars per year). Perhaps the most familiar of these types of fees is the first: An annual fee equal to some percent of the account's balance, often expressed in terms of "basis points." A fee of 100 basis points is equivalent to 1 percent of the account's balance. Given assumptions about the account's balance and the time horizon, other types of fees can be expressed in terms of an annual management fee and vice versa. For example, an initial contribution fee (front-load) of 10 percent is equivalent to an annual management fee of roughly 50 basis points. And for a \$20,000 account, a \$20 fixed annual charge is equivalent to an annual fee of 10 basis points.²³

However they are expressed, the bottom line from fees is that they reduce the value of an individual account relative to its value without such fees. And although expressing the fees in terms of annual basis points may be the most familiar to investors, that form is not necessarily the most insightful. In particular, the accumulated effects of charges over many years may not be immediately obvious. We therefore prefer to express the fees in terms of the accumulation ratio, which provides a useful summary of their effects over an entire career.

²² John Chapman, "Pension plans made easy," *Money Management*, November 1998, page 88.

²³ For further discussion of the relationship among various types of fees, see, for example, Peter Diamond, "Administrative Costs and Equilibrium Charges with Individual Accounts," December 16, 1998 draft. Our calculations do not reflect the incentive and insurance effects of the various types of fees. For example, an annual management fee may provide the most effective incentive for investment funds to earn high returns (since they receive higher earnings when they do better). Similarly, such fees are insurance to the individual against poor performance (since the individual pays a lower total amount in management fees when performance is poor). The issue of optimal incentive fees for investment managers is an important policy issue, but is beyond the scope of this paper.

To compute the impact of fees on the accumulation ratio, it is necessary to make specific assumptions about the account's value over time (e.g., what rate of return it earns, how quickly the contribution level increases, etc.). For this purpose, we employ the Minimum Funding Requirement assumptions published by the Faculty and Institute of Actuaries in the U.K.²⁴ Under this set of assumptions, which are used to establish the minimum funding requirements for pensions, the inflation rate is assumed to be 4 percent per year, the effective nominal rate of return on equities is assumed to be 9 percent per year, and nominal wage growth is assumed to be 6 percent per year.²⁵

Applying the MFR assumptions, and assuming a 40-year working life for a worker who earns £14,000 at the start of his career and contributes 10 percent of his earnings to his pension, the following table shows the effect of the accumulation ratio from various fees:

Impact of fees on accumulation ratio over 40 years

Annual management fees (basis points, as percent of account balance)	Fixed annual charges (pounds per month)	Accumulation ratio
0	0	1.00
20	0	0.95
50	0	0.89
100	0	0.79
150	0	0.71
0	£2	0.99
20	£2	0.94
50	£2	0.88
100	£2	0.78
150	£2	0.70

Note: Applies Minimum Funding Requirement assumptions.

The table underscores a point that several other analysts have made: An annual management fee of 100 basis points can reduce the value of an individual account by slightly more than 20 percent over a typical working life.

Accumulation ratios for individual accounts in the U.K.

Drawing on data from *Money Management* (a financial services publication in the U.K.), *Investments Intelligence* (a data source for Independent Financial Advisers) and other sources, we have constructed a detailed database of the fees charged by personal pensions in the U.K. Using these data, we have computed the accumulation ratios for each year over the past decade.²⁶

²⁴ "Current Factors for Use in MFR Valuation" in Guidance Note 27 of the Faculty and Institute of Actuaries.

²⁵ Unlike the U.S., the U.K. has had relatively steady real wage growth of about 2 percent per year since the early 1970s. The distribution of income has widened in the U.K. (as in the U.S.), but male manual workers in the U.K. still experienced real wage increases of over 1 percent per year on average over the past three decades.

²⁶ The *Money Management* data assume that the pension is held for 25 years, whereas the *Investments Intelligence* data assume a 35-year horizon. We have converted the 25-year and 35-year figures to 40-year equivalents, so that the horizon is consistent with a full working life. The conversion process is facilitated by the fact that the fee

As the table below indicates, the (unweighted) average of the 40-year accumulation ratio is 0.72 over the past decade.²⁷

Management fees and accumulation ratio, unweighted average over providers, 1989-1998

Year	Average annual management fees (basis points)	Accumulation ratio (assuming 40-year career)
1989	149.2	0.71
1990	151.4	0.71
1991	152.6	0.71
1992	155.6	0.70
1993	148.7	0.71
1994	147.1	0.72
1995	137.8	0.73
1996	131.1	0.74
1997	127.9	0.75
1998	124.0	0.75
<i>Average, 1989-1998</i>	<i>142.5</i>	<i>0.72</i>

Source: *Money Management* and authors' calculations. Calculations assume 6 percent nominal wage growth, 9 percent asset returns, and contributions over 40 years.

Conclusion

Our conclusion is that a figure of 0.75 for the accumulation ratio -- slightly above the average level over the past decade, and consistent with the figure for 1998 -- is a conservative estimate from the U.K. experience.

Transfer ratio

The accumulation ratio assumes that a worker holds an individual account with the same provider over her entire career. In reality, however, many individuals switch financial providers, and providers impose extra charges on such transfers. The accumulation ratio therefore does not capture all the costs associated with building up an individual account over a career. Analysts that rely solely on the accumulation ratio implicitly assume that transfer costs are zero, perhaps because they fail to recognize how frequently people switch funds and how costly such transfers are.

structure tends not to change significantly toward the end of the published 25- or 35-year horizon. We are therefore able to combine the fee structure toward the end of the published horizon with a projection of the account balance for the remainder of the 40-year period to arrive at a projection for the fees during that final period. After undertaking such a projection, we calculate the accumulation ratio for the 40-year period and the constant annual fee that would produce the same accumulation ratio.

²⁷ "Unweighted average" means that we have taken the unweighted average over all providers rather than weighting the data by the market shares of the various providers. This technique is potentially biased if fees are systematically related to market share. Alternative estimates suggest that any such bias is minimal (for a variety of data-related reasons, it is easier to take unweighted averages rather than weighted ones). Nonetheless, the simple averaging technique may be responsible for the rise in recent years in the accumulation ratio: That increase is likely due to a larger number of commission-free providers, who do not have substantial market share.

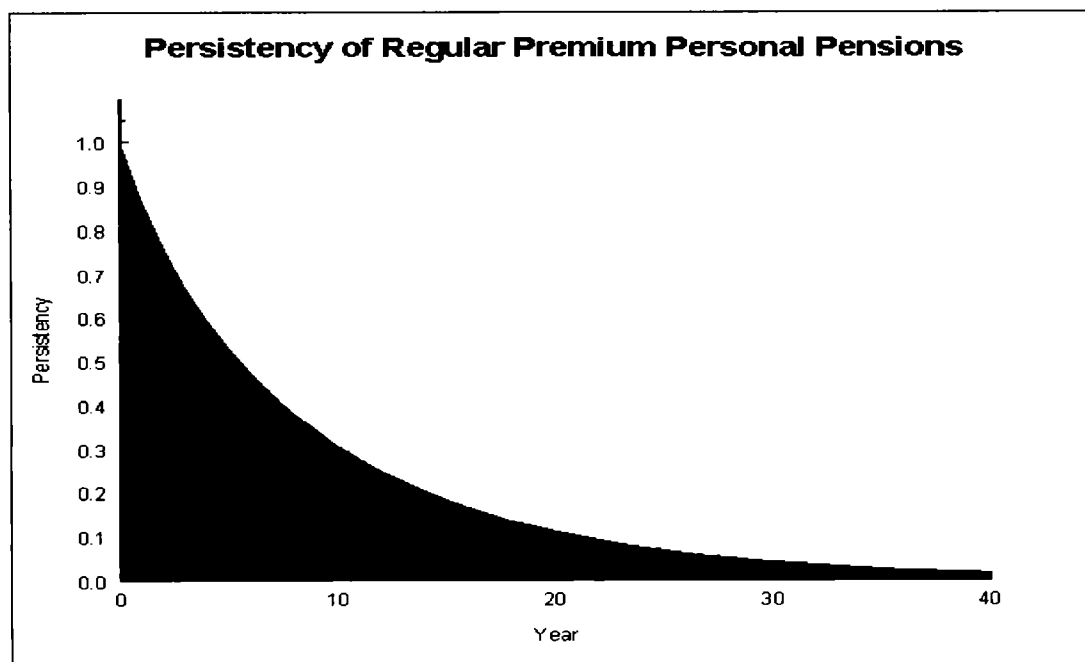
To incorporate the effects of transferring accounts during a working career, we define the concept of the transfer ratio, which measures the dissipation of an individual account's value purely from such transfers. The product of the accumulation ratio and the transfer ratio provides a measure of how much of an individual account's value is absorbed by all charges -- including annual management fees, front loads, fixed annual fees, and transfer charges -- before retirement and annuitization. (The annuitization ratio then measures additional costs from annuitizing the account.)

The importance of transfers is illustrated by data on the duration of accounts held with the same financial provider. As the table below indicates, of all the personal pensions held with financial companies in 1993, 14.5 percent were transferred within one year, 25.4 percent were transferred within two years, 33.8 percent were transferred within three years, and 39.4 percent were transferred within four years. In other words, roughly 40 percent of the individual accounts held in 1993 were transferred within four years -- contravening the assumption implicit in the accumulation ratio that a worker holds an account with a single provider over her entire career.

Percent of personal pension accounts transferred

Beginning year:	Ending year: 1994	1995	1996	1997
1993	14.5	25.4	33.8	39.4
1994	NA	14.9	25.3	33.2
1995	NA	NA	13.4	13.4
1996	NA	NA	NA	12.6

Note: Based on persistency data for regular premium pensions sold by company representatives. Data from the 4th Personal Investment Authority's Persistency Survey.



Although it is difficult to extrapolate from the experience of a subset of the population over a very short time horizon, the dramatic number of transfers over that short horizon highlights their potential importance. We have used the 1993-97 data to project the transfer rates over longer time horizons.²⁸ The figure above shows the results: It illustrates the percentage of accounts remaining with the original provider ("persistence") as a function of the number of years since the account was opened. The projection suggests that roughly half of the accounts will have been transferred within five years, and almost all of the accounts (over 99 percent) will be transferred at some point over a 40-year working life.²⁹

The transfer ratio depends significantly on the timing of a worker's switching decision and on the structure of fees in the new and old accounts. Any given number of switches is less costly (relative to the lifetime balance in the account) if the transfers are done earlier rather than later. The intuition is that the transfer effectively taxes the accumulated balance in an account -- and the accumulated balance is generally lower earlier in a career than later. A worker who decides to transfer providers late in his career could lose a substantial fraction of his retirement income.

FRONTLOADED ANNUAL FEES AND THE TRANSFER RATIO

Most financial providers claim that they impose no additional charges for transferred accounts. In one sense, their claim is true: providers rarely impose an explicit fee for transferring an account to them. But in another sense, the claim is misleading, since providers front-load their annual charges to the disadvantage of those with transferred accounts. Such front-loading imposes an implicit charge on transferred accounts, since such transferred accounts are unable to amortize the front-loaded costs over as many years as continuously held accounts.

For example, assume that funds charge \$50 for the first year of an account, and \$20 for each additional year. Then an account held for 40 years with the same provider will pay an average of \$20.75 per year, but an account held for 20 years with one provider and then 20 years with another provider will pay an average of \$21.50 per year. The accumulation ratio would reflect the \$20.75 charge per year, and would therefore underestimate the charges for the worker who transferred accounts. The difference is captured by our transfer ratio.

The transfer ratio also depends on the types of fees charged by the new and old providers. In the U.K., financial providers impose a wide variety of costs on transferred accounts. Some of the costs are explicit (for example, exit fees when the account is transferred away from a given provider or initial contribution fees at the new provider). Other components of the costs are more subtle, such as front-loaded annual fees (which are distinct from initial contribution fees, or front loads). Front-loaded annual fees impose additional costs on accounts that are transferred relative to ones that are held with a single firm (see box). If, however, the only type of fees in

²⁸ We used a Weibull hazard function to estimate the persistence function.

²⁹ The results for long-duration accounts depend strongly on the form of the hazard function. John Chapman concludes that "only about one in six keep their plans up to maturity." His data are for a 25-year horizon, but suggest a somewhat higher level of persistence over that time horizon that our projection would imply. Over that time period, our projection would suggest that only about 5 percent -- rather than 16 percent -- of accounts would remain with their original provider. However, Chapman does not reveal how he arrived at his figures, which are based on the same underlying data source as ours.

both accounts is a constant annual management fee, the transfer ratio will be 1.0 regardless of how many times a worker switches between such accounts.

Transfer ratios for individual accounts in the U.K.

As with the accumulation ratio, we have computed the transfer ratio assuming a 40-year horizon rather than the 25-year horizon assumed in the published figures from *Money Management*. For this 40-year horizon, the table below indicates the cost of various illustrative switching scenarios (for workers who open an account at age 25 and then switch at the specified ages), and their effect on the transfer ratio over a 40-year horizon. Although transfer ratios for personal pensions have improved significantly over time, the transfer charges remain a significant source of costs.³⁰

Illustrative 40-year transfer ratio for various aged workers, average (unweighted), 1998

Switching Ages (Age at first switch, age at second switch, age at third switch, etc.)	Transfer Ratio
30, 39, 40	0.78
30, 31	0.90
30, 35, 40	0.81
30, 35, 40, 43	0.72
40, 41, 47	0.73
47, 48	0.79

Note: Applies Minimum Funding Requirement assumptions (6 percent nominal wage growth, and 9 percent per year nominal equity returns). Assumes that account is opened at age 25.

We have combined these various transfer costs with our projections for switching behavior to compute a "typical" transfer ratio. In particular, applying the projected persistency figures from above to the 1998 charges for specific types of switches, along with the Minimum Funding Requirement assumptions for nominal wage growth and equity yields, produces a transfer ratio of 0.73.

Conclusion

Given the potential biases in the numbers and the idiosyncratic nature of the transfer ratio, any estimate of its value is likely to be vary significantly from person to person. Our method for projecting the "typical" transfer ratio combines data on the pattern of when accounts are transferred with the cost for each type of transfer. That method produces a transfer ratio of 0.73. But the transfer ratio has been increasing over time, and persistency is somewhat higher for

³⁰ The dramatic nature of transfer costs is perhaps best illustrated by the fact that in 1994, there was one provider which paid *zero* transfer value for the first 59 months of a plan. In other words, the transfer ratio was 0.0 for this provider until the sixth year that the account was held. Presumably, none of the holders of such accounts switched within six years. The average (unweighted) transfer ratios are biased upwards because of an increase in level commission plans in recent years. Such level commission plans, which have a transfer ratio of 1.0 (see discussion above), have lower volume than over providers. Our unweighted average is therefore biased upward. Furthermore, the figures presented do not account for costs associated with individuals starting up and stopping contributions. Our estimate of 0.80 is thus conservative for these additional reasons.

pensions sold through different channels (e.g., Independent Financial Advisors rather than the insurance companies themselves). To be conservative, we therefore adopt a figure of 0.80 for the transfer ratio -- which seems modest given U.K. experience. The transfer ratio may be significantly lower (i.e., transfer costs may be significantly higher) than that for many workers.

Combining our estimates of the accumulation ratio and the transfer ratio suggests a total cost during a typical working life of roughly 40 percent of an account's no-charge value ($1 - 0.75 \times 0.80 = 1 - 0.6 = 0.40$). Our estimates are validated by a study by John Chapman, published in *Money Management*.³¹ He concluded that the annual charge equivalent of accumulation and transfer costs would amount to 250 basis points per year, or about 42 percent over a typical 40-year career. That is slightly higher than our figures, but of the same order of magnitude.

Annuity ratio

A final source of charges and other costs is the purchase of an annuity upon retirement. Retirees who are concerned about outliving their savings have an incentive to purchase an annuity, which provides some sort of payment for every year that the annuitant (or the annuitant's dependent) is alive, in exchange for a lump sum payment up front. It may be worth emphasizing that the costs associated with annuities (the annuity ratio) are distinct from those associated with accumulating the balance to be annuitized (the product of the accumulation and transfer ratios).

For those who have accumulated retirement funds in an individual account, the purchase of an annuity provides insurance against depleting the account before death. Such insurance is costly, however, for two reasons:

- Adverse selection. As noted above, the purchase of an annuity in the U.K. is voluntary before age 75. Those who choose to purchase such an annuity are likely to have longer life expectancies than the general population -- and in a competitive market, such longer life expectancies will be reflected in the annuity price. This adverse selection effect means that if someone with the typical life expectancy wishes to purchase an annuity, she must pay a premium relative to the actuarial fair price. That premium reduces the value of her annuity, relative to a no-charge and actuarially fair level.³²
- Cost loadings. In addition, annuity provision involves administrative costs, mortality risks, and other burdens for providers. The annuity value may therefore also be lower than its no-charge, actuarially fair level because of these costs. On the other hand, annuities also provide

³¹ John Chapman, "Pension plans made easy," *Money Management*, November 1998, page 88.

³² Analyses of adverse selection in annuities markets should not conflate two sources of the effect: adverse selection in the distribution of those who choose to purchase an annuity relative to the population as a whole, and adverse selection within the pool of annuitants in the distribution of annuities purchased. In other words, those with longer-than-average life expectancies may be both more likely to purchase an annuity (one source of adverse selection) than the overall population, and also may likely to purchase a higher valued annuity (another source of adverse selection) than other annuitants with shorter life expectancies. Our data suggest that the former effect explains roughly half of the overall adverse selection in the U.K. annuities market, and the latter effect explains the other half. Delineating carefully the two types of adverse selection is an important element of annuities studies, which could offer significant insight into the underlying causes of the effect. Studies that conflate the two effects are ignoring potentially useful information.

a form of insurance to life insurance companies, since they are negatively correlated with life insurance pay-outs. On net, we believe that the pure cost loading on annuities is relatively small in the U.K. James Poterba and Mark Warshawsky reach similar conclusions for the annuities market in the United States: when they use government bond yield in the calculations, they find that the vast majority of annuity costs is accounted for by adverse selection rather than traditional cost loadings.³³

Annuity ratios in the U.K.

Using data from U.K. annuity providers, we have computed annuity ratios for a wide variety of annuity types and in various years. The annuity ratio computations are very sensitive to mortality and interest rate assumptions. A significant issue with historical analysis of the annuity ratio is therefore whether to use *ex ante* mortality and interest rate figures (i.e., the figures projected at the time the annuity was issued) or *ex post* figures (i.e., what has actually happened). The situation is even more complicated by delays in the public release of annuitant life tables. For example, to compute accurate *ex ante* projections, should we assume that insurers had access to information that was subsequently published in new annuitant life tables? To avoid such problems, we decided to focus primarily on the most recent annuitant life figures. This particular *ex ante* approach has the substantial advantage of relying on very recently published mortality tables; the insurers presumably do not have much additional information.

As with the accumulation and transfer ratios, the annuity ratio varies substantially across providers. To provide an additional level of conservatism to our figures, we decided to use the fifth best rate in the market rather than the average rate. (The unweighted average rate is significantly lower than the fifth best rate.)

Applying the most recent U.K. population life table (English Life Table 15) and the Bank of England's published term structure of interest rates, our data suggest that the male annuity ratio for the fifth best rate on the market is currently roughly 0.85. This figure is of the same order of magnitude as in the United States.³⁴ The theoretical U.K. annuity ratio, accounting for adverse selection but assuming no cost loadings, is approximately 0.90 -- with the 0.05 difference between the market ratio and the theoretical ratio reflecting the cost loadings.

Comparing the theoretical annuity ratio to the fifth best one in the market, it is clear that the principal cost embodied in the annuity ratio is the adverse selection one -- rather than more traditional cost loadings on annuity provision. It is thus important to emphasize that the annuity ratio may be significantly closer to 1.0 if annuitization were mandatory (which could eliminate the adverse selection effect).

The adverse selection effects that produce most of the costs in the annuity ratio do not represent profits to the annuity providers. Given the current pool of annuitants, the annuity prices

³³ James Poterba and Mark Warshawsky, "The Costs of Annuity Retirement Payments from Individual Accounts," NBER Working Paper 6918, January 1999.

³⁴ For example, James Poterba and Mark Warshawsky conclude that the annuity ratio in the United States for a 65-year old male annuity buyer is 0.85. See Poterba and Warshawsky, "The Costs of Annuity Retirement Payments from Individual Accounts," *ibid*.

accurately reflect life expectancies and do not produce significant excess profits. But from the perspective of a typical person wanting to purchase an annuity in the market, the adverse selection costs nonetheless reduce the value of accumulated funds relative to an actuarially fair annuity for that typical person. That is the cost of a voluntary annuities market.

Conclusion

Since the theoretically computed annuity ratio is roughly 0.90, and since the fifth best rate on the market is currently about 0.85, we conclude that a conservative estimate of the annuity ratio is 0.90.

IV. SUMMARY AND CONCLUSIONS

This paper has provided an overview of costs in the U.K. personal pension and annuities markets. Those costs are surprisingly high, reducing the value of an individual account by almost 50 percent relative to its no-cost level. To summarize, our conclusions are that reasonable estimates of the three components of the charge ratio are:

- Accumulation ratio: 0.75
- Transfer ratio: 0.80
- Annuity ratio: 0.90

Even assuming that the maximum (25 percent of the accumulated balance) lump sum withdrawal is made upon retirement, those estimates suggest that the overall charge ratio is:

$$\text{Charge ratio} = 1 - 0.75 \times 0.80 \times (0.75 \times 0.90 + 0.25) = 0.45$$

If no lump sum payment is made, the overall charge ratio is then:

$$\text{Charge ratio} = 1 - 0.75 \times 0.80 \times 0.90 = 0.46$$

In other words, almost half of an account's value is dissipated by charges regardless of the size of the lump sum withdrawal taken at retirement.

Potential criticisms

The figures presented here are clearly subject to several sets of criticisms. Perhaps most importantly, they are partly based on unweighted averages and are dependent on specific assumptions regarding stock returns and nominal wage growth. In the face of such potential criticisms, we would note:

- Whenever possible, we have checked the unweighted averages against their properly weighted analogues. The differences are not significant.
- We have adopted the government's assumptions regarding stock returns and wage growth, which are the standard assumptions used in financial projections.

[Automated Records Management System Hex-Dump Conversion]

- We have "rounded up" in all our figures. In particular, our estimates of all three component ratios are conservative. The average accumulation ratio over the past decade, for example, was 0.72, rather than the 0.75 figure we adopt; our projected transfer ratio was 0.73, rather than the 0.80 figure we use; and the annuity ratio was 0.85, rather than the 0.90 figure we adopt. Using the actual estimated figures rather than the more conservative ones we have applied, the total charge ratio (assuming no lump sum withdrawal) would be 55 percent -- about ten percentage points higher than the figure we present.
- Finally, we have implicitly studied costs for relatively high contribution rates, because we have based our estimates on contribution levels including those *above* the minimum government rebate level, which is itself somewhat larger than most individual accounts proposals in the United States (roughly 3 percent of mean earnings). Assuming some economies of scale, the charge ratio is likely to be higher than our figures suggest for individuals contributing only the government tax rebate to their individual accounts.

Given these precautions, our results may be subject to some criticism but are unlikely to be grossly misleading. The conclusion is clear: The U.K. experience with individual accounts involves high administrative and other costs.

Lessons for the United States

As noted in the introduction, individual accounts can be organized in a variety of ways. For example, some proposals for individual accounts in the United States would aggressively take advantage of potential economies of scale through centralized provision, whereas others would allow individuals more choice through decentralized provision. The U.K. experience debunks the argument that competitive pressures will automatically reduce costs in the latter, decentralized approach.

Whatever the benefits of the services provided by financial firms to their customers, the costs embodied in the voluntary, privately managed U.K. system are high, and it is unlikely that the U.S. would want to adopt the same approach. Indeed, the approach may even be losing favor in Britain: The U.K. government recently released a Green Paper that advocates moving away from personal pensions because of their high costs (see appendix on the Green Paper).

Our larger World Bank project on individual accounts in the U.K. is studying in more detail the causes of administrative and other costs at the level of individual providers, and we hope that this research will further illuminate this crucial issue. In the meanwhile, the debate in the United States should take careful note of the results from the U.K., which suggest that a voluntary, privately managed approach to individual accounts could prove to be surprisingly costly.

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Appendix I: Individual accounts in the U.K.

The 1986 Social Security Act promulgated that as of July 1, 1988, individuals could opt out of SERPS, the state-run Social Security system, and into individual accounts. In exchange for opting out of SERPS, workers are given a rebate on their NIC taxes. Between 1988 and 1993, to encourage movement into individual accounts, the government offered an additional incentive rebate to workers switching into personal pensions from SERPS. Between 1993 and 1997, the incentive rebate was reduced and limited to account holders over the age of 30. The incentive rebate has since been eliminated, and the basic rebate structure has been changed to an age-based system. The table below gives the rebate percentages for various years.

Rebate rate for opting out of SERPS

	Basic rebate (percent of SERPS earnings ³⁵)	Additional "incentive" rebate for contributing to individual account (percent of SERPS earnings)
1987-1988	6.25	2.00 ³⁶
1988-1989	5.80	2.00
1990-1991	5.80	2.00
1991-1992	5.80	2.00
1992-1993	5.80	2.00
1993-1994	4.80	1.00 ³⁷
1994-1995	4.80	1.00
1995-1996	4.80	1.00
1996-1997 and after	3.40 to 9.00, depending on age	1.00 for 1996-1997, zero afterwards

The rebates are deposited into a specific type of individual account, called an Appropriate Personal Pension (APP) account. Two points of worth noting about the rebates:

- In 1995-1996, the median rebate was £450, or roughly \$750. That dollar level corresponds to roughly 3 percent of average (mean) annual earnings for workers covered by the Social Security system in the United States, and 5 percent of median earnings.³⁸ The rebates are thus of the same order of magnitude as imagined under many individual account proposals in the United States: the rebate-financed contributions to individual accounts would represent roughly 3 percent of payroll in the United States.

³⁵ "SERPS" earnings are subject to both an upper earnings limit (as in the United States) and a lower earnings limit. In 1996, the lower earnings limit was roughly \$5,000 and the upper earnings limit was roughly \$40,000.

³⁶ For 1987/88 to 1992/93 inclusive, members of an Appropriate Personal Pension received a 2 percent incentive contribution *unless* they had been in an occupational scheme and left voluntarily after 5 April 1988 while still working for the same employer.

³⁷ The 1 percent incentive contribution was available only for holders of an Appropriate Personal Pension who were aged 30 or over. This incentive contribution was available only through 1996-1997.

³⁸ In 1996, mean earnings (including earnings above the maximum taxable cap) in the United States were \$24,928. Mean earnings including only taxable payroll were \$21,254. Median earnings were \$15,243 in 1994. See Tables 4.B1 and 4.B3 in Social Security Administration, *Annual Statistical Supplement 1997*.

- For some types of individuals, it makes financial sense to forgo SERPS entitlement in exchange for the tax rebate. Not all personal pensions, however, are used to opt out of SERPS. The structure of rebates received from the government is such that it does not make sense for older workers, especially women, to contract out of SERPS and into individual accounts. Similarly, the self-employed are not covered by SERPS, and therefore cannot opt out of it. Such people can still use personal pensions for other purposes, however. In particular, they can use personal pensions to take advantage of tax incentives for pension saving (discussed below). The regulations governing personal pensions depend in part on whether the deposits come from government rebates.³⁹

Types of personal pensions

Number of personal pension plans by type of pension

Year	Unit-linked	With profits	Unit-linked as percentage of total
1990	94	42	69.1 %
1992	91	43	69.4 %
1994	90	37	70.9 %
1996	88	38	69.8 %
1997	86	36	70.5 %
1998	91	41	68.9 %

Source: *Money Management* Personal Pensions Surveys

There are two main types of personal pension plans in the U.K.: unit-linked plans and with-profits plans. Unit-linked plans are similar to U.S. mutual funds, and with-profits plans are similar to U.S. participating insurance policies. In particular, account holders in with-profits plans share in the insurer's profitability, with bonuses based on a share of that profitability.⁴⁰ The majority of personal pensions, however, are conventional unit-linked plans (see table).

³⁹ For example, the "Protected Rights" that accumulate from rebates cannot be withdrawn before the State Retirement Age (currently 65 for males and 60 for females), and are subject to more detailed regulation than funds that come from voluntary member contributions.

⁴⁰ The differences between with-profits and unit-linked policies are not as significant as one would initially think, since unit-linked providers can adjust their fee structure depending on their profitability -- and thus their fees may be implicitly linked to their profitability.

Appendix II: Mathematics of Cost Ratios

This appendix presents examples of formulae for the accumulation, transfer and annuity ratios used in this paper. The specific formulae depend on the context (e.g., joint vs. single annuitization, guarantee period, how management fees are extracted). However, the stylized formulae presented here are broadly applicable.

The *accumulation ratio* is defined as the ratio of accumulated assets at retirement with charges to accumulated assets at retirement without charges. The accumulation ratio therefore depends on the years remaining to retirement as well as rates of return used in the projection and, of course, the charges. The specific formula is:

$$AR(t) = \frac{\sum_{i=1}^t \sum_{j=1}^n \tilde{a}_{ij} \tilde{c}_{ij}^* \prod_{k=1}^{(i-1)n+j-1} \tilde{r}_k}{\sum_{i=1}^t \sum_{j=1}^n a_{ij} c_{ij}^* \prod_{k=1}^{(i-1)n+j-1} r_k}$$

where n is the number of compounding periods per year, t is the number of years to retirement, r is the rate of return, c is the level of contributions and starred values indicate contributions and returns net of fees. Typically, n will be set to 12 when considering monthly contributions. The sums on the top and the bottom of the accumulation ratio are normally computed recursively by adding each month's contribution net of charges if applicable and letting the funds accumulate (again net of charges if appropriate).

The *transfer ratio* is the ratio of contribution amounts with rates of return and contributions adjusted for the costs of transfer from fund to fund as indicated by the tilde superscripts. Examples of where the tilde values differ from the starred values are when there are costs for changing funds (lower c on a net basis) or lower rates of return in initial years in a fund (lower r). The transfer ratio also can be calculated recursively by looking at the impact on the value of the accumulated fund each time the worker changes funds. Such changes will reflect themselves in lower tilde c values (for any transfer costs) and lower tilde r values (for higher management fees in initial years). The transfer ratio is hence dependent on switching times between schemes, as discussed in the main text.

$$TR(t) = \frac{\sum_{i=1}^t \sum_{j=1}^n \tilde{a}_{ij} \tilde{c}_{ij}^* \prod_{k=1}^{i(n-1)+j-1} \tilde{r}_k}{\sum_{i=1}^t \sum_{j=1}^n a_{ij} c_{ij}^* \prod_{k=1}^{i(n-1)+j-1} r_k}$$

The *annuity ratio* captures the ratio of (a) the rate of return on an annuity calculated using insurer life tables and including standard expenses to (b) the rate of return on an annuity calculated using population life tables and assuming zero costs. For simplicity, the formula below illustrates this ratio for an annuity with no insurer expense loadings. The annuity ratio formula also depends on the specific type of annuity; the formula below is for a level-annuity payable monthly in advance

to a single life who experiences mortality q (with the starred variable referring to insurer mortality experience and the unstarred q referring to population experience; the two differ because of selection effects):

$$AN(t) = \frac{\prod_{i=1}^t \prod_{j=1}^n \prod_{k=1}^{i(n-1)+j-1} \frac{1}{1 + \frac{r_k}{n}} \frac{q_k}{n}}{\prod_{i=1}^t \prod_{j=1}^n \prod_{k=1}^{i(n-1)+j-1} \frac{1}{1 + \frac{r_k}{n}} \frac{q_k}{n}}$$

The product of these three terms then produces the ratio of retirement income with the market costs to retirement income assuming zero costs.

Appendix III: Occupational Pension Schemes in the U.K.

In the U.K. debate, occupational pension schemes are held out as a solution to the many problems of high-cost individual accounts. Indeed, the recent U.K. Green Paper (see Appendix IV) focuses on how to reduce costs by mandating employer pension provision. The underlying idea in the Green Paper is that occupational pensions are relatively inexpensive and that the variance among providers is small. To examine this hypothesis, we wrote to 2,000 of the largest occupational pension funds in the U.K. and asked for their annual reports and accounts. We are in the process of coding the many responses we have received, but it is useful to provide some preliminary results.

Five conclusions can be drawn from the existing data:

1. Occupational schemes are surprisingly expensive to run, especially for small employers. In some cases, administrative costs per member exceeded £1,000 pounds per member per year, not including investment management fees. Average costs per member for administration are about £175 per member, which is close to results found in a recent survey by the Government Actuary.
2. Occupational schemes have significant economies of scale because of fixed regulatory costs. The high costs result, at least in part, from regulatory requirements imposing high fixed costs, including a mandated trustee structure and other professional services (such as actuarial valuation). And the high fixed costs engender significant economies of scale in pension schemes.
3. Investment management fees are lower than for personal pensions. The administrative costs discussed above do not include investment management fees. Occupational pension funds pay lower investment management fees than private pensions, primarily because they are in a wholesale market. The average investment management fee for the first 163 schemes in our occupational pension database was 23 basis points.
4. Overall accumulation charges are only slightly lower for occupational schemes than for personal pensions. Overall accumulation fees correspond to a lifetime accumulation cost ratio of about 20 percent (assuming an average entry wage of £14,000), which is only slightly lower than that for personal pensions. The difference is likely to be even smaller for small company schemes, which do not enjoy as much market power as larger schemes.
5. Portability is better with personal pensions than with occupational defined benefit schemes. The transfer ratios from occupational defined benefit schemes are lower than for personal pension schemes. Transfer ratios in occupational schemes are particularly low because of the way in which benefit accrual is backloaded. In addition, U.K. legislation mandates that transfer values be computed with reference to projected final salary corrected for projected inflation instead of projected nominal wage growth. As a result, early leavers lose projected real wage growth as well as higher marginal accrual rates in the future when they leave their employer's pension scheme. Transfer ratios of young individuals from occupational pension schemes are much worse than those provided by personal pensions.

Appendix IV: The December 1998 U.K. Green Paper

In December 1998, the U.K. government released a Green Paper on pension reform. The Green Paper acknowledges serious problems with the existing pension system:

“The pension mis-selling scandal and the Maxwell affair have knocked confidence hard. Many people are put off by the complexity of pensions, and many others by the difficulty of finding affordable and reliable independent financial advice.” --U.K. Green Paper, December 1998

To address these problems, the paper proposes a series of changes to both the structure and regulation of the pension system. The U.K. government is seeking public comments on the proposed reforms by March 31, 1999, after which it will likely introduce legislation. The principal features of the proposals are:

State Second Pension. A new State Second Pension would replace the existing State Earnings Related Pension Scheme (SERPS). The government report criticizes SERPS for failing to provide sufficient benefits to lower-income workers, the disabled, and those providing care to family members. The new State Second Pension is designed to provide an adequate pension to these types of people.

Relative to SERPS, the State Second Pension would provide a significantly larger pension benefit to those earning less than \$15,000 per year. It would also provide credits for the long-term disabled and for those on family leave, effectively treating such people as if they were working. As with the current SERPS, workers could opt out of the State Second Pension if they were covered by an approved private pension. The structure of the State Second Pension -- under which benefits would be independent of earnings, but the rebate for opting out would be related to earnings -- would provide differentiated incentives to opt out. In particular, it would *reduce* the incentive for lower-income workers to leave the state system, and *increase* the incentive for middle- and upper-income workers to opt out. The Green Paper also provides a new type of private pension for those opting out, the so-called stakeholder pension.

Stakeholder Pension. The government is proposing a new type of private pension, which could largely replace the personal pensions that have been the focus of the misselling scandal. This “stakeholder pension” would be subject to minimum standards for cost, access, and terms. The minimum standards would include a simple fee structure, based on a percentage of the account’s value rather than a flat amount; a limit on the level of fees, although the precise level has not yet been determined; no penalties for stopping or restarting contributions; disclosure requirements; and corporate governance restrictions.

To reduce the cost of contacting and recruiting potential contributors, the system would require employers to serve as the conduit to the pension schemes. In particular, employers would be required to identify a stakeholder pension scheme, to provide information to workers about it, and to provide the scheme with access to workers to promote contributions. Employers will also be required to deduct pension contributions directly from payroll and submit them to the nominated pension scheme. Initially, firms would only be required to transmit funds to a single

nominated scheme, and “employees choosing to join other schemes would need to make their own arrangements, although it would be open to employers to provide this facility if they wished.” Eventually, however, the government hopes that funds could be transmitted to any stakeholder pension. It therefore intends to consult with industry about a clearinghouse, which would collect payments from participating firms and submit them to the appropriate stakeholder pension. At this point, the precise operations of any such clearinghouse remain unclear.

Employers that already provide an occupational scheme to employees would not face these requirements. The Green Paper did not provide an estimate of the costs to employers of facilitating access to the stakeholder pensions, nor of the degree to which marketing and sales costs would be reduced by funneling scheme choices through employers.

PRELIMINARY DRAFT
(1/17/99)

**INDIVIDUAL ACCOUNTS
AND SOCIAL SECURITY:
WHY A SIMPLE RATE OF RETURN
COMPARISON IS MISLEADING**

Peter R. Orszag

January 1999

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RATES OF RETURN ON INDIVIDUAL ACCOUNTS AND SOCIAL SECURITY: WHY A SIMPLE RATE OF RETURN COMPARISON IS MISLEADING

Peter R. Orszag¹
January 1999

Introduction

Proponents of individual accounts often compare the potential rate of return on such accounts to the rate of return on Social Security contributions. They conclude that workers would enjoy a substantially higher rate of return under a system of individual accounts. Even experienced financial analysts make such arguments:

- The *Financial Times* has written that the "rate of return [on individual accounts] would be higher -- perhaps 6 to 8 per cent on past stock market performance, against the roughly 2 per cent the social security system will produce."²
- The financial commentator James Glassman has noted, "Returns to the investment portion of Social Security are extremely low. For persons born in 1960, returns are estimated at between 1 percent and 2 percent in real (inflation-adjusted) terms...By contrast with Social Security, the real returns to large-capitalization stocks between 1926 and 1997 have averaged 7.2 percent."³

Despite its apparent plausibility, and its use by many prominent analysts of Social Security reform, the simple rate of return comparison is misleading. As the economists John Geanakoplos, Olivia Mitchell, and Stephen Zeldes have shown, the comparison is

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² Nicholas Timmins, "The biggest question in town: America faces critical choices over the future of its most popular spending programme," *Financial Times*, March 20, 1998, page 23.

³ James Glassman, "Can Americans Handle Their Own Retirement Investing Choices?" Testimony before the Committee on Commerce, U.S. House of Representatives, July 24, 1998, page 1.

flawed because the two rates of return are not truly comparable.⁴ In fact, analytically accurate comparisons would, under reasonable assumptions, eliminate the differential rate of return between individual accounts and Social Security contributions.⁵

Individual accounts have many costs and benefits, a full examination of which is beyond the scope of this paper. But as the paper will demonstrate, arguments in favor of individual accounts on the basis of their ostensibly higher rates of return -- often cited as their most important benefit -- confuse rather than inform the debate. The purpose of the paper is thus relatively narrow. It is intended to evaluate the analytical justification (or lack thereof) for one specific claim made about individual accounts, not to evaluate their overall costs and benefits.

This paper is organized into seven sections in addition to this introduction:

- Sections I and II present examples illustrating the flaws in the simple rate of return comparison.
- Section III and IV examine rates of return on Social Security contributions and the Social Security Trust Fund, which provides important background for evaluating the simple rate of return comparison in more depth.
- The subsequent sections (Sections V, VI, and VII) explore the problems with the simple rate of return comparison in more detail.

I. An example: Rates of return under the Gramlich commission proposals

As an example of how the rate of return differential is more apparent than real, consider the report of the 1994-1996 Advisory Council on Social Security, chaired by Edward Gramlich (then an economics professor at the University of Michigan, and now serving on the Federal Reserve Board of Governors). The Advisory Council, often referred to unofficially as the Gramlich commission, was unable to reach a unanimous position on the role of individual accounts in Social Security reform. Instead, it split into three factions, each with a significantly different view regarding individual accounts.⁶

⁴ John Geanakoplos, Olivia Mitchell, and Stephen Zeldes, "Social Security's Money's Worth," Pension Research Council Working Paper 98-9, August 1998.

⁵ The "rate of return" can be measured in many different ways. In this paper, we define it as the real (inflation-adjusted) internal rate of return. If inflation-adjusted contributions are thought of as deposits into a bank account, and inflation-adjusted benefits are thought of as withdrawals from that account, the internal rate of return is the interest rate on the deposits that produces a zero final balance in the account. For a discussion of other measures of the returns to Social Security, see Dean Leimer, "A Guide to Social Security's Money Worth Issues," *Social Security Bulletin* (Summer 1995), pages 3-20.

⁶ The Advisory Council report is available on-line at <http://www.ssa.gov/policy/adccouncil>.

- The Maintain Benefit proposal did not include individual accounts. Instead, it considered investing a portion of the Social Security Trust Fund in the stock market. The Maintain Benefit plan's most prominent supporter was Robert Ball, a former Commissioner of Social Security.
- The Individual Account proposal included individual accounts financed by contributions equal to 1.6 percent of payroll, in addition to the current payroll taxes devoted to Social Security. The accounts would be managed by the government to reduce administrative costs. The Individual Account plan's leading supporter was Edward Gramlich, the chairman of the commission.
- The Personal Security Account proposal included individual accounts financed by diverting 5 percent of payroll from the current Social Security tax to the accounts. In other words, the current 12.4 percent payroll tax would effectively be reduced to 7.4 percent, and the 5 percent of payroll difference would be deposited into individual accounts. The accounts would be managed by the private sector to minimize government interference in the capital markets. The Personal Security Account plan was supported by Carolyn Weaver of the American Enterprise Institute, and Sylvester Schieber of Watson Wyatt Worldwide, among others.

The three plans thus adopted substantially different approaches to individual accounts: the Maintain Benefits plan had none, the Individual Accounts plan had relatively modest accounts that were financed by additional contributions on top of the existing funding for the traditional Social Security program, and the Personal Security Account plan had larger individual accounts that were financed out of the existing Social Security payroll tax. The simple rate of return comparison would therefore suggest that these plans should produce significantly different rates of return.⁷

Despite the dramatically different sizes of the individual accounts in the three Gramlich commission proposals, however, their estimated rates of return were very similar. For example, consider an average two-earner couple born in 1997. According to projections conducted by the Social Security actuaries and published in the Gramlich commission report, the real rate of return for such a couple would be:

- Between 2.2 and 2.7 percent per year under the Maintain Benefits plan, depending on the share of the Trust Fund invested in equities;
- 2.2 percent per year under the Individual Accounts plan; and

⁷ The three proposals varied along other dimensions in addition to their approaches to individual accounts. But the logic of the simple comparison would suggest that any such differences would be dominated by the dramatically different approaches to individual accounts -- at least with regard to their impact on the rate of return.

- 2.6 percent per year under the Personal Security Account plan.⁸

The results for other birth years and other types of beneficiaries are broadly similar: the differences in returns are minimal. Those minimal differences, furthermore, are mostly explained by the differential risk embodied in the three approaches.

To those who advocate the simple return comparison, these results must come as a shock. Yet the approximate equality of returns across plans with substantially different approaches to individual accounts -- especially when the returns are evaluated on a risk-adjusted basis -- is precisely what one *should* expect when the analysis is undertaken in a rigorous manner.⁹

II. A simplified example of why the simple rate of return comparison is misleading

The similarity of returns under the three Gramlich commission plans underscores that the simple rate of return comparison is misleading. But it does not explain *why* the comparison is misleading. This section provides a simplified example that may help us understand the apparently puzzling results from the Gramlich commission report -- and therefore the problems with the simple rate of return comparison.

Imagine a simple pay-as-you-go system, under which one generation pays \$1 while it is young and receives \$1 while old. Generation A is old in period 1, and therefore receives \$1. That \$1 is paid for by Generation B, which is young in period 1. Then in period 2, Generation B is old and receives \$1 -- paid for by Generation C, which is young in period 2, and so on. The table below presents the operation of the system.

The simplified pay-as-you-go system

	Generation			
Period	A	B	C	D
1	+\$1	-\$1		
2		+\$1	-\$1	
3			+\$1	-\$1

⁸ The figures for the Individual Account and Personal Security Account plans assume that workers invest their individual accounts in equities in the same proportion as 401(k) portfolios are held. In particular, workers under age 40 are assumed to hold 55 percent of their account in equities; workers aged 40 to 49 are assumed to hold 50 percent in equities; workers 50-59 are assumed to hold 40 percent in equities; and workers aged 60 and older are assumed to hold 20 percent in equities. Office of Actuary, Social Security Administration, October 9, 1996, as printed in *Report of the 1994-1996 Advisory Council on Social Security*, Appendix II, Table IRR.

⁹ Most economists believe that the internal rate of return calculation should include the value of all contributions (including the employer-provided portion of payroll taxes, and any transition taxes that must be paid because of diverting funding away from the pay-as-you-go system) as well as all benefits (including spousal and survivor benefits). The Gramlich commission figures do so. They do not, however, adjust for risk.

4				+\$1
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Assume further that the interest rate is 10 percent per period. Now consider the system from the perspective of Generation C during period 2:

- Under the pay-as-you-go system, Generation C pays \$1 during period 2, and receives \$1 back during period 3. The pay-as-you-go system's rate of return is thus zero.
- Under an individual account system, Generation C would invest the \$1 contribution, and receive \$1.10 in period 3. The rate of return would appear to be 10 percent.

The analysts quoted in the introduction would therefore suggest that a switch from the pay-as-you-go system to individual accounts would produce substantially higher returns for Generation C: 10 percent rather than 0 percent. But would it?

If Generation C put \$1 into individual accounts during period 2, that \$1 could not be used to finance the benefits for Generation B. Unless society is willing to allow Generation B to go without benefits, those benefits must be paid for somehow.

Assume the benefits are financed through borrowing, and that the interest costs are paid for by the older generation in each period. With an interest rate of 10 percent, the interest payments would cost 10 cents per period. The net benefit to Generation C during period 3, therefore, would be \$1 ($\$1.10 - \$0.10 = \$1$). Thus Generation C would earn a zero rate of return -- just as under the pay-as-you-go system -- once the interest costs are included (it would pay \$1, and receive a net benefit of \$1). Indeed, for Generation C and each generation thereafter, the extra return from the individual account is more apparent than real: it is exactly offset by the cost of the debt that financed Generation B's benefits.

Other assumptions about financing the benefits do not alter that basic conclusion. For example, if the benefits for Generation B were financed through an additional tax on Generation C rather than through borrowing, then Generation D and all subsequent generations would enjoy a 10 percent rate of return. But Generation C would earn a *negative* rate of return: it would pay \$2 to earn \$1.10, rather than \$1 to earn \$1.

Similarly, if benefits were financed by borrowing but the interest costs were paid for by the younger generation rather than the older generation in each period, Generation C would enjoy a 10 percent rate of return. But Generation D and all subsequent generations would receive a zero rate of return (they would pay \$1.10 while young, and receive \$1.10 when old).¹⁰

The method of financing the benefits to Generation B does not affect the fundamental point that other generations must pay for them. How that burden is shared across

¹⁰ The \$1.10 payment when young would comprise \$1 in deposits into the individual accounts, and \$0.10 in interest costs on the bonds. The \$1 in deposits, at a 10 percent interest rate, would produce \$1.10 when old.

generations is a crucial issue in Social Security reform, especially one that involves individual accounts. Unfortunately, it is often obscured by the simple rate of return comparison.

Individual accounts financed from the unified budget surplus

The simplified example can also be used to examine using the unified budget surplus to create individual accounts. Assume that starting in period 2, the government runs a unified budget surplus of \$0.50 and uses that surplus to fund individual accounts in each period thereafter. The pay-as-you-go system is left untouched.

The total benefits accruing to Generation C in period 3, and every subsequent generation, will then be \$1.55: \$1 from the pay-as-you-go system, and \$0.55 from the individual account (the \$0.50 deposit in the individual account earns a 10 percent rate of return, and thus produces \$0.55 the next period). Even when the contribution from the surplus into the individual account is counted as a cost -- as it should be, given the opportunity costs of using the surplus for other purposes -- the rate of return increases from zero to 3.3 percent ($\$1.55/\$1.50 - 1 = 1.033 - 1 = .033$).

It is important to note, however, that the 3.3 percent return could also be achieved by investing the \$0.50 from the surplus each period into a trust fund for the pay-as-you-go system. In particular, assume that the government uses \$0.50 of the surplus each period to partially fund the pay-as-you-go system, starting in period 2.¹¹ In period 2, the \$0.50 is put into a trust fund that earns 10 percent. Then by period 3, the trust fund will grow to \$0.55. The \$0.55 would allow the system to give \$0.55 in extra benefits to Generation C. Meanwhile, the trust fund would receive an additional \$0.50 from the budget in period 3, allowing \$0.55 more in benefits during period 4, and so on.

The rate of return under such a partially funded system would be 3.3 percent ($\$1.55/\$1.50 = 1.033$) -- the same rate of return as achieved with individual accounts financed by the surplus. The conclusion is that it is the additional contributions from the surplus -- the partial funding of the retirement system -- that raises the rate of return, not the individual accounts per se. In this case, the simple rate of return comparison is misleading because the rate of return on *additional* contributions is higher than the rate of return on existing contributions, regardless of whether the additional funding is invested in individual accounts or the traditional system (through a trust fund).¹²

¹¹ Partial funding means that the \$0.50 is *not* used to finance additional benefits for Generation B (which remain \$1), but is instead saved to provide future benefits to Generation C.

¹² In this simplified example, we have assumed only one "interest rate," which we assumed was both the government bond yield and the rate of return on an individual account. In the real world, of course, there are many types of financial assets (e.g., equities and bonds), which carry different interest rates or rates of return. As discussed below, much -- if not all -- of such differences in rates of return result from differences in the riskiness of the assets. The simplified example thus implicitly uses a *risk-adjusted* interest rate, which adjusts for differences in rates of return that result solely from differences in risk. Similarly, we assumed that the administrative costs of the individual accounts and of the Trust Fund were both zero. In reality, the administrative costs of individual accounts, especially if they are privately managed, are likely to be higher than the administrative costs of the Trust Fund. These issues are examined in more detail below.

Summary of lessons from the simplified example

As noted, the examples above abstract from reality in many ways. Nonetheless, it provides lessons for rate of return comparisons in the real world:

- If individual accounts are financed from revenue currently devoted to Social Security, then the analysis should include the subtle -- but nonetheless real -- cost of paying for promised Social Security benefits. The vast majority of current Social Security revenue is dedicated to paying current benefits. Redirecting revenue away from Social Security does not obviate those costs.

Simple rate of return comparisons exclude the costs of paying the benefits of current beneficiaries from the returns on individual accounts, even though those costs are implicitly embedded in the rate of return on Social Security. The comparison is thus biased, in the same way that a comparison between the apparent 10 percent return on individual accounts and the zero percent return on the pay-as-you go system in the simplified example was biased. Analytically, since the payments to current beneficiaries are not avoided by setting up individual accounts, the returns on individual accounts should not be artificially inflated by excluding their cost.

- If the individual accounts are financed from the unified budget surplus (or from additional payroll contributions), an analysis should compare the return on individual accounts to the return on *additional* funding for the Social Security system -- not existing returns under Social Security. Moreover, if additional funds were invested by the Social Security system in the same manner as they would be under individual accounts, the marginal rate of return would be the same under either approach -- and would be higher than the rate of return on existing Social Security contributions.¹³
- Analytically correct comparisons should also reflect risk, administrative costs, and other issues.

As the two examples above have illustrated, the simple relative rate of return argument is biased. It either ignores the cost of benefits promised under the current system, or inappropriately compares the rate of return on additional funding to the rate of return on current contributions.

The rest of this paper explores these issues in more detail. We first examine the rate of return on Social Security contributions (Section III) and the Social Security Trust Fund (Section IV), and then further examine the simple rate of return comparison in different contexts (Sections V-VII).

¹³ As discussed below, the rules governing the Social Security Trust Fund currently would not allow it to mimic the portfolio likely to be held in individual accounts. Admittedly, that artificial constraint reduces the apparent return on additional financing for Social Security relative to individual accounts. But it is not clear that the constraint should remain, and it is also not clear that any differential that results from it would remain if rates of return were risk-adjusted.

III. Rates of return under Social Security

To understand the rate of return comparison, it is important to understand the rate of return on Social Security contributions. The current Social Security program is primarily a mature pay-as-you-go system. "Mature" means that new beneficiaries were covered by the system throughout their working lives. "Pay-as-you-go" means that benefits are paid out of contributions from current workers, with each generation paying for the previous generation's benefits, and then receiving benefits paid for by the next generation (as in the simplified example in the box above). Since almost 90 percent of Social Security revenue is devoted to paying current benefits, the Social Security system is primarily a pay-as-you-go system.¹⁴

As Paul Samuelson showed 40 years ago, the real rate of return in a mature pay-as-you-go system is equal to the sum of the labor force growth rate and the productivity growth rate (see appendix).¹⁵ Labor force growth is expected to slow from roughly 1 percent per year to 0.1 percent per year over the next 75 years, and the economy's underlying productivity growth rate is estimated to be roughly 1 percent per year. As a result, the inflation-adjusted rate of return on Social Security contributions for current and future cohorts of workers is somewhere between 1 and 2 percent in real terms.¹⁶

The Samuelson formula assumes that benefit payments each year are equal to contributions. The projections for the Social Security system, on the other hand, suggest that projected revenue will fall below projected benefits as the baby boomers retire. But it is worth emphasizing that the 1 to 2 percent real rate of return on Social Security contributions is only slightly affected by the projected 75-year actuarial imbalance in the system. For example, in addition to the rates of return on the three proposed reform plans, the Gramlich commission projections include alternative rates of return that provide insight into the impact of the actuarial imbalance. One rate of return ignores the actuarial imbalance and simply assumes that current law benefits are paid despite the lack of sufficient revenue, while another rate of return assumes that tax rates are ultimately increased to ensure that revenue matches benefits in each year.

For a single male with average earnings born in 1985, the rate of return if current law benefits are paid is 1.6 percent per year, whereas the rate of return if taxes are raised to

¹⁴ According to the intermediate projection of the Social Security actuaries, the system will receive \$449.9 billion in non-interest revenue in 1999, and pay \$396.3 billion in benefits. Thus, 88 percent of current revenue is expected to be devoted to paying benefits. See *1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds* (GPO: Washington, 1998), Table III.B3.

¹⁵ Paul Samuelson, "An Exact Consumption-Loan Model of Interest with or without the Social Contrivance of Money," *Journal of Political Economy*, December 1958, pages 219-234.

¹⁶ These computations ignore the role of the Social Security Trust Fund, an added complication that is discussed below.

match future revenue is 1.1 percent per year. Similarly, for an average two-earner couple born in 1985, the former return is 2.2 percent per year and the latter is 1.7 percent per year.¹⁷ The differences are noticeable, but not dramatic. The 75-year actuarial imbalance thus has implications for the rate of return, but not as much as some may have suspected. The reason is that the primary determinant of the rate of return on Social Security at this point is the sum of productivity and labor force growth (the Samuelson formula). The projected actuarial imbalance does not substantially alter that result, because the imbalance -- although it is large in absolute dollar terms -- is small relative to the contribution rate (2.2 percent of payroll, relative to a total payroll contribution rate of 12.4 percent).¹⁸

Returns for early beneficiaries under a pay-as-you-go system

The section above focused on the Samuelson return to a pay-as-you-go system. But in the early years of such a system, beneficiaries receive a substantially higher rate of return than the Samuelson formula would suggest. For example, consider Generation A from the box above. That first generation in the pay-as-you-go system enjoyed \$1 in benefits, but had not contributed anything to the system. Their rate of return was thus infinite.

Similarly, early beneficiaries under the Social Security system enjoyed extremely high rates of return because they received benefits disproportionate to their contributions. Indeed, the earliest beneficiaries under Social Security -- those born in the 1870s -- enjoyed rates of return approaching 40 percent.

Rate of return for selected birth cohorts under Old Age Survivors Insurance program

Birth cohort	Inflation-adjusted annual internal rate of return
1876	36.5
1900	11.9
1925	4.8
1950	2.2

Source: Dean Leimer, "A Guide to Social Security Money's Worth Issues," *Social Security Bulletin*, Summer 1995, Table 3.

It is important to note that the decline in rates of return from the earliest cohort of beneficiaries is not principally the result of demographics. Rather, it is a feature of any pay-as-you-go system, under which early beneficiaries receive excessively high rates of return -- a situation that is not sustainable. The rate of return for subsequent beneficiaries necessarily declines. As the system matures, that seminal decline in rates of return could be attenuated or exacerbated by changes in productivity and labor force growth rates.

¹⁷ Office of Actuary, Social Security Administration, October 9, 1996, as printed in *Report of the 1994-1996 Advisory Council on Social Security*, Appendix II, Table IRR.

¹⁸ The rest of this paper does not discuss the actuarial imbalance, which in any case is not critical to the rate of return on Social Security.

IV. The Social Security Trust Fund

The above discussion did not take account of the fact that Social Security is not purely a pay-as-you-go system: the Social Security Trust Fund is expected to amount to over \$850 billion by the end of this year.¹⁹ The Trust Fund, whatever its other macroeconomic and budgetary effects, represents a legal commitment to pay future benefits. The presence of the Trust Fund as a commitment to pay future benefits is important because it can change the rate of return.

The presence of the Trust Fund implies that the Social Security system is not purely a pay-as-you-go system. Not surprisingly, therefore, its rate of return diverges from the pure pay-as-you-go one identified by Samuelson.

In our simplified example above, for example, the presence of a trust fund raised the rate of return to 3.3 percent relative to the zero rate of return under the pure pay-as-you-go system. In fact, with a trust fund, the overall rate of return is equal to the weighted average of the Samuelson return and the rate of return on the Trust Fund, with the weights reflecting the degree to which the system is a pure pay-as-you-go one. In our example above, the trust fund represented one-third of the total contribution (\$0.50 out of \$1.5 in total contributions). The overall rate of return was therefore equal to $0.33 \times (\text{return on trust fund}) + 0.67 \times (\text{return on pay-as-you-go system}) = 0.33 \times (10\%) + 0.67 \times (0\%) = 3.3$ percent.

Note that the smaller the relative size of the trust fund, the more the overall rate of return approaches the Samuelson one. For example, if the trust fund included only \$0.25 rather than \$0.50, the overall rate of return would be 2 percent rather than 3.3 percent. If the trust fund were \$0.10, the overall return would be 0.9 percent. As the trust fund becomes a smaller share of the total program, the overall return converges to the Samuelson return (zero in the simplified example above). Similarly, the larger the size of the trust fund relative to the overall program, the closer the overall rate of return becomes to the rate of the return on the trust fund. For example, assume the trust fund were \$1. Then the overall return would be 5 percent. For a trust fund of \$2, the overall return would be 6.7 percent, and so on. As the trust fund becomes larger relative to the total program, the overall return approaches the rate of return on the trust fund (10 percent in our simplified example).

The assets held by the Social Security Trust Fund

Under the Social Security Act, the Social Security Trust Fund must hold assets guaranteed as to principal and interest by the United States Government. The vast

¹⁹ 1998 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and the Federal Disability Insurance Trust Funds (GPO: Washington, 1998), Table III.B3. The \$850 billion figure includes both the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund.

majority of the Trust Fund's assets are special-purpose Treasury securities, which are non-tradeable and always redeemable at their par value.²⁰

Some proposals, including the one put forward by Henry Aaron and Robert Reischauer of the Brookings Institution, would allow the Trust Fund to invest in private-sector securities. To attenuate concerns regarding government ownership of private-sector firms, such proposals usually create an independent investment board that would oversee the portfolio, along with other precautions against political interference.²¹ Canada has recently changed the regulations governing its Social Security system to allow it to invest in private securities.²²

Allowing the Social Security Trust Fund to invest in private securities would raise the measured rate of return on Social Security contributions. For example, between 1959 and 1996, the special-purpose Treasury securities held by the Trust Fund earned 3.84 percent per year less than a broad market index of equities. Allowing the Trust Fund to invest in private securities would also affect the degree of risk embodied in the Trust Fund assets. On a risk-adjusted basis, it is not clear that the rate of return would increase -- an issue discussed in more detail below.²³

V. The Simple Rate of Return Comparison and "Carve-Out" Individual Accounts

The discussion of the rate of return under Social Security is important background for this section, which explores the simple rate of return comparison when individual accounts are financed out of revenue that would otherwise flow into the Social Security program. Such accounts are often referred to as "carve-out" individual accounts, since they finance contributions by carving out part of current Social Security payroll revenue.

As Geanakoplos, Mitchell, and Zeldes show, one important perspective on the rate of return to current and future Social Security contributions is obtained by realizing that a pay-as-you-go system cannot create excess returns -- returns above the inflation-adjusted interest rate -- in the aggregate. The fact that the system does not and cannot generate excess returns in the aggregate leads to an important conclusion: If some cohort of

²⁰ The special purpose Treasury securities issued on a specific date carry a yield equal to the average market yield on that date for all marketable Treasury bonds with an outstanding maturity of 4 years or more.

²¹ Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform* (Century Foundation Press: New York, 1998).

²² For a discussion of the Canadian program, see David Slater, "Prudence and Performance: Managing the CPP Investment Board," C.D. Howe Institute Commentary, Toronto.

²³ If a risk-adjusted gain exists, allowing the Trust Fund to invest in private-sector securities is critical for the results of the simplified example above to hold. In such a case, by definition, diversification into equities raises the *risk-adjusted* rate of return (see discussion in Section VII below). If such diversification were only available under individual accounts, not under the Trust Fund, the rate of return comparison would suggest a gain to individual accounts -- but only because the Trust Fund was artificially restricted from capturing the risk-adjusted benefit to investing in stocks.

beneficiaries enjoys a rate of return higher than the inflation-adjusted interest rate, all other cohorts must earn a rate of return lower than that interest rate.²⁴ Thus, if early generations received excess rates of return -- as they did under the Social Security system -- later generations must receive sub-market rates of return.

For those later generations, the simplistic comparison would suggest that individual accounts (earning the interest rate) would yield more than Social Security contributions. The difficulty, as Geanakoplos, Mitchell, and Zeldes emphasize, is that we do not avoid the burden of paying for the high rates of return enjoyed by early participants through the creation of individual accounts. For a given level of total funding, the excess returns enjoyed by early generations must be paid for by lower returns in later generations -- a relationship that is not changed by diverting funding into individual accounts. That is the fundamental problem in the simple rate of return comparison.

To understand the logic, return again to the example presented in the box above. The excess return enjoyed by Generation A was equal to \$1. As the box explains, allowing Generation C to divert its payroll taxes into individual accounts would require some other source of financing for the benefits due to Generation B. And that financing eliminates the ostensibly higher returns on individual accounts. Once the \$1 had been given away to Generation A, future generations must bear the burden regardless of whether individual accounts are created.

Alan Greenspan has made the same point in a slightly different way. As he notes, "Any move toward privatization will confront the problem of how to finance previously promised benefits. That would presumably involve making the implicit accrued unfunded liability of the current social security system to beneficiaries explicit."²⁵ The cost of financing that liability would then reduce the net return to individual accounts.

Chairman Greenspan phrases his point in terms of the unfunded liability, whereas Geanakoplos, Mitchell, and Zeldes phrase theirs in terms of the excess returns enjoyed by early beneficiaries under Social Security. But their points are precisely the same, just approached from different ends, because the unfunded liability is the mirror image of the earlier excess returns. To see why, again consider the simplified example from the box above. The excess return to Generation A was \$1, precisely the unfunded liability (the amount due to Generation B if Generation C were allowed to invest its \$1 into individual accounts).

The conclusion, as Professor Peter Diamond of MIT has put it, is that "the reason the rate-of-return remains below the market return is the presence of an unfunded liability...current workers must receive a lower return from Social Security to pay for the higher returns received by earlier generations. The same analysis holds for individual accounts. The creation of individual accounts does not change the history that leaves

²⁴ Geanakoplos, Mitchell, and Zeldes show that the net present value of transfers across all generations must be zero. That statement implies the one in the text.

²⁵ Alan Greenspan, Statement before the Task Force on Social Security, Committee on the Budget, United States Senate, November 20, 1997, page 4.

Social Security with unfunded liability. The rate-of-return from Social Security, including both individual accounts and the financing of the transition, is not increased by the creation of individual accounts per se."²⁶

VI. The Simple Rate of Return Comparison and "Add-On" Individual Accounts

The above analysis applies to financing individual accounts out of funds diverted from the current Social Security payroll tax. An alternative is to finance individual accounts from additional resources -- either from an increase in the payroll tax rate or from the budget surplus. Such accounts can be referred to as "add-on" individual accounts, since they are created on top of the existing funding for the Social Security program. Edward Gramlich has put forward a proposal to finance add-on individual accounts from additional contributions; Martin Feldstein has proposed financing such accounts out of the projected budget surplus.

As the simplified example above shows, add-on individual accounts would indeed raise the rate of return to Social Security (where "Social Security" is interpreted to include the accounts). But additional financing would also raise the rate of return to the conventional Social Security program, by increasing the relative size of the Trust Fund. As discussed earlier, such an increase would raise the overall rate of return on contributions by increasing the relative size of the Trust Fund, and reducing the relative size of the pure pay-as-you-go return.

The simple comparison in this case is misleading because it compares the rate of return on the additional financing through add-on individual accounts to the rate of return on *existing* Social Security contributions, rather than to the rate of return on additional contributions.²⁷ And the difference is important. For example, assume that the rules governing the Trust Fund were modified to allow investments in the stock market. Then consider \$100 put into individual accounts, and that the \$100 were invested 50 percent in equities and 50 percent in bonds. An extra \$100 put into the Trust Fund, and similarly invested, would earn the same rate of return. (Indeed, as discussed below, it could earn a *higher* rate of return net of administrative costs, since the Trust Fund would likely enjoy lower administrative costs than individual accounts.) The return on existing contributions is lower than the return on additional contributions, regardless of whether the existing contributions were invested in the Trust Fund or individual accounts -- an effect that the simple rate of return comparison fails to recognize.

²⁶ Peter Diamond, Testimony before the Committee on Ways and Means, Subcommittee on Social Security, U.S. House of Representatives, June 18, 1998, available at www.house.gov/ways_means/.

²⁷ In other words, it compares the return on individual accounts to the average Social Security return, rather than the marginal Social Security return.

The conclusion is clear: regardless of how individual accounts are financed, the difference between a market return and the rate of return on current Social Security contributions is not particularly helpful in evaluating whether individual accounts are beneficial.

VII. Other Problems with the Simple Comparison

The sections above have highlighted significant flaws in the simple rate of return comparison, regardless of how individual accounts are financed. This section briefly explores two other potential problems with such a comparison: risk and administrative costs.

Risk

Most individuals do not like risk. To compensate for higher risk, riskier assets carry higher expected returns. Risk is therefore one of the reasons that stocks tend to have a relatively high expected rate of return: By many common measures, stocks are relatively risky. For example, the S&P 500 index has declined (in nominal terms) by more than 10 percent in 8 of the past 70 years.²⁸ Economists also note that stock returns tend to be high during strong economic periods, so that they are risky in the sense that they do not provide insurance against bad times.

The risks embodied in stocks are highlighted by calculations done by Gary Burtless of the Brookings Institution. Burtless studies the replacement rates -- the ratio of retirement income to previous wages -- that workers would have achieved if they had invested 2 percent of their earnings in stocks over a 40-year career, and annuitized the accumulated balance upon reaching age 62. Workers reaching age 62 in 1968 would have enjoyed a 39 percent replacement rate from those investments, whereas the replacement rate for workers retiring in 1974 -- only six years later -- would have been 17 percent.²⁹ The estimates are subject to a variety of criticisms, but their key point is not: stock returns embody significant variation from year to year.³⁰

Since individuals are averse to risk, comparing rates of return on assets with different risk characteristics is misleading: an asset with a higher return but substantially more risk may

²⁸ Council of Economic Advisers, *Economic Report of the President 1997* (Government Printing Office: Washington, 1997), page 113. It should be noted that bonds also have risk in real terms. Bonds held to maturity have little or no risk in nominal terms, but they do have risk in real (inflation-adjusted) terms: If inflation turns out to be higher than expected, the real value of the bond's principal is reduced. That means that unexpected inflation poses a risk to bondholders. The Treasury Department has recently begun issuing inflation-indexed bonds that protect investors against such risk.

²⁹ Gary Burtless, Testimony before the Committee on Ways and Means, Subcommittee on Social Security, U.S. House of Representatives, June 18, 1998, available at www.house.gov/ways_means/.

³⁰ For a discussion of the calculations and their potential biases, see Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform* (Century Foundation Press: New York, 1998), pages 32-36.

not be preferable to a lower-yielding, lower-risk asset. To analyze the relative attractiveness of different assets, it is thus necessary to adjust for risk.

To evaluate assets with different risks on a comparable basis, economists use a *risk-adjusted* rate of return. Such a risk-adjusted rate of return takes the measured rate of return and adjusts it for the risk embodied in the asset. If the measured rate of return on an asset is high only because it is riskier than other assets, its risk-adjusted rate of return would not be high: the risk adjustment would eliminate the differential in the measured rate of return. Thus, the risk-adjusted rate of return allows us to evaluate measured rates of return on a comparable basis. Only to the extent that the risk-adjusted rate of return is higher on one asset than another would that asset necessarily be preferable to individuals.

Economists have developed a variety of tools for measuring and correcting for risk to allow them to compute risk-adjusted rates of return. But the task is very difficult. For example, it is hard to know precisely how risk averse individuals are. "Risk" may also depend on a wide variety of factors. For example, some economists believe that over long enough periods, stocks are not particularly risky.³¹ More broadly, the riskiness of an asset will depend on the characteristics of other assets held by, or income earned by, individuals.

These measurement problems complicate risk adjustments, but do not obviate their importance. Indeed, one critical question is whether the higher returns to stocks can be explained solely by their riskiness. Some economists have concluded that they cannot -- in other words, that the rate of return on stocks is higher than can be explained by their riskiness.³² The complexities of risk adjustment make it difficult to reach a definitive conclusion.

A risk-adjusted gain to investing in stocks would make such investments attractive. In such a case, permitting diversification into stocks -- either through individual accounts or by allowing the Trust Fund to invest in private-sector securities -- would raise the risk-adjusted rate of return. But the increase would not be as large as suggested by the unadjusted rate of return on stocks. It would also result from diversification into stocks, not from individual accounts *per se*, since the diversification could be accomplished either through the Trust Fund or through individual accounts.³³

³¹ Jeremy Siegel, *Stocks for the Long Run* (McGraw Hill: New York, 1998).

³² Rajnish Mehra and Edward Prescott, "The Equity Premium: A Puzzle," *Journal of Monetary Economics*, March 1985, pages 145-161.

³³ Investing in stocks through the Trust Fund, unlike investing through individual accounts, allows risk to be spread across generations. If the market turns down in a specific year, all generations can bear some of the burden if the investments are undertaken through the Trust Fund. But under a system of individual accounts, specific generations will bear the entire burden of the market downturn. The Trust Fund may therefore be a more effective means of absorbing risk than individual accounts. More broadly, the relative costs and benefits of investing in stocks through the Trust Fund or through individual accounts is an important policy issue. For example, some believe that the Trust Fund should not be allowed to invest in private-sector securities, given concerns over government interference in the stock market. In that case, given a risk-adjusted gain to stocks, the risk-adjusted improvement in returns under individual accounts

A full risk analysis of the Social Security system relative to a system of individual accounts would entail a wide variety of other risks in addition to equity risks. For example, the Social Security system is progressive and therefore provides a form of lifetime earnings insurance (if lifetime earnings are lower than expected, the replacement rate from Social Security benefits is higher than expected -- at least partially cushioning the blow of the lower than expected earnings). It also provides disability and survivors insurance in addition to retirement benefits. On the other hand, the Social Security system is also subject to a variety of demographic and possibly even political risks that may be less powerful under individual accounts. A comprehensive risk analysis is clearly beyond the scope of this paper, but the need to undertake such a comprehensive risk analysis provides yet another reason to be somewhat wary of the simple rate of return comparison.

In summary, the simple rate of return comparison ignores a variety of very complicated risk issues. A higher rate of return that results purely from assuming more risk does not necessarily make individuals better off -- a fact ignored by the simple rate of return comparison.

Administrative costs

Another factor absent from the simple rate of return comparison is administrative costs. The simple comparison implicitly assumes that administrative costs are similar under Social Security and individual accounts. If, however, administrative costs differ, the simple rate of return comparison is misleading. For any given gross rate of return, higher administrative costs reduce the net benefit to investors -- which is the bottom line for investors. The simple rate of return comparison does not adjust the market rate of return for differential administrative costs between Social Security and individual accounts, providing another reason that it does not accurately reflect the relative attractiveness of individual accounts.

The administrative costs of running the Social Security system are very low. The costs of administering the retirement and survivor's insurance programs amount to only 0.7 percent of benefit payments.³⁴

Individual accounts would involve higher administrative costs than the Social Security system, and the structure of the accounts would determine how much higher the costs would be. One approach to individual accounts would be to have centralized

would be the result of the rules that we have imposed rather than the movement to individual accounts *per se*.

³⁴ Henry J. Aaron and Robert D. Reischauer, *Countdown to Reform* (Century Foundation Press: New York, 1998), page 86. Note also that these administrative costs are already embodied in the rate of return on existing Social Security contributions.

management, similar to the Thrift Savings Plan for Federal employees, with restricted investment options. The Gramlich commission estimated that administrative costs under such a system would amount to roughly 10 basis points per year. Such costs, accumulated over 40 years of work, would reduce the ultimate value of an individual account by about 2 percent.

An alternative approach would be a decentralized system of individual accounts, in which workers held their accounts with various financial firms and were allowed a broad array of investment options. Under such an approach, the costs would be even higher because of advertising expenses, the loss of economies of scale, and other additional costs. The Gramlich commission estimated that administrative costs under such a system would amount to roughly 100 basis points per year -- or about 20 percent of an account's value when cumulated over an entire working life. Experience from both Chile and the U.K. suggests that such an approach to individual accounts would involve significantly higher administrative costs than Social Security.³⁵

Individual accounts are thus likely to be more expensive to administer than the current Social Security system. The cost differential would depend on how any such accounts were designed. But the existence of any administrative cost differential provides yet another reason that the simple rate of return comparison is misleading.

Conclusion

Many proponents of individual accounts cite the higher rate of return on the stock market relative to Social Security contributions as the most important benefit of individual accounts. As this paper has argued, such a comparison is misguided: it either neglects the costs of paying for current benefits or the fact that additional funding for Social Security would also earn a higher rate of return than existing contributions. It also ignores potential differences in risk and administrative costs.

Individual accounts have a wide variety of costs and benefits, all of which deserve careful scrutiny in the current debate. But the simple rate of return comparison confuses rather than informs the debate.

³⁵ For more extensive discussions of the likely administrative costs under individual accounts, see National Academy of Social Insurance, "Report of the Panel on Privatization of Social Security," available at www.nasi.org, and Olivia Mitchell, "Administrative Costs in Public and Private Retirement Systems," in Martin Feldstein, ed., *Privatizing Social Security* (University of Chicago Press: Chicago, 1998).

Appendix: The Arithmetic of Samuelson's Pay-As-You-Go Rule

Paul Samuelson has shown that the rate of return to a pay-as-you-go system is equal to the growth rate in productivity plus the growth rate in the labor force. This result may be most easily understood by realizing that under a pay-as-you-go system, total benefits are equal to total taxes. Furthermore, for a given tax rate, total taxes will be proportional to total earnings. The growth rate in total taxes is therefore equal to the growth rate in total earnings, which itself is equal to the growth rate in productivity plus the growth rate in the labor force. Then consider a generation that pays taxes this period (which fund benefits for current retirees) and receives benefits next period (which are paid for by future taxes). The increase in total taxes between the two periods will equal the growth rate in productivity plus the growth rate in the labor force (as explained above). But since the system is a pay-as-you-go one, the taxes in the second period are equal to the benefits in that period. Therefore, the benefits in the second period will be equal to the taxes in the first period scaled up by productivity and labor force growth. In other words, the generation under scrutiny will earn a rate of return equal to productivity plus labor force growth. The same argument could then be applied to future generations.

The point can also be expressed in algebra. Assume there are N workers in the first period, and that the workforce grows by g percent per period. Then there will be $N(1+g)$ workers in the second period. Also that output per worker is y in the first period and that it grow by k percent per period. Then output per worker will be equal to $y(1+k)$ in the second period. Then if benefits under the pay-as-you-go system are financed by a tax at constant rate t , the rate of return to the first group of workers is approximately $g+k$, or the sum of the labor force growth rate and the productivity growth rate.

Contribution per worker in first period = ty

Benefit per retiree in second period

$$= \frac{\text{Total taxes}}{\text{Retirees}} = \frac{\text{Tax rate} \times \text{output per worker} \times \text{number of workers in period 2}}{\text{Number of workers in period 1}} = \frac{ty(1+k)N(1+g)}{N} = ty(1+k)(1+g)$$

$$\text{Rate of return} = \frac{\text{Benefits}}{\text{Contributions}} - 1 = \frac{ty(1+k)(1+g)}{ty} - 1 = (1+k)(1+g) - 1 \approx k + g$$

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-FEB-1999 11:51:27.00

SUBJECT: Revised statement

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

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The following is a HEX DUMP:

STATEMENT OF JANET YELLEN

Release of the 1999 Economic Report of the President

Thank you all for coming in today to hear about the 1999 Economic Report of the President. Each year, one of the most closely watched aspects of the Report's release is the color of the cover. And, as you can see, unlike this year's budget document, the Economic Report is in red -- symbolizing our Nation's "red hot economy." [Or, as one of our economists suggested "After so many years of government red ink, the Government Printing Office had a surplus of red -- and the CEA is helping them out."]

In any case, as you all know, the President is required to submit to Congress each year a Report that describes the state of the US economy. But, the Report has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains: a chapter on the benefits of a strong labor market; a chapter on the aging American population; a chapter on regulation and innovation; and, two chapters on international issues -- one discussing the recent world-wide financial turmoil and one describing reform of the international financial architecture.

Let me first talk briefly about the current state of our economy, and then talk about the direct and measurable benefits that American workers are enjoying from our strong and healthy economy. Finally, I will touch briefly on the challenges that remain as we move into the 21st Century.

[Automated Records Management System Hex-Dump Conversion]

STATE OF THE ECONOMY

We detail in Chapter 2 of the Report that our Nation's economy is the strongest it has been in a generation. In 1998, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent. Nonagricultural jobs increased by about 2.9 million during the year, and the average unemployment rate for the year dropped to 4.5 percent, its lowest level since 1969. The consumer price index rose by only 1.6 percent, its smallest increase since 1964, and other measures of inflation were even more muted. And, as you all know, this year the Federal budget moved strongly into surplus and those surpluses are projected well into the future, amounting to about 4.5 trillion total surpluses in the unified budget over the next 15 years. I will return to the budget and Social Security in a few minutes.

The current economic expansion is only the third on record that has lasted at least 7 years and this year's report puts the expansion in its historical context by comparing it with the other two long expansions--the 106-month long expansion of the 1960s (the longest in peace or war) and the 92-month long expansion of the 1980s. Judged in terms of overall economic performance this expansion has been not only long but excellent--especially with respect to inflation and unemployment. By this time in the expansion of the 1960s, for example, inflation was rising sharply and was much higher than now, at about 5%. In the 80s expansion, inflation was also rising at this stage and had reached 5%. By contrast, Inflation now is much lower and has been coming down. Since the need to combat high or rising inflation is what typically brings an expansion to an end, this greatly raises the prospects for a continuing expansion. The [Automated Records Management System Hex-Dump Conversion]

combination of low inflation and low unemployment is particularly remarkable and shatters long held views and simple textbook theories about the possibility of combining low unemployment and inflation. In fact, the misery index, which is the sum of inflation and unemployment, is lower at this stage of the current expansion than in either the expansion of the 60s or the 80s.

This is also an expansion which is investment driven--to a far greater extent than in either of the other two long expansions. This investment is a contribution to future growth and it is working to hold inflation down. Of course, it didn't occur by accident --it's the consequence of fiscal discipline and a conscious choice to shift the policy mix toward tighter fiscal policy and a lower interest rate, accommodative monetary policy.

The continuing strong economic performance in 1998 is all the more remarkable because it took place at a time of considerable stress to the world economy. We are not out of the woods, of course, as ongoing concerns about Brazil remind us. But the U.S. economy has entered 1999 on course to continue growing and the chances are good that next year at this time we will be on the verge of marking the longest economic expansion—whether in peace or war—ever.

THE BENEFITS TO AMERICAN WORKERS OF A STRONG ECONOMY

Because of our Nation's strong and healthy economy, American workers are enjoying direct and measurable progress. In the *Report*, we describe the CEA's analysis of real wage growth. Let me talk briefly about some of these findings:

[Automated Records Management System Hex-Dump Conversion]

Wage growth has been particularly strong for historically disadvantaged groups. After years of decline, the real wages of black men began to increase in 1993, and they have risen by 5.8 percent in the last 2 years (since 1996). Black women and Hispanic men and women have also experienced recent gains. The tight labor market of the 1990s appears to be helping even young minority workers, who suffered greater wage declines than others in the 1980s. In 1998 alone, the real wages of young black men aged 16-24 rose by 6.2 percent.

It is well known that less-skilled men have experienced long-term wage decline since the later 1970s. In 1998, real wages among men aged 20 and over who are high school dropouts rose by 7 percent. This was the first time since at least 1979 that their wages rose. In addition, real hourly wages for the lowest two tenths of the distribution of men and women have increased 5-6 percent since 1993.

Immigrants, too, are earning more. Mexican- and Central American-born immigrants -- who account for about 30 percent of new immigrants since 1980 -- have had real wage growth since 1995 of almost 7 percent for men and almost 4 percent for women.

In addition to these direct and measurable benefits, American workers are benefiting from our strong economy in other ways. An economy with strong job creation and low unemployment makes broad and lasting changes in our labor market and in the well-being of the American people. For example, a high-employment economy can *reduce long-term joblessness* by encouraging participation by those who might otherwise be forced to sit on the sidelines, and

it makes it easier to absorb less skilled or younger and more inexperienced workers into the labor force. The unemployment rate of black youth aged 16-24 was lower in 1998 than in any year since the data series began in 1973. These new workers gain much-needed job experience, building the skills they will need to hold down a job in the future. And the strong, economy is *helping to move welfare recipients into the workforce.*

CHALLENGES IN A CHANGING ECONOMY

Although our economy is strong and Americans are working in record numbers our Nation still faces other, broader challenges as we move into the 21st century. The President recently laid out this broad agenda in his State of the Union and again in his FY2000 budget.

One of the key challenges we face is to prepare our nation for the seismic demographic shift which is underway. the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling. The same demographic effects on work to threaten the finances of Social Security also impact Medicare and Medicaid.

As you know, in his State of the Union the President proposed a plan for how to use the currently projected unified budget surpluses and how to address the financial imbalance of the Social Security system. He proposed: devoting 62% of the surpluses over the next 15 years--more than \$2.5 trillion--to strengthening the Social Security system, with a small portion devoted to equity purchases. Assuming that a solution for social security can be achieved, the President has also proposed using 15% of the projected surpluses for Medicare, ensuring the

Medicare Trust Fund is secure for another 20 years. And he proposed to create a new system of universal savings accounts (USA Accounts) outside of Social Security with 12 percent to help working Americans build wealth to meet their retirement needs--a way of strengthening the current pension system and helping Americans save. The government would provide an equal dollar contribution for most working individuals and provide matches for individual contributions with larger matches going to lower income workers. Finally, the President would reserve 11 percent of the projected surpluses for military readiness and education and research.

Rather than commenting in detail this morning on the President's Social Security plan, let me talk about the overall macroeconomic impact of this plan. For the nation as a whole, the central problem in coping with an aging population is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute. National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. The framework offered by the President for the use of emerging budget surpluses would dramatically increase saving. Evaluated from a macroeconomic perspective--from the perspective of national savings--this plan saves, in essence, between 77

and 89 percent of the projected surpluses, depending on one's evaluation of the saving impact of the USA accounts. The transfers to Social Security and Medicare amount to 77 percent of the federal budget and about 2 percent of GDP, and they are pure additions to national saving. In addition, the USA accounts amount to 12 percent of the budget and could be viewed as a tax cut that is highly likely to add to personal saving. Only 11 percent of the surpluses are devoted to additional government spending.

Dedicating the surpluses to Social Security and Medicare serves two purposes. First, it helps to lock in the surpluses so they are not used for tax cuts or wasteful spending. Second, it gives these critical programs a "first call" on the benefits of our fiscal discipline. And these benefits will be large.

This is a fiscally conservative, pro-growth plan that comes close in its macroeconomic impact to a plan of simply paying off debt. Publicly held debt is projected to fall from 44 percent of GDP today to about 7 percent in 2014. That would represent the smallest burden of government debt on the economy since the United States entered World War I in 1917. In addition, some of the surpluses will be used to purchase equities, which will represent an asset of the government. The dramatic decline in national debt would increase private capital investment, keep interest rates low or drive them lower, raise future national income, free up government resources by reducing debt servicing costs and fuel economic growth.

INTERNATIONAL CHALLENGES

Two chapters of our Report focus on the international economy, the first on global capital

flows and the causes of the international financial crisis and the second on the evolution and reforms of the international financial system that are needed to make it less crisis prone.

Although the United States is doing well, a third of all world economies were in recession or experiencing markedly slower growth by late 1998. And world economic growth is projected to remain depressed in 1999, reaching levels near those registered during the pronounced world slowdowns of 1974-75, 1980-83, and 1990-91. One reflection of our strong growth and the world economy's weak growth is a rise in our trade deficit.

We recognize that, at this time of continued turmoil in the international economy, we must do more to help create stability and open markets around the world. We must press forward with open trade. At this time of economic fragility in so many regions, the United States must not build new walls of protectionism, that could set off a chain reaction around the world that would imperil the world's growth. We must also continue to work to strengthen the architecture of our international financial system. The United States must continue to lead in stabilizing the world financial system.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been strong -- we have enjoyed solid growth, strong job creation, low unemployment and low and stable inflation. And there are broad and lasting benefits that American workers are enjoying as a result of strong economy. Even so, there are still long-term challenges facing our

nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-FEB-1999 13:52:42.00

SUBJECT: Statement for WH press briefing

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Attached is a brief statement for the WH press briefing. It is quite a bit shorter than your other statement. But, given that you will be talking to the non-economic, more political reporters.... and it will be at the end of Lockhart's briefing, I thought that this would be a more appropriate length.

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D22]MAIL41228563O.036 to ASCII,
The following is a HEX DUMP:

STATEMENT OF JANET YELLEN

Release of the 1999 *Economic Report of the President*

Thank you. Today we released the 1999 *Economic Report of the President*. Each year, one of the most closely watched aspects of the Report's release is the color of the cover. And, as you know, this is not the budget document -- which of course was black this year to symbolize our Nation's budget surpluses. No, instead, this document is a report on the state of the economy --- and this year our economy is "red hot." So, that is why we chose a red cover -- red to symbolize our Nation's "red hot economy."

In any case, as you all know, the President is required to submit to Congress each year a Report that describes the state of the US economy. The report also traditionally presents a broad range of analyses of current economic policy issues. This year, in addition to the discussion of the state of the US economy, the report looks at a range of other issues -- the aging of the American population, regulation and innovation, and the recent international financial turmoil. But, one of the most important highlights of this year's Report is a discussion of the direct and measurable benefits that American workers are enjoying from our strong and healthy economy. And, because this section includes some new work done by the CEA on recent wage growth, I'd like to focus your attention on that aspect of the report.

STATE OF THE ECONOMY

But, first let me make a couple of comments about the state of our economy. Our Nation's economy is the strongest it has been in a generation. In 1998, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent. Nonagricultural jobs increased by about 2.9 million during the year, and the average unemployment rate for the year dropped to 4.5 percent, its lowest level since 1969. The consumer price index rose by only 1.6 percent, its smallest increase since 1964, and other measures of inflation were even more muted. And, as you all know, this year the Federal budget moved strongly into surplus and those surpluses are projected well into the future.

The continuing strong economic performance in 1998 is all the more remarkable because it took place at a time of considerable stress to the world economy. We are not out of the woods, of course, as ongoing concerns about Brazil remind us. But the U.S. economy has entered 1999 on course to continue growing -- and the chances are good that next year at this time we will be on the verge of marking the longest economic expansion ever.

THE BENEFITS TO AMERICAN WORKERS OF A STRONG ECONOMY

Because of our Nation's strong and healthy economy, American workers are enjoying direct and measurable progress. As I said earlier, for this year's Report, the CEA conducted an analysis of recent real wage growth -- and we found that wage growth has been particularly strong for historically disadvantaged groups.

- * After years of decline, the real wages of black men began to increase in 1993, and they have risen by 5.8 percent in the last 2 years (since 1996) -- which is truly an impressive increase. Black women and Hispanic men and women have also experienced recent gains.
- * Our tight labor market also appears to be helping even young minority workers, who suffered greater wage declines than others during the 1980s. In 1998 alone, the real wages of young black men aged 16-24 rose by 6.2 percent.
- * Less-skilled men -- who have experienced a long-term wage decline since the later 1970s -- also are experiencing impressive gains. In 1998, real wages among men aged 20 and over who are high school dropouts rose by 7 percent. This was the first time since at least 1979 that their wages rose. In addition, real hourly wages for the lowest two tenths of the distribution of men and women have increased 5-6 percent since 1993.

* Immigrants, too, are earning more. Mexican- and Central American-born immigrants -- who account for about 30 percent of new immigrants since 1980 -- have had real wage growth since 1995 of almost 7 percent for men and almost 4 percent for women.

These are truly impressive gains for historically disadvantaged groups.

CONCLUSION

There are a number of other issues in the report that I could discuss -- but let me stop there and just conclude by saying that over the past year the performance of the U.S. economy has been excellent. We have enjoyed solid growth, strong job creation, low unemployment and low and stable inflation. And there are broad and lasting benefits that American workers are enjoying as a result of this strong economy -- particularly for historically disadvantaged groups, who have seen impressive wage gains in recent years. There are still long-term challenges facing our nation as we enter the 21st Century. And, President Clinton has presented a broad agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-FEB-1999 18:56:17.00

SUBJECT: Draft of CNP Speech

TO: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Attached is a draft of the CNP speech--it is very close to the remarks from this morning but a bit longer particularly on the international side. Any comments are welcome. ===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D73]MAIL41797373S.036 to ASCII,
The following is a HEX DUMP:

The 1998 Economic Report of the President

Dr. Janet Yellen
Chairman, President's Council of Economic Advisers
Center for National Policy
February 4, 1999

Thank you. It is a pleasure to be here. I want to thank the Center for National Policy for again hosting the release of the annual *Economic Report of the President*. In particular, I want to thank Mo Steinbruner and **[Mike Pietro?]** for all of their help in arranging this event.

I would also like to thank my colleagues--Jeff Frankel and Rebecca Blank--for all their hard work and dedication in producing this year's *Report*.

Finally, I want to thank the staff of the Council, many of whom are here with us today. During the past several months, the staff have been working long nights and weekends to produce the *Economic Report*. And, what is truly remarkable is that they have also continued to do the other work of the Council, which does not stop just because it is time to produce the *Economic Report*. I appreciate all of their hard work, their thoughtful insights and their good spirits. Their dedication and professionalism deserve special recognition.

As you probably know, the Employment Act of 1946, which created the Council of Economic Advisers, requires the President to submit an *Economic Report* to the Congress each year. This Act, together with its later amendments, gave the Federal government responsibility for stabilizing short-run economic fluctuations, promoting balanced and noninflationary economic growth, and fostering low unemployment. One purpose of the *Economic Report* is to tell Congress whether we have met those responsibilities. I am happy to say, in this the

fifty-third year after the Act, that the state of the economy is truly extraordinary. Last year was a year for baseball home-run records, and it was also a year for economic records as we achieved the longest peacetime economic expansion on record—and the records go back to 1854.

I will elaborate on this point in a moment, but I would also like to note that the *Report of the Council of Economic Advisers* has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains a chapter on the benefits of a strong labor market and one on work, retirement, and the economic well-being of the elderly. This year's microeconomics chapter focuses on regulation and innovation. It examines this Administration efforts in three areas—antitrust, the environment, and electric power restructuring—to ensure that regulation not only does not interfere with innovation, but indeed fosters beneficial technological change and adapts itself to such change as well. Finally, the Report devotes two chapters to the crisis in the international economy. The first analyzes capital flows in the global economy and discusses both the emergence of the crisis and policy responses to the crisis. The second focuses on the evolution and reform of the international monetary system with an eye to understanding how such crises can be avoided in the future.

In the remainder of my remarks I will touch briefly on the current state of the economy and the characteristics of this expansion. Then I want to discuss three themes: 1) the benefits of the strong economy and a strong labor market—especially for groups that had not seen much economic progress for a long time; 2) the importance of fiscal discipline in preparing our nation for the seismic demographic shift which is underway; and 3) the importance of addressing challenges in the world economy in a way that preserves the benefits of outward-looking trade and investment policies.

STATE OF THE ECONOMY

Our Nation's economy is the strongest it has been in a generation. In 1998, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent. Nonagricultural jobs increased by about 2.9 million during the year, and the average unemployment rate for the year dropped to 4.5 percent, its lowest level since 1969. The consumer price index rose by only 1.6 percent, its smallest increase since 1964, and other measures of inflation were even more muted.

As you all know, this year the Federal budget moved strongly into surplus. In the 1992 fiscal year the budget deficit was \$290 billion and expected to rise further with no change in policy. But beginning in 1993, the deficit began to decline steadily as a consequence of a shift to fiscal discipline. In 1998, the budget *surplus* was \$69 billion, the largest surplus as a share of GDP since 1957, and surpluses are projected well into the future: the Administration now projects surpluses in the unified Federal budget amounting to about \$4.5 trillion over the next 15 years. I will return to the budget and the use of those surpluses to address demographic challenges in a few minutes.

The current economic expansion is only the third on record that has lasted at least 7 years and this year's report puts the expansion in its historical context by comparing it with the other two long expansions--the 106-month long expansion of the 1960s (the longest in peace or war) and the 92-month long expansion of the 1980s. Judged in terms of overall economic performance this expansion has been not only long but excellent--especially with respect to inflation and unemployment. By this time in the expansion of the 1960s, for example, inflation was rising sharply and was much higher than now, at about 5%. In the 80s expansion, inflation

was also rising at this stage and had reached 5%. By contrast, inflation now is much lower and has been coming down. Since the need to combat high or rising inflation is what typically brings an expansion to an end, this greatly raises the prospects for a continuing expansion. The combination of low inflation and low unemployment is particularly remarkable and shatters long held views and simple textbook theories about the possibility of combining low unemployment and inflation. In fact, the misery index, which is the sum of inflation and unemployment, is lower at this stage of the current expansion than in either the expansion of the 60s or the 80s.

This is also an expansion which is investment driven--to a far greater extent than in either of the other two long expansions. This investment contributes to future growth and is working to hold inflation down. Of course, it didn't occur by accident --it's the consequence of fiscal discipline and reflects a conscious choice to shift the policy mix toward a tighter fiscal policy coupled with a lower interest rate, accommodative monetary policy to stimulate investment and spur economic growth.

The continuing strong economic performance in 1998 is all the more remarkable because it took place at a time of considerable stress to the world economy. While the international environment remains exceptionally risky, the U.S. economy has entered 1999 on course to continue growing and the chances are good that next year at this time we will be on the verge of marking the longest economic expansion—whether in peace or war—ever.

THE BENEFITS OF A STRONG LABOR MARKET

The Clinton Administration laid a strong policy foundation for growth in 1993 when the

President put in place an economic strategy grounded in deficit reduction, targeted investments, and opening markets abroad. These were not only the right policies to stimulate the job creation needed to move the economy to full employment. They were also the right policies for attacking the longer term problems of sluggish productivity growth and widening income inequality that have afflicted our nation's economy since the early 1970s. I am happy to say that in this year's *Report* we are able to report some encouraging evidence of improvements for low-wage and minority workers associated with the strong labor market created in this expansion.

It was once commonly accepted that an economic expansion is a rising tide that lifts all boats, so that the most surefire way to alleviate poverty and help disadvantaged groups was to keep the economy expanding. However, in the late 1970s, a new, long-term trend toward widening inequality began to afflict the economy, most likely as a consequence of pervasive technological changes raising the demand for skilled labor and lowering the demand for unskilled workers. In addition, productivity growth declined substantially, for reasons that are still not well understood. During the expansion of the 1980's, real wages declined. Men were disproportionately impacted. During this expansion, we saw real wages stagnate for the first five years of the expansion. However, this has finally become an expansion in which a rising tide is lifting all boats. American workers are enjoying direct and measurable progress and in the *Report*, we describe the CEA's analysis of real wage growth. Let me talk briefly about some of these findings:

Wage growth has been particularly strong for historically disadvantaged groups. After years of decline, the real wages of black men began to increase in 1993, and they have risen by 5.8 percent in the last 2 years (since 1996). Black women and Hispanic men and women have

also experienced recent gains. The tight labor market of the 1990s appears to be helping even young minority workers, who suffered greater wage declines than others in the 1980s. In 1998 alone, the real wages of young black men aged 16-24 rose by 6.2 percent.

It is well known that less-skilled men have experienced long-term wage decline since the later 1970s. In 1998, real wages among men aged 20 and over who are high school dropouts rose by 7 percent. This was the first time since at least 1979 that their wages rose. In addition, real hourly wages for both male and female workers in the bottom two deciles of the distribution of income have increased 5-6 percent since 1993.

Immigrants, too, are earning more. Mexican- and Central American-born immigrants -- who account for about 30 percent of new immigrants since 1980 -- have had real wage growth since 1995 of almost 7 percent for men and almost 4 percent for women.

It is too early to declare victory in reversing adverse long-term trends in income distribution. In particular, it remains hard to know how much of this turnaround is due to particularly favorable business cycle conditions. Nor is this Administration taking the improvements for granted. First, it is committed to maintaining the macroeconomic stability that is a necessary condition for ensuring that all Americans participate in the country's growing prosperity. Second, the Administration continues to stress the importance of education and training policies that address the challenges of a changing economy and a changing society.

MAINTAINING FISCAL DISCIPLINE

Although our economy is strong and Americans are working in record numbers our Nation still faces other, broader challenges as we move into the 21st century.

One of the key challenges we face is to prepare our nation to meet the needs of an aging population. The ratio of

employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling. The same demographic effects that have impaired the finances of Social Security also impact Medicare and Medicaid.

As you know, in his State of the Union the President proposed a plan for how to use the currently projected unified budget surpluses and how to address the financial imbalance of the Social Security system. He proposed devoting 62% of the surpluses over the next 15 years--about \$2.8 trillion with a small portion, about 1/4, devoted to equity purchases--to extend the solvency of the Social security system until 2055. Further reforms would be needed to achieve full 75 year actuarial balance, which is the most commonly used measure of financial soundness.

Assuming that a solution for social security can be achieved, the President has also proposed using 15% of the projected surpluses for Medicare, ensuring the Medicare Trust Fund is secure for another 20 years. The President has emphasized the need to utilize the extra funding as part of a broad effort to strengthen the Medicare program. He also proposed creating a new system of universal savings accounts (USA Accounts) outside of Social Security with 12 percent to help working Americans build wealth to meet their retirement needs--a way of strengthening the current pension system and helping Americans save. The government would provide an equal dollar contribution for most working individuals and provide matches for individual contributions with larger matches going to lower income workers. Finally, the President would reserve 11 percent of the projected surpluses for military readiness and education and research.

Rather than commenting in detail on the President's Social Security plan, let me talk about the overall macroeconomic

impact of this plan. For the nation as a whole, the central problem in coping with an aging population is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute. National saving increased from 3.1 percent of gross domestic product in 1992 to 6.7 percent in the first three quarters of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output with the personal saving rate hitting zero in the last quarter of the year. The framework offered by the President for the use of emerging budget surpluses would dramatically increase national saving. Evaluated from a macroeconomic perspective--from the perspective of national savings--this plan saves, in essence, between 77 and 89 percent of the projected surpluses, depending on one's evaluation of the saving impact of the USA accounts. The transfers to Social Security and Medicare amount to 77 percent of the federal budget and about 2 percent of GDP, and they are pure additions to national saving. The USA accounts amount to 12 percent of the unified budget surpluses and could be viewed as a tax cut that is highly likely to add to personal saving. Only 11 percent of the surpluses are devoted to additional government spending.

Dedicating the surpluses to Social Security and Medicare serves two purposes. First, it helps to lock in the surpluses so they are not used for tax cuts or wasteful spending. Second, it

gives these critical programs a “first call” on the benefits of our fiscal discipline. And these benefits will be large.

This is a fiscally conservative, pro-growth plan that comes close in its macroeconomic impact to a plan of simply paying off debt. Publicly held debt is projected to fall from 44 percent of GDP today to about 7 percent in 2014. That would represent the smallest burden of government debt on the economy since the United States entered World War I in 1917. In addition, some of the surpluses will be used to purchase equities, which will represent an asset of the government. The dramatic decline in national debt would increase private capital investment, keep interest rates low or drive them lower, raise future national income, free up government resources by reducing debt servicing costs and fuel economic growth.

MEETING THE INTERNATIONAL CHALLENGE

I would like to say a few words about the challenges we face on the international economic front. The last year has been an extraordinarily tumultuous one for the world economy. As you know, what seemed like currency crisis confined to developing Southeast Asia in the summer of 1997, erupted during 1998 into a deep, global economic crisis.

A third of all world economies were in recession or experiencing markedly slower growth by late 1998. World economic growth is estimated by the International Monetary Fund (IMF) at only 2.2 percent in 1998 and is projected to remain at this low level in 1999, after robust growth of 4.2 percent in 1997. Projected world growth has almost declined to levels registered during the pronounced world slowdowns of 1974–75, 1980–83, and 1990–91. Japan’s hopes for recovery from a long-standing slump have been dashed. And the U.S. and other industrial countries have not escaped without impacts. In particular, our trade deficit has burgeoned, with

our exports falling absolutely in real terms as a consequence of reduced demand from impacted Asian economies. Manufacturing industries have been particularly impacted.

The Administration clearly recognizes that, at this time of economic fragility in so many regions, we must not build new walls of protectionism, that could set off a dangerous chain reaction around the world, imperilling the world's prospects for growth. As the crisis economies recover, their demand for U.S. goods and services will increase as well, once again fueling our own export growth. Instead, we must push to expand trade and open markets.

Beyond keeping markets open, the United States has been focused since the outset of the crisis on the need to take steps to spur growth throughout the industrial world, and to contain the crisis through IMF-lending cum reform programs in crisis countries. We have recognized the need to enhance the IMF's ability to lend by providing precautionary credit lines to countries that have implemented serious reform programs but are nevertheless threatened by capital outflows; And we are focused on the importance of alleviating suffering in crisis afflicted countries through safety net spending and also through lending to help countries recapitalize their banking systems and emerge from debt.

Over the longer term, the Administration believes that a serious program of reform is needed to strengthen the international financial system to make it less crisis prone and to improve the mechanisms available for dealing with any crises that may nevertheless occur.

Unfortunately, it turns out that there is just no silver bullet--no simple solution that would guarantee countries the benefits of global capital flows while eliminating the risk that a crisis of confidence could once again result in the painful withdrawal of that access. Even so,

international agreement is finally emerging on the steps that can and should be taken to strengthen the architecture of the financial system so that it is less crisis-prone going forward. Last fall, the central bank governors and finance ministers from a group of industrial and key emerging market countries, informally dubbed the G-22, formed three working groups, which issued reports on aspects of international financial reform. One report focuses on measures to increase transparency and accountability in the operations of individual countries, of financial and corporate institutions and of the international financial institutions themselves. The purpose is to enhance the availability, relevance and reliability of information available for evaluating risk in lending. A second working group proposed a series of reforms to strengthen domestic financial institutions: improvements in prudential supervision and regulation are particularly needed in order to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis. A final report sought to identify policies to make the system less crisis prone--for example, through reducing implicit and explicit government guarantees which create moral hazard and exacerbate risktaking. For example, deposit insurance, the implicit promise of bailouts of corporations considered too big to fail, and semi-fixed exchange rate regimes which reduced the perceived riskiness of foreign currency exposure--all increased the exposure of crisis countries and created fragility. Finally, the reports identify policies which could improve creditor coordination in crises and promote the orderly, cooperative and equitable resolution of international financial crises that may occur in the future. The United States is working intensively with key emerging markets, other industrialized nations, and the relevant international organizations, to put in place the building blocks of this new architecture to ensure that the unprecedented growth, increase in welfare and

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opportunity experienced in the 50 years after the creation of the Bretton Woods system are maintained in the future.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been extraordinary: strong growth and low unemployment combined with low and stable inflation. And there are enormous social and economic benefits to our high-employment economy. But that success--and the economy's present strength--cannot be taken for granted. Moreover, there are still long-term changes and challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era. We must preserve our hard-won fiscal discipline while investing in people and opening markets at home and abroad. At the same time, we must ensure that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-FEB-1999 08:25:39.00

SUBJECT: Statement

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

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STATEMENT OF JANET YELLEN
Release of the 1999 *Economic Report of the President*

Thank you all for coming in today to hear about the 1999 *Economic Report of the President*. Each year, one of the most closely watched aspects of the Report's release is the color of the cover. And, as you can see, unlike this year's budget document, the Economic Report is in red -- symbolizing our Nation's "red hot economy." [Or, as one of our economists suggested "After so many years of government red ink, the Government Printing Office had a surplus of red -- and the CEA is helping them out."]

In any case, as you all know, the President is required to submit to Congress each year a Report that describes the state of the US economy. But, the Report has also traditionally been a vehicle for presenting a broad range of analyses of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains: a chapter on the benefits of a strong labor market; a chapter on the aging American population; a chapter on regulation and innovation; and, two chapters on international issues -- one discussing the recent world-wide financial turmoil and one describing reform of the international financial architecture.

Let me first talk briefly about the current state of our economy, and then talk about the direct and measurable benefits that American workers are enjoying from our strong and healthy economy. Finally, I will touch briefly on the challenges that remain as we move into the 21st Century.

STATE OF THE ECONOMY

We detail in Chapter 2 of the Report that our Nation's economy is the strongest it has been in a generation. In 1998, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent. Nonagricultural jobs increased by about 2.9 million during the year, and the average unemployment rate for the year dropped to 4.5 percent, its lowest level since 1969. The consumer price index rose by only 1.6 percent, its smallest increase since 1964, and other measures of inflation were even more muted.

As you all know, this year the Federal budget moved strongly into surplus. In the 1992 fiscal year the budget deficit was \$290 billion and expected to rise further with no change in policy. Publicly held debt had increased from 26 percent of GDP in 1981 to 50 percent in 1993, and it too was expected to increase rapidly during the rest of the 1990s. But beginning in 1993, the deficit began to decline steadily as a consequence of a shift to fiscal discipline. In 1998, the budget *surplus* was \$69 billion, the largest surplus as a share of GDP since 1957, and surpluses are projected well into the future. The ratio of debt-to-GDP has fallen to 44 percent. More important, the Administration now projects substantial surpluses in the unified Federal budget of about 4.5 trillion over the next 15 years and a further decline in debt well into the future if we are able to sustain fiscal discipline. I will return to the budget and Social Security in a few minutes.

The current economic expansion is only the third on record that has lasted at least 7 years and this year's report puts the expansion in its historical context by comparing it with the other two long expansions--the 106-month long expansion of the 1960s (the longest in peace or war) and the 92-month long expansion of the 1980s. Judged in terms of overall economic performance this expansion has been not only long but excellent--especially with respect to inflation and unemployment. By this time in the expansion of the 1960s, for example, inflation was rising sharply and was much higher than now, at about 5%. In the 80s expansion, inflation was also rising at this stage and had reached 5%. By contrast, Inflation now is much lower and has been coming down. Since the need to combat high or rising inflation is what typically brings an expansion to an end, this greatly raises the prospects for a continuing expansion. The combination of low inflation and low unemployment is particularly remarkable and shatters long held views and simple textbook theories about the possibility of combining low unemployment and inflation. In fact, the misery index, which is the sum of inflation and unemployment, is lower at this stage of the current expansion than in either the expansion of the 60s or the 80s.

This is also an expansion which is investment driven--to a far greater extent than in either of the other two long expansions. This investment is a contribution to future growth and it is working to hold inflation down.

The continuing strong economic performance in 1998 is all the more remarkable because it took place at a time of considerable stress to the world economy. We are not out of the woods, of course, as ongoing concerns about Brazil remind us. But the U.S. economy has entered 1999 on course to continue growing and the chances are good that next year at this time we will be on the verge of marking the longest economic expansion--whether in peace or war--ever.

THE BENEFITS TO AMERICAN WORKERS OF A STRONG ECONOMY

Because of our Nation's strong and healthy economy, American workers are enjoying direct and measurable progress. In the *Report*, we describe the CEA's analysis of real wage growth. Let me talk briefly about some of these findings:

These trends are particularly strong for historically disadvantaged groups. After years of decline, the real wages of black men began to increase in 1993, and they have risen by 5.8 percent in the last 2 years (since 1996). Black women and Hispanic men and women have also experienced recent gains. The tight labor market of the 1990s appears to be helping even young minority workers, who suffered greater wage declines than others in the 1980s. In 1998 alone, the real wages of young black men aged 16-24 rose by 6.2 percent.

It is well known that less-skilled men have experienced long-term wage decline since the later 1970s. In 1998, real wages among men aged 20 and over who are high school dropouts rose by 7 percent. This was the first time since at least 1979 that their wages rose. In addition, real hourly wages for the lowest two tenths of the distribution of men and women have increased 5-6 percent since 1993.

Immigrants, too, are earning more. Mexican- and Central American-born immigrants --

who account for about 30 percent of new immigrants since 1980 -- have had real wage growth since 1995 of almost 7 percent for men and almost 4 percent for women.

In addition to these direct and measurable benefits, American workers are benefiting from our strong economy in other ways. An economy with strong job creation and low unemployment makes broad and lasting changes in our labor market and in the well-being of the American people.

A high-employment economy can *reduce long-term joblessness*. A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less skilled or younger and more inexperienced workers into the labor force. For example, the unemployment rate of black youth aged 16-24 was lower in 1998 than in any year since the data series began in 1973. These new workers gain much-needed job experience, building the skills they will need to hold down a job in the future.

A strong, high-employment economy will *help move welfare recipients into the workforce*. Keeping the unemployment rate low and job growth high is necessary if we are to move current welfare recipients into the work force. Early evidence on this point is encouraging: employment and labor force participation rates among single mothers with children under 18 have increased rapidly in the past few years. In just the 4 years from 1993 to 1997, the participation rate of single mothers aged 16-45 increased by almost 9 percentage points. This is partly the result of recent welfare reform: the greatest acceleration in employment rates has occurred among those single women most likely to be affected by welfare reform, namely, those with young children. The rise in employment among single mothers is also strongly related to the expansion of the Earned Income Tax Credit, which since 1993 has rewarded work by low wage earners more than ever before. Nevertheless, it is obvious that a strong economy in which job opportunities are plentiful is an important complement to programs and policies that encourage work.

And, finally, a high-employment economy *improves the well-being of low-income Americans*. From the 1980s until the early 1990s, the benefits of an expanding economy were offset by the sustained declines in wages at the low end of the earnings distribution. Since 1993, living standards for all Americans are on the rise, especially for those at the bottom of the income distribution. The poverty rate fell to 13.3 percent in 1997, from 15.1 percent in 1993; the poverty rate for black Americans is at a historical low, and in 1998 unemployment among blacks fell to its lowest rate since 1973. Maintaining a full-employment economy is essential if this progress is to continue.

CHALLENGES IN A CHANGING ECONOMY

Although our economy is strong and Americans are working in record numbers our Nation still faces other, broader challenges as we move into the 21st century. The President recently laid out this broad agenda in his State of the Union and again in his FY2000 budget.

One of the key challenges we face is to prepare our nation for the seismic demographic shift which is underway. The ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling. The same demographic effects on work to threaten the finances of Social Security also impact Medicare and Medicaid.

For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute. National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output.

As you know, in his State of the Union the President proposed a plan for how to use the currently projected unified budget surpluses and how to address the financial imbalance of the Social Security system. He proposed: devoting 62% of the surpluses over the next 15 years--more than \$2.5 trillion--to strengthening the Social Security system, with a small portion devoted to equity purchases. Assuming that a solution for social security can be achieved, the President has also proposed using 15% of the projected surpluses for Medicare, ensuring the Medicare Trust Fund is secure for another 20 years. And he proposed to create a new system of universal savings accounts (USA Accounts) outside of Social Security with 12 percent to help working Americans build wealth to meet their retirement needs--a way of strengthening the current pension system and helping Americans save. The government would provide an equal dollar contribution for most working individuals and provide matches for individual contributions with larger matches going to lower income workers. Finally, the President would reserve 11 percent of the projected surpluses for military readiness and education and research.

Rather than commenting in detail this morning on the President's Social Security plan, let me talk about the overall macroeconomic impact of this plan. This framework offered by the President for the use of emerging budget surpluses would dramatically extend the Administration's commitment to fiscal discipline and saving for our Nation's future. Evaluated from a macroeconomic perspective--from the perspective of national savings--this plan saves, in essence, between 77 and 89 percent of the projected surpluses, depending on one's evaluation of the saving impact of the USA accounts. The transfers to Social Security and Medicare amount to 77 percent of the federal budget and about 2 percent of GDP, and they are pure additions to national saving. In addition, the USA accounts amount to 12 percent of the budget and could be viewed as a tax cut that is highly likely to add to personal saving. Only 11 percent of the surpluses are devoted to additional government spending.

Dedicating the surpluses to Social Security and Medicare serves two purposes. First, it helps to lock in the surpluses so they are not used for tax cuts or wasteful spending. Second, it gives these critical programs a "first call" on the benefits of our fiscal discipline. And these

benefits will be large.

This is a fiscally conservative, pro-growth plan that comes close in its macroeconomic impact to a plan of simply paying off debt. Publicly held debt is projected to fall from 44 percent of GDP today to about 7 percent in 2014. That would represent the smallest burden of government debt on the economy since the United States entered World War I in 1917. In addition, some of the surpluses will be used to purchase equities, which will represent an asset of the government. The dramatic decline in national debt would increase private capital investment, keep interest rates low or drive them lower, raise future national income, free up government resources by reducing debt servicing costs and fuel economic growth.

INTERNATIONAL CHALLENGES

Two chapters of our Report focus on the international economy, the first on global capital flows and the causes of the international financial crisis and the second on the evolution and reforms of the international financial system that are needed to make it less crisis prone. Although the United States is doing well, a third of all world economies were in recession or experiencing markedly slower growth by late 1998. And world economic growth is projected to remain depressed in 1999, reaching levels near those registered during the pronounced world slowdowns of 1974-75, 1980-83, and 1990-91. One reflection of our strong growth and the world economy's weak growth is a rise in our trade deficit.

We recognize that, at this time of continued turmoil in the international economy, we must do more to help create stability and open markets around the world. We must press forward with open trade. At this time of economic fragility in so many regions, the United States must not build new walls of protectionism, that could set off a chain reaction around the world that would imperil the world's growth. We must also continue to work to strengthen the architecture of our international financial system. The United States must continue to lead in stabilizing the world financial system.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been strong -- we have enjoyed solid growth, strong job creation, low unemployment and low and stable inflation. And there are broad and lasting benefits that American workers are enjoying as a result of strong economy. Even so, there are still long-term challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 3-FEB-1999 13:18:28.00

SUBJECT: Re: SPR

TO: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

I can live with it, although I am worried about that it will look like
(and probably are) trying to raise the price of oil.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ryan D. Edwards (CN=Ryan D. Edwards/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 4-FEB-1999 15:51:10.00

SUBJECT: Note on Regulatory Reform (NOT URGENT)

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Hi Janet and Becky,

This is NOT an urgent issue, but it's probably one you should have on your radar screen. I've tried to keep the brouhaha over OECD's regulatory reform project to a minimum, but unfortunately there may be a slight problem regarding the regulatory reform questionnaire and whose responsibility it should be, if anyone's, to complete it according to OECD's wishes on the topic.

As you may know, the OECD wanted the U.S. to fill out its standard regulatory reform questionnaire, which I believe was first passed out in March of 1998.

Bob Winship's group at the State Department apparently coordinated the response to the questionnaire, and as far as I know, CEA has never been involved in it at all. Jeremy Rudd confirmed this.

In December, Stan Otto at the U.S. Mission received a batch of documents with a letter from Michael Feiner of the OECD, requesting a follow-up to the questionnaire in order to facilitate the construction of a WP-1 database on regulatory reform. Eventually, Stan passed this on to me. I think I received it in the middle of last month.

I talked to Bob Winship, who hadn't seen the letter and who told me he didn't think it would be possible to retrieve any more data from anyone involved in the original questionnaire process that he oversaw. I also contacted the OECD contact, Giuseppe Nicoletti, and asked for clarification as to what was being asked for. Nicoletti came up with a long laundry list of things that he wanted extended or fixed, including many parts which should have been completed in the "first pass" by Bob Winship or whoever he found to work on it.

I've expressed my belief to Stan Otto and Bob Winship that the request for more and clarified data would be best handled by Bob, since he coordinated the original response. I said that CEA's role thus far has been minimal at best. Stan seemed to understand where I was coming from; however, Bob and his department feel that since this "new" work was commissioned under WP-1, they never agreed to complete it and don't have the resources to do

so.

So it appears as if nobody's going to do it --- that is, the questionnaire is currently incomplete and according to Nicoletti (who may or may not have an interest in overstating the severity of the situation), severely lacking in one major category compared with other OECD nations. It would be a pretty major undertaking to try and do what OECD wants here in house.

I don't have a major problem with leaving it undone, personally. I think it would be very good to have it completed, but CEA hasn't been with it from the start, which hardly makes it easy for us to jump in, and I think other things probably take priority in terms of our own time. Obviously, it would be best from our perspective if State would do it. Unfortunately, I don't think that'll happen.

I won't take any more action unless you have a strong preference that we should.

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 4-FEB-1999 19:44:59.00

SUBJECT: CNP Speech and remarks to reporters

TO: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D40]MAIL42549783V.036 to ASCII,

The following is a HEX DUMP:

The 1998 Economic Report of the President

Dr. Janet Yellen
Chairman, President's Council of Economic Advisers
Center for National Policy
February 4, 1999

Thank you. It is a pleasure to be here. I want to thank the Center for National Policy for again hosting the release of the annual *Economic Report of the President*. In particular, I want to thank Mo Steinbruner for her help in arranging this event.

I would also like to thank my colleagues--Jeff Frankel and Rebecca Blank--for all their hard work and dedication in producing this year's *Report*.

Finally, I want to thank the staff of the Council, many of whom are here with us today. During the past several months, the staff have been working long nights and weekends to produce the *Economic Report*. And, what is truly remarkable is that they have also continued to do the other work of the Council, which does not stop just because it is time to produce the *Economic Report*. I appreciate all of their hard work, their thoughtful insights and their good spirits. Their dedication and professionalism deserve special recognition.

As you may know, the Employment Act of 1946, which created the Council of Economic Advisers, requires the President to submit an *Economic Report* to the Congress each year. This Act, together with its later amendments, gave the Federal government responsibility for stabilizing short-run economic fluctuations, promoting balanced and noninflationary economic growth, and fostering low unemployment. One purpose of the *Economic Report* is to tell Congress whether we have met those responsibilities. I am happy to say, in this the fifty-third

year after the Act, that the state of the economy is truly extraordinary. Last year was a year for baseball home-run records, and it was also a year for economic records as we achieved the longest peacetime economic expansion on record—and the records go back to 1854. In fact, that's why we chose a red cover for this year's *Economic Report* -- to symbolize our Nation's "red hot economy."

I will elaborate on this point in a moment, but I would like to note that the *Report of the Council of Economic Advisers* has also traditionally been a vehicle for presenting analyses of a broad range of current economic policy issues. This year, in addition to a chapter on macroeconomic policy and performance, the Report contains a chapter on the benefits of a strong labor market and one on work, retirement, and the economic well-being of the elderly. This year's microeconomics chapter focuses on regulation and innovation. It examines this Administration's efforts in three areas—antitrust, the environment, and electric power restructuring—to ensure that regulation not only does not interfere with innovation, but indeed fosters beneficial technological change and adapts itself to such change as well. Finally, the Report devotes two chapters to the crisis in the international economy. The first analyzes capital flows in the global economy and discusses both the emergence of the crisis and policy responses to the crisis. The second focuses on the evolution and reform of the international monetary system with an eye to understanding how such crises can be avoided in the future.

In the remainder of my remarks I will touch briefly on the current state of the economy and the characteristics of this expansion. Then I want to discuss three themes: 1) the benefits of the strong economy and a strong labor market—especially for groups that had not seen much economic progress for a long time; 2) the importance of fiscal discipline in preparing our nation for the

seismic demographic shift which is underway; and 3) the importance of addressing challenges in the world economy in a way that preserves the benefits of outward-looking trade and investment policies.

STATE OF THE ECONOMY

Our Nation's economy is the strongest it has been in a generation. In 1998, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent. Nonagricultural jobs increased by about 2.9 million during the year, and the average unemployment rate for the year dropped to 4.5 percent, its lowest level since 1969. The consumer price index rose by only 1.6 percent, its smallest increase since 1964, and other measures of inflation were even more muted.

As you all know, this year the Federal budget moved strongly into surplus. In the 1992 fiscal year the budget deficit was \$290 billion and expected to rise further with no change in policy. But beginning in 1993, the deficit began to decline steadily as a consequence of a shift to fiscal discipline. In 1998, the budget *surplus* was \$69 billion, the largest surplus as a share of GDP since 1957, and surpluses are projected well into the future: the Administration now projects surpluses in the unified Federal budget amounting to about \$4.5 trillion over the next 15 years. I will return to the budget and the use of those surpluses to address demographic challenges in a few minutes.

The current economic expansion is only the third on record that has lasted at least 7 years and this year's report puts the expansion in its historical context by comparing it with the other two long expansions--the 106-month long expansion of the 1960s (the longest in peace or war) and the 92-month long expansion of the 1980s. Judged in terms of overall economic performance this expansion has been not only long but excellent--especially with respect to

inflation and unemployment. By this time in the expansion of the 1960s, for example, inflation was rising sharply and was much higher than now, at about 5%. In the 80s expansion, inflation was also rising at this stage and had reached 5%. By contrast, inflation now is much lower and has been coming down. Since the need to combat high or rising inflation is what typically brings an expansion to an end, this greatly raises the prospects for a continuing expansion. The combination of low inflation and low unemployment is particularly remarkable and shatters long held views and simple textbook theories about the possibility of combining low unemployment and inflation. In fact, the misery index, which is the sum of inflation and unemployment, is lower at this stage of the current expansion than in either the expansion of the 60s or the 80s.

This is also an expansion which is investment-driven--to a far greater extent than in either of the other two long expansions. This investment contributes to future growth and is working to hold inflation down. Of course, it didn't occur by accident --it's the consequence of fiscal discipline and reflects a conscious choice to shift the policy mix toward a tighter fiscal policy coupled with a lower interest rate, accommodative monetary policy to stimulate investment and spur economic growth.

The continuing strong economic performance in 1998 is all the more remarkable because it took place at a time of considerable stress to the world economy. While the international environment remains exceptionally risky, the U.S. economy has entered 1999 on course to continue growing and the chances are good that next year at this time we will be on the verge of marking the longest economic expansion—whether in peace or war—ever.

THE BENEFITS OF A STRONG LABOR MARKET

The Clinton Administration laid a strong policy foundation for growth in 1993 when the President put in place an economic strategy grounded in deficit reduction, targeted investments, and opening markets abroad. These were not only the right policies to stimulate the job creation needed to move the economy to full employment. They were also the right policies for attacking the longer term problems of sluggish productivity and outright real wage declines for lower wage workers that had afflicted our nation's economy since the early 1970s. I am happy to say that in this year's *Report* we are able to present some encouraging evidence of improvements for low-wage and minority workers associated with the strong labor market created in this expansion.

It was once commonly accepted that an economic expansion is a rising tide that lifts all boats, so that the most surefire way to alleviate poverty and help disadvantaged groups was to keep the economy expanding. However, in the late 1970s, a new, long-term trend toward widening inequality began to afflict the economy, most likely as a consequence of pervasive technological changes raising the demand for skilled labor and lowering the demand for unskilled workers. In addition, productivity growth declined substantially, for reasons that are still not well understood. During the expansion of the 1980's, real wages declined, particularly among less skilled men. During the current expansion, we saw real wages stagnate for the first five years of the expansion. However, this has finally become an expansion in which a rising tide is lifting all boats. American workers are enjoying direct and measurable progress and in the *Report*, we describe the CEA's analysis of real wage growth. Let me talk briefly about some of these findings:

Wage growth has been particularly strong for historically disadvantaged groups. After years of decline, the real wages of black men began to increase in 1993, and they have risen by 5.8 percent in the last 2 years (since 1996). Black women and Hispanic men and women have also experienced recent gains. The tight labor market of the 1990s appears to be helping even young minority workers, who suffered greater wage declines than others in the 1980s. In 1998 alone, the real wages of young black men aged 16-24 rose by 6.2 percent.

It is well known that less-skilled men have experienced long-term wage decline since the later 1970s. In 1998, real wages among men aged 20 and over who are high school dropouts rose by 7 percent. This was the first time since at least 1979 that their wages rose. In addition, real hourly wages for men at the 10th and 20th percentiles of the earnings distribution rose 6 percent since 1993.

Immigrants, too, are earning more. Mexican- and Central American-born immigrants -- who account for about 30 percent of new immigrants since 1980 -- have had real wage growth since 1995 of almost 7 percent for men and almost 4 percent for women.

It is too early to declare victory in reversing adverse long-term trends in wages for less skilled workers. In particular, it remains hard to know how much of this turnaround is due to particularly favorable business cycle conditions. Nor is this Administration taking the improvements for granted. First, it is committed to maintaining the macroeconomic stability that is a necessary condition for ensuring that all Americans participate in the country's growing prosperity. Second, the Administration continues to stress the importance of education and training policies that address the challenges of a changing economy and a changing society.

MAINTAINING FISCAL DISCIPLINE

Although our economy is strong and Americans are working in record numbers our Nation still faces other, broader challenges as we move into the 21st century.

One of the key challenges we face is to prepare our nation to meet the needs of an aging population. The ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling. The same demographic effects that have impaired the finances of Social Security also impact Medicare and Medicaid.

As you know, in his State of the Union the President proposed a plan for how to use the currently projected unified budget surpluses and how to address the financial imbalance of the Social Security system. He proposed devoting 62% of the surpluses over the next 15 years--about \$2.8 trillion with a small portion, about 1/4, devoted to equity purchases--to extend the solvency of the Social security system until 2055. Further reforms would be needed to achieve full 75 year actuarial balance, which is the most commonly used measure of financial soundness. Assuming that a solution for social security can be achieved, the President has also proposed using 15% of the projected surpluses for Medicare, ensuring the Medicare Trust Fund is secure for another 20 years. The President has emphasized the need to utilize the extra funding as part of a broad effort to strengthen the Medicare program. He also proposed creating a new system of universal savings accounts (USA Accounts) outside of Social Security with 12 percent of the surplus to help working Americans build wealth to meet their retirement needs--a way of strengthening the current pension system and helping Americans save. The government would provide an equal dollar contribution for most working individuals and provide matches for individual contributions with larger matches going to lower income workers. Finally, the President would reserve 11 percent of the projected surpluses for military readiness and

education and research.

Rather than commenting in detail on the President's Social Security plan, let me talk about the overall macroeconomic impact of this plan. For the nation as a whole, the central problem in coping with an aging population is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute. National saving increased from 3.1 percent of gross domestic product in 1992 to 6.7 percent in the first three quarters of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output with the personal saving rate hitting zero in the last quarter of the year. The framework offered by the President for the use of emerging budget surpluses would dramatically increase national saving. Evaluated from a macroeconomic perspective--from the perspective of national savings--this plan saves, in essence, between 77 and 89 percent of the projected surpluses, depending on one's evaluation of the saving impact of the USA accounts. The transfers to Social Security and Medicare amount to 77 percent of the federal budget and about 2 percent of GDP, and they are pure additions to national saving. The USA accounts amount to 12 percent of the unified budget surpluses and could be viewed as a tax cut that is highly likely to add to personal saving. Only 11 percent of the surpluses are devoted to additional government spending.

Dedicating the surpluses to Social Security and Medicare serves two purposes. First, it helps to lock in the surpluses so they are not used for tax cuts or wasteful spending. Second, it gives these critical programs a “first call” on the benefits of our fiscal discipline. And these benefits will be large.

This is a fiscally conservative, pro-growth plan that comes close in its macroeconomic impact to a plan of simply paying off debt. Publicly held debt is projected to fall from 44 percent of GDP today to about 7 percent in 2014. That would represent the smallest burden of government debt on the economy since the United States entered World War I in 1917. In addition, some of the surpluses will be used to purchase equities, which will represent an asset of the government. The dramatic decline in national debt would increase private capital investment, keep interest rates low or drive them lower, raise future national income, free up government resources by reducing debt servicing costs and fuel economic growth.

MEETING THE INTERNATIONAL CHALLENGE

I would like to say a few words about the challenges we face on the international economic front. The last year has been an extraordinarily tumultuous one for the world economy. As you know, what seemed like currency crisis confined to developing Southeast Asia in the summer of 1997, erupted during 1998 into a deep, global economic crisis.

A third of all world economies were in recession or experiencing markedly slower growth by late 1998. World economic growth is estimated by the International Monetary Fund (IMF) at only 2.2 percent in 1998 and is projected to remain at this low level in 1999, after robust growth of 4.2 percent in 1997. Projected world growth has almost declined to levels registered during the pronounced world slowdowns of 1974–75, 1980–83, and 1990–91. Japan’s hopes

for recovery from a long-standing slump have been dashed. And the U.S. and other industrial countries have not escaped without impacts. In particular, our trade deficit has burgeoned, with our exports falling absolutely in real terms as a consequence of reduced demand from impacted Asian economies. Manufacturing industries have been particularly impacted.

The Administration clearly recognizes that, at this time of economic fragility in so many regions, we must not build new walls of protectionism, that could set off a dangerous chain reaction around the world, imperilling the world's prospects for growth. As the crisis economies recover, their demand for U.S. goods and services will increase as well, once again fueling our own export growth. Instead, we must push to expand trade and open markets.

Beyond keeping markets open, the United States has been focused since the outset of the crisis on the need to take steps to spur growth throughout the industrial world, and to contain the crisis through IMF-lending cum reform programs in crisis countries. We have recognized the need to enhance the IMF's ability to lend by providing precautionary credit lines to countries that have implemented serious reform programs but are nevertheless threatened by capital outflows; And we are focused on the importance of alleviating suffering in crisis-afflicted countries through safety net spending and also through lending to help countries recapitalize their banking systems and emerge from debt.

Over the longer term, the Administration believes that a serious program of reform is needed to strengthen the international financial system to make it less crisis prone and to improve the mechanisms available for dealing with any crises that may nevertheless occur.

Unfortunately, it turns out that there is just no silver bullet--no simple solution that would

guarantee countries the benefits of global capital flows while eliminating the risk that a crisis of confidence could once again result in the painful withdrawal of that access. Even so, international agreement is finally emerging on the steps that can and should be taken to strengthen the architecture of the financial system so that it is less crisis-prone going forward. Last fall, the central bank governors and finance ministers from a group of industrial and key emerging market countries, informally dubbed the G-22, formed three working groups, which issued reports on aspects of international financial reform. One report focuses on measures to increase transparency and accountability in the operations of individual countries, of financial and corporate institutions and of the international financial institutions themselves. The purpose is to enhance the availability, relevance and reliability of information available for evaluating risk in lending. A second working group proposed a series of reforms to strengthen banks and other domestic financial institutions: improvements in prudential supervision and regulation are particularly needed in order to create stronger incentives for borrowers and lenders to weigh risk and act with appropriate discipline, thereby reducing the odds of a crisis. A final report sought to identify policies to make the system less crisis prone--for example, through reducing implicit and explicit government guarantees which create moral hazard and exacerbate risktaking. For example, deposit insurance, the implicit promise of bailouts of corporations considered too big to fail, and semi-fixed exchange rate regimes which reduced the perceived riskiness of foreign currency exposure--all increased the exposure of crisis countries and created fragility. Finally, the reports identify policies that could improve creditor coordination in crises and promote the orderly, cooperative and equitable resolution of international financial crises that may occur in the future. The United States is working intensively with key emerging markets, other

industrialized nations, and the relevant international organizations, to put in place the building blocks of this new architecture to ensure that the unprecedented growth, increase in welfare and opportunity experienced in the 50 years after the creation of the Bretton Woods system are maintained in the future.

CONCLUSION

Let me conclude by saying that over the past year the performance of the U.S. economy has been extraordinary: strong growth and low unemployment combined with low and stable inflation. And there are enormous social and economic benefits to our high-employment economy. But that success--and the economy's present strength--cannot be taken for granted. Moreover, there are still long-term changes and challenges facing our nation as we enter the 21st Century. The Clinton Administration has an agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era. We must preserve our hard-won fiscal discipline while investing in people and opening markets at home and abroad. At the same time, we must ensure that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.

STATEMENT OF JANET YELLEN

Release of the 1999 *Economic Report of the President*

Thank you. Today we released the 1999 *Economic Report of the President*. Each year, one of the most closely watched aspects of the Report's release is the color of the cover. And, as you know, this is not the budget document -- which of course was black this year to symbolize our Nation's budget surpluses. No, instead, this document is a report on the state of the economy --- and this year our economy is "red hot." So, that is why we chose a red cover -- red to symbolize our Nation's "red hot economy."

In any case, as you all know, the President is required to submit to Congress each year a Report that describes the state of the US economy. The report also traditionally presents a broad range of analyses of current economic policy issues. This year, in addition to the discussion of the state of the US economy, the report looks at a range of other issues -- the aging of the American population, regulation and innovation, and the recent international financial turmoil. But, one of the most important highlights of this year's Report is a discussion of the direct and measurable benefits that American workers are enjoying from our strong and healthy economy. And, because this section includes some new work done by the CEA on recent wage growth, I'd like to focus your attention on that aspect of the report.

STATE OF THE ECONOMY

But, first let me make a couple of comments about the state of our economy. Our Nation's economy is the strongest it has been in a generation. In 1998, growth was strong and job creation was vigorous while inflation declined. Real GDP grew 3.9 percent. Nonagricultural jobs increased by about 2.9 million during the year, and the average unemployment rate for the

year dropped to 4.5 percent, its lowest level since 1969. The consumer price index rose by only 1.6 percent, its smallest increase since 1964, and other measures of inflation were even more muted. And, as you all know, this year the Federal budget moved strongly into surplus and those surpluses are projected well into the future.

The continuing strong economic performance in 1998 is all the more remarkable because it took place at a time of considerable stress to the world economy. While the international environment remains exceptionally risky, the U.S. economy has entered 1999 on course to continue growing -- and the chances are good that next year at this time we will be on the verge of marking the longest economic expansion ever.

THE BENEFITS TO AMERICAN WORKERS OF A STRONG ECONOMY

Because of our Nation's strong and healthy economy, American workers are enjoying direct and measurable progress. As I said earlier, for this year's Report, the CEA conducted an analysis of recent real wage growth -- and we found that wage growth has been particularly strong for historically disadvantaged groups.

- * After years of decline, the real wages of black men began to increase in 1993, and they have risen by 5.8 percent in the last 2 years (since 1996) -- which is truly an impressive increase. Black women and Hispanic men and women have also experienced recent gains.

- * Our tight labor market also appears to be helping even young minority workers, who suffered greater wage declines than others during the 1980s. In 1998 alone, the real wages of young black men aged 16-24 rose by 6.2 percent.

* Less-skilled men -- who have experienced a long-term wage decline since the late 1970s -- also are experiencing impressive gains. In 1998, real wages among men aged 20 and over who are high school dropouts rose by 7 percent. This was the first time since at least 1979 that their wages rose. In addition, real hourly wages for men at the tenth and 20th deciles of the earnings distribution rose 6 percent since 1993.

* Immigrants, too, are earning more. Mexican- and Central American-born immigrants -- who account for about 30 percent of new immigrants since 1980 -- have had real wage growth since 1995 of almost 7 percent for men and almost 4 percent for women.

These are truly impressive gains for historically disadvantaged groups.

CONCLUSION

There are a number of other issues in the report that I could discuss -- but let me stop there and just conclude by saying that over the past year the performance of the U.S. economy has been excellent. We have enjoyed solid growth, strong job creation, low unemployment and low and stable inflation. And there are broad and lasting benefits that American workers are enjoying as a result of this strong economy -- particularly for historically disadvantaged groups, who have seen impressive wage gains in recent years. There are still long-term challenges facing our nation as we enter the 21st Century. And, President Clinton has presented a broad agenda for helping to equip the American people with the skills and flexibility and security to take advantages of the opportunities and possibilities in this new economic era.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 5-FEB-1999 09:03:17.00

SUBJECT: SPR - Urgent

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:

Janet and Jeff: OMB wants to make an argument on energy security grounds for the SPR increase (see below). If there ever was an argument for energy security, it certainly does not hold at present with low oil prices and with virtually all imports from friendly countries (mostly outside the Middle East). My recommendation is not to make an energy security argument -- it is bad on the merits and makes it easier for DOE to come back for further requests in the future.

Let me know how you would like me to handle this and I will get back to Ron. Steve

----- Forwarded by Alan S. Polasky/CEA/EOP on 02/05/99
08:57 AM -----

Ronald Minsk
02/05/99 08:43:45 AM
Record Type: Record

To: ROBERT.CUMBY @ MS01.DO.treas.sprint.com @ inet, Alan S. Polasky/CEA/EOP
cc:
Subject: SPR - Urgent

OMB wants to allow DOE to characterize the SPR purchase as enhancing the nation's energy security.

OMB notes that this Administration's energy policy has repeatedly identified the SPR as a key component of our emergency response capability, and that although it strongly agrees that DOE should not say anything to suggest that this program is aimed at propping up producer prices, we should let them take credit for the program in some context. When we sold SPR oil (twice) for budget purposes, the Administration was criticized by energy policy types. Now that we are doing the right thing by replacing what we took out, OMB believes that we should be able to talk about how the action demonstrates our commitment to this 25-year, bi-partisan mainstay of national energy policy, not hide from it.

Please let me know if this is acceptable to your agencies ASAP. Call me at 456-2809 or page me at 757-5000 if I am not at my desk.

Thanks!

Ron

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 5-FEB-1999 11:50:05.00

SUBJECT:

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Janet: Larry Summers said that he could live with energy security - but would draw the line on helping the oil industry (which has been ruled as being off the table). I relayed a message to Ron Minsk that we would not fight adding energy security to the justification. The SPR addition will probably move quite quickly - DOE is quite anxious to announce it. Steve

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ryan D. Edwards (CN=Ryan D. Edwards/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-FEB-1999 13:25:43.00

SUBJECT: Bob Lawrence info for OECD

TO: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Lisa D. Branch (CN=Lisa D. Branch/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:

Hi Janet and Becky,

Stan Otto was inquiring about Bob Lawrence today, and at some point we'll need to inform the State Department and the Mission as to his name, rank, and serial number, etc. etc. I'm assuming he'll attend the WP-3 on March 9th.

Lisa expressed to me the idea that perhaps you might want to draft a brief letter to the Mission concerning Jeff's leaving and Bob's status. If you'd like me to help out in any way, just let me know.

Best,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Howard A. Shelanski (CN=Howard A. Shelanski/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-FEB-1999 13:31:02.00

SUBJECT: remarks

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D57]MAIL49128324P.036 to ASCII,
The following is a HEX DUMP:

Remarks of CEA Chair Janet Yellen

I am pleased to release the Council of Economic Advisers' progress report on growth in the telecommunications industry from 1993 to 1998.

Our report is meant to provide an overview -- to take stock of developments to date -- rather than to analyze the economic issues underlying current regulatory proceedings or specific legislative proposals.

The evidence reviewed demonstrates that the telecommunications industry has grown significantly since 1993, creating hundreds of thousands of new jobs, bringing entry by hundreds of new firms, and providing an expanding range of innovative services to consumers. It has contributed substantially to the growth of our national economy, now in the longest peacetime expansion on record.

As Secretary Daley has shown in his remarks, American consumers have benefitted from the growth of competition and innovation in different sectors of the telecommunications market. Across the board, the market today is bigger and has more options for consumers than the market of 5 years ago, and has borne out the predictions about industry growth made at the time Vice President Gore announced the National Information Infrastructure Initiative in 1993. Looking at the industry sector by sector, the data show areas of established success and areas where competition is still developing. The wireless, long-distance, and equipment markets have seen the development of substantial competition, with more services and products becoming available to consumers at lower prices.

The telecommunications industry has also met the challenge of providing advanced infrastructure for the information sector. The interdependence of telecommunications and information services is only increasing as more Americans from an increasing range of

educational and economic backgrounds use the Internet. As telecommunications competition has grown, so too has the range of services that will allow consumers to access information more quickly and effectively from their computers, promising significant educational and commercial benefits

The market for residential, local telecommunications services is one area in which competition is just beginning. Some delays in opening local markets have been due to recently resolved litigation. But in addition, the history of competition in other sectors, notably long-distance, shows that entry can take time for economic reasons. This is particularly true in a market, like the market for local, residential services, where regulation and the underlying economics may skew competitors' incentives toward the business market and away from residential customers. But entry is nonetheless occurring, as Secretary Daley described. And, while more remains to be done for competition to occur in parts of the local market, the lesson from markets with a longer history of entry is that, with time and opportunity, competition can flourish and produce the expected benefits.

To be sure, there remain important challenges for telecommunications policy to address – for example, ensuring that competition develops further and that regulation adapts as technology and markets change. But our progress report finds that, by any fair measure, the development of the telecommunications market in the United States must be considered a success. This success provides no basis for complacency, but neither do remaining challenges provide a reason to change the current regulatory approach. Instead, both are strong reasons to adhere more strongly to the underlying principle of open competition that is bringing great economic benefits to American workers, consumers, and businesses, and to make sure that competition has the opportunity to develop in markets where it so far has been unable to do so.

Thank you. And as the Department of Commerce is the Administration's official advisor on telecommunications policy, I will defer your questions to Secretary Daley or to Assistant Secretary Larry Irving.

Withdrawal/Redaction Marker

Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
002. email	Michele Jolin to Janet L. Yellen at 08:56:47.00. Subject: 2 things. (partial) (1 page)	02/09/1999	b(6)

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
CEA ([Yellen])
OA/Box Number: 950000

FOLDER TITLE:

[02/02/1999 - 02/15/1999]

2013-0723-F
ab1294

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-FEB-1999 08:56:47.00

SUBJECT: 2 things

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

1) Cheryl Sandburg, who is Larry Summers assistant, will get the op-ed to me as soon as their press folks are done with it. I will check with her this morning to see where they are.

2)  (b)(6)
 (b)(6)

[002]

Thanks
Michele

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-FEB-1999 09:05:47.00

SUBJECT: Re: Carol Parry/Fed

TO: Jonathan Orszag (CN=Jonathan Orszag/OU=OPD/O=EOP @ EOP [OPD])

READ:UNKNOWN

TEXT:

Upon further reflection, I think we should proceed to nominate Carol Parry for the Fed position. I gather that she is very interested and would like some feedback on whether we remain interested in her. I would suggest that you discuss this with Gene and see if he is willing to proceed.

Withdrawal/Redaction Marker

Clinton Library

DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
003. email	Douglas W. Elmendorf to Jeff Liebman and Janet L. Yellen at 15:54:46.00. Subject: today's Social Security hearing. (partial) (1 page)	02/09/1999	b(6)

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
CEA ([Yellen])
OA/Box Number: 950000

FOLDER TITLE:

[02/02/1999 - 02/15/1999]

2013-0723-F
ab1294

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

Freedom of Information Act - [5 U.S.C. 552(b)]

P1 National Security Classified Information [(a)(1) of the PRA]
P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
P3 Release would violate a Federal statute [(a)(3) of the PRA]
P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

C. Closed in accordance with restrictions contained in donor's deed of gift.

PRM. Personal record misfile defined in accordance with 44 U.S.C. 2201(3).

RR. Document will be reviewed upon request.

b(1) National security classified information [(b)(1) of the FOIA]
b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-FEB-1999 15:54:46.00

SUBJECT: today's Social Security hearing

TO: Jeff B. Liebman (CN=Jeff B. Liebman/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])
READ:UNKNOWN

TEXT:

According to Louise Sheiner:

[003]

1. Robert Walker (b)(6) emphasized two misleading points in his testimony:

- a. Total debt (aka debt subject to limit) is increased under the plan.
- b. The SS system has not really been reformed since the 2013 date is unmoved.

These arguments aren't a surprise, but Walker apparently found a receptive audience to them, and we should decide how to spread the correct explanation.

2. Bob Greenstein said that real reform is needed, and proposed that transfers should only occur to the extent they are matched by structural reforms dollar for dollar. Can this be written into legislation? Given the renewed emphasis on real reform, can we afford not to have a strong version included in our legislation?

Doug

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: DAVID.FISCHER@MS01.DO.treas.sprint.com@INET@LNGTWY (DAVID.FISCHER@MS01.DO.treas.sprint.com@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME: 9-FEB-1999 19:00:37.00

SUBJECT: draft op-ed

TO: Janet L. Yellen@eop (Janet L. Yellen@eop [CEA])
READ:UNKNOWN

TO: Alice H. Williams@eop (Alice H. Williams@eop [CEA])
READ:UNKNOWN

TEXT:

Date: 02/09/1999 06:39 pm (Tuesday)

From: David Fischer

To: janet, , EX.MAIL."douglas_w._elmendorf@cea.eop.gov",
EX.MAIL."williams_a@a1.eop.gov"

Subject: draft op-ed

Here's the latest. I'm also faxing a copy.

David Fischer

622-2004===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D78]MAIL45230834X.036 to ASCII,
The following is a HEX DUMP:

DRAFT

February 9, 6:00 p.m.

The Social Security reform plan that President Clinton proposed in his State of the Union address last month will provide financial security to future generations of retirees and strengthen our nation's economy. Having charted a course of fiscal responsibility and economic prosperity over the past six years, the President is now recommending that we put the budget surpluses that have resulted from this record to the best possible use by shoring up Social Security well into the next century.

According to the Office of Management and Budget's latest projections, the federal government will accumulate \$4.8 trillion in surpluses over the coming decade. The President's budget proposal devotes 62 percent of these surpluses to the Social Security system; 15 percent to Medicare; 12 percent towards the creation of retirement savings accounts for American workers; and the remaining 11 percent for defense and other high priority investments. Of the roughly \$2.8 trillion in surpluses that will go to Social Security, one-fifth will be invested in a broad-based basket of private-sector equities, providing a higher rate of return for the program's investments. The remaining four-fifths will be used to purchase Treasury securities -- the same securities that the Social Security system has invested in since its inception.

Together, the transfer of new monies into the Social Security Trust Fund and the investment in equities will solve more than half of the long-term funding shortage that Social Security faces today, extending its solvency to 2055. In order to close the remainder of this gap,

the President has further called for a bipartisan process to make the tough choices that will be necessary to put Social Security on sound financial footing.

Since the President's speech, some analysts have called for larger transfers to the Social Security Trust Fund in order to achieve long-term actuarial balance without any structural reform; other analysts have argued for smaller transfers and more emphasis on structural changes in the program. We believe that the President has struck an appropriate balance. Avoiding structural reforms in Social Security altogether would require too large a commitment of funds for which there are other pressing national needs, such as Medicare and military readiness. At the same time, resolving the entire Social Security problem through changes in benefits and payroll taxes is unnecessary in an era of projected surpluses.

A defining characteristic of the President's proposal is that it would result in a substantial reduction of the national debt. Indeed, according to current projections, the government would pay off all debt held by the public by 2018. When President Clinton took office, federal debt held by the public amounted to 50 percent of GDP — twice as high as it had been 12 years earlier. Now we have the prospect not only of reversing the damage that was done during the 1980s, but also of wiping out all debt obligations accumulated since 18xx, the last time the federal government was free of debt.

Interest expenses currently account for a full 15 percent of total federal spending. The reduction — and eventual elimination — of these payments will create new capacity for the

nation to meet our obligations to tomorrow's retirees. Moreover, the dramatic reduction in government debt will boost our national saving rate — a critical need as we prepare the country to withstand the coming demographic tidal wave — thereby making room in private portfolios to hold productive capital rather than government paper. That, in turn, will reduce interest rates and bolster confidence in the economy, increasing economic growth, job creation and standards of living. As Federal Reserve Chairman Alan Greenspan told Congress last month: "If we allow these surpluses to run, we are reducing the national debt — the public debt — and that is a very important element in sustaining economic growth."

In essence, the President proposes to use the Social Security and Medicare Trust Funds as "lock-boxes" — in other words, as a way of insuring that the surpluses are not drained for other purposes. This approach has two key virtues: First, it will greatly increase the probability that these projected surpluses will materialize. Second, it will strengthen the capacity of these two vital programs to meet their current obligations to beneficiaries.

Since the President put his plan forward, a number of important questions have been raised:

Is the President's budget based on sound accounting? Absolutely. This plan reserves the great preponderance of the surpluses for Social Security, insuring that they are not used for other purposes. As we have explained, using these surpluses to reduce the debt saves the government money on interest payments, just as a family that pays off its outstanding credit card

debt is able to eliminate costly monthly finance charges. The benefits owed to retirees does not change regardless of what steps the government takes; they are due their Social Security payments in any case. What does change through the reduction of the federal debt is the cost to the government of servicing its outstanding loans, freeing up the funds that the Social Security system will need in the future.

Can we have confidence that government investment in equities will be invested in a neutral, non-intrusive way? The Administration takes concerns on this topic seriously, which is why we have proposed a framework that would isolate these private-sector equities from political pressures. Under the President's plan, an apolitical, independent board would select private sector investment managers through competitive bidders. Furthermore, investments would be limited to broad-based index funds, eliminating the possibility of individual stock picking or market timing concerns. Finally, our proposal limits the share of Trust Fund assets that could be invested, so as to insure that these funds never account for more than a small fraction of the stock market.

How would the rate of return of the President's plan compare to a system of individual accounts? We believe that this structure will allow the Social Security Trust Fund to earn higher returns than under a system of individual accounts, while imposing less risk on retirees. Individual investors as a group cannot earn a higher return on equities than the market average, which is the return that the Trust Fund would earn. As for risk, a prudent amount of equity investment through the Trust Fund would allow financial risk to be spread both across the

population at a point in time and across generation, in contrast to the focusing of risk through individual accounts. In addition, international experience and domestic evidence amply demonstrate that the administrative costs of managing individual accounts would dwarf the costs of running a single large fund.

A great debate is now underway in Washington and throughout the country: How should we use the government surpluses now on the horizon? The Republicans have an answer — a 10 percent across-the-board tax cut that would favor the rich while providing no benefit to 43 million (CK with tax policy) Americans, while costing the government \$1.5 trillion over the next 15 years. President Clinton has a different answer: He would dedicate the great preponderance of the surpluses to investing for the future in order to grow the economy and prepare the country for the demographic challenges of the 21st century.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-FEB-1999 19:21:53.00

SUBJECT: Re: 2 things

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Sounds good to me.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Ryan D. Edwards (CN=Ryan D. Edwards/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-FEB-1999 13:35:49.00

SUBJECT: LTCM contact info?

TO: Alice H. Williams (CN=Alice H. Williams/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Hi Janet and Alice,

Do we have contact information for Long-Term Capital Management? Doug and Chad would like to include a round-up piece in the WEB this week on recent events, based on a news article I'd like to confirm.

Thanks,

-Ryan

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-FEB-1999 14:40:04.00

SUBJECT: new version

TO: kdynan (kdynan @ frb.gov @ inet [UNKNOWN])

READ:UNKNOWN

TEXT:

----- Forwarded by Janet L. Yellen/CEA/EOP on 02/10/99
02:39 PM -----

DAVID.FISCHER @ MS01.DO.treas.sprint.com

02/10/99 01:06:00 PM

Record Type: Record

To: Michele Jolin, Janet L. Yellen

cc:

Subject: new version

Date: 02/10/1999 01:01 pm (Wednesday)

From: David Fischer

To: janet, elmendor, michelej

Subject: new version

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D39]MAIL43332744U.036 to ASCII,
The following is a HEX DUMP:

DRAFT

February 10, 9:00 a.m.

The Social Security reform plan that President Clinton proposed in his State of the Union address last month will provide financial security to future generations of retirees and strengthen our nation's economy. Having charted a course of fiscal responsibility and economic prosperity over the past six years, the President is now recommending that we put the resulting budget surpluses to the best possible use by extending the guarantee of the Social Security system well into the next century.

According to the Office of Management and Budget's latest projections, the federal government will accumulate \$4.5 trillion in surpluses over the next 15 years. The President's budget proposal devotes 62 percent of these surpluses to the Social Security system; 15 percent to Medicare; 12 percent towards the creation of retirement savings accounts for American workers; and the remaining 11 percent for defense and other high priority investments.

Of the roughly \$2.8 trillion in surpluses that will go to Social Security, four-fifths will be used to purchase Treasury securities — the same securities that the Social Security system has invested in since its inception. The remaining one-fifth will be invested in an index of private-sector equities, which should yield a higher rate of return for the program's investments.

Together, the transfer of new monies into the Social Security Trust Fund and the

investment in equities will solve more than half of the long-term funding shortage that Social Security faces today, extending its solvency to 2055. In order to close the remainder of this gap, the President has further called for a bipartisan process to make the tough choices that will be necessary to put Social Security on sound financial footing.

The transfers to Medicare will extend the life of that trust fund by 12 years to 2020. Further reforms of that program will also be needed. As part of this process, the President proposes the addition of a prescription drug benefit to Medicare — an essential missing ingredient in today's package of benefits provided by the program.

In essence, the President proposes to use the Social Security and Medicare Trust Funds to lock away the surpluses and ensure that they are not drained for other purposes. This approach has two key virtues: First, it will greatly increase the probability that these projected surpluses will materialize. Second, it will strengthen the capacity of these two vital programs to meet their current obligations to beneficiaries.

Since the President's speech, some analysts have argued for smaller transfers to the Social Security Trust Fund and more emphasis on structural changes in the program. But resolving the entire Social Security problem through changes in benefits and payroll taxes is unnecessary in an era of projected surpluses. Other analysts have called for larger transfers in order to achieve long-term actuarial balance without any structural reform. However, avoiding structural reforms in Social Security altogether would require too large a commitment of funds for which there are

other pressing national needs, such as Medicare, education, and military readiness. We believe that the President has struck an appropriate balance by incorporating both the surpluses and future structural reforms. As he said in the State of the Union address, we must commit to a bipartisan effort to make these “difficult but fully achievable choices over and above the dedication of the surplus.”

A defining characteristic of the President’s proposal is that it would result in a substantial reduction of the national debt. Indeed, according to current projections, the government would pay off all debt held by the public by 2018. When President Clinton took office, federal debt held by the public amounted to 50 percent of GDP — twice as high as it had been 12 years earlier. Now we have the prospect of reversing the damage that was done during the 1980s.

Interest expenses on the federal debt currently amount to nearly 3 percent of GDP and account for a full 15 percent of total federal spending. The reduction — and eventual elimination — of these payments will create new capacity for the government to meet its obligations to tomorrow’s retirees. Indeed, even as Social Security expenses rise during the next century, the reduction in interest expense will be more than enough to offset this obligation at least through the first half of the next century. Moreover, the dramatic reduction in government debt will make room in private portfolios to hold productive capital rather than government paper. The substantial boost to our national saving rate — a critical need as we prepare the country to withstand the coming demographic tidal wave — will reduce interest rates and raise productivity, incomes, and standards of living. As Federal Reserve Chairman Alan Greenspan

told Congress last month: “If we allow these surpluses to run, we are reducing the national debt — the public debt — and that is a very important element in sustaining economic growth.”

Since the President put his plan forward, a number of important questions have been raised:

Is the President's budget based on sound accounting? Absolutely. This plan reserves the great preponderance of the surpluses for Social Security, insuring that they are not used for other purposes. As we have explained, using these surpluses to reduce the debt saves the government money on interest payments, just as a family that pays off its outstanding credit card debt is able to eliminate costly monthly finance charges. In paying down the debt, we create the fiscal capacity to meet our existing obligations to pay Social Security benefits. By placing Treasury securities in the Trust Fund, we insure that Social Security receives the first claim on the benefits that we will achieve through debt reduction — so that we meet our existing obligations before developing any new uses for these funds.

Can we have confidence that government holding of equities will be invested in a neutral, non-intrusive way? The Administration takes concerns on this topic seriously, which is why we have proposed a framework that would isolate these equities from political pressures. Under the President's plan, an apolitical, independent board would select private sector investment managers through a competitive bidding process. Investments would be limited to broad-based index funds, eliminating the possibility of individual stock picking or market timing concerns.

In addition, our proposal limits the share of Trust Fund assets that could be invested in equities, so as to insure that these funds never account for more than a small fraction of the stock market.

Would workers receive as high a rate of return on the equity investments under the President's plan as they would under a system of individual accounts? In fact, the rate of return would be *higher* under the President's plan, because the costs of investing on a consolidated basis — via the Social Security Trust Fund — are vastly lower than the costs of investing on an individual basis. International experience amply demonstrates this fact. In England, whose retirement system allows investments to be made on an individual rather than consolidated basis, a recent study has shown that transaction costs drain off 25 percent of account accumulations over the lifetime of a typical worker. In contrast, the costs associated with consolidated investment would absorb about one-quarter of one percent of account accumulations over the same length of time.

Moreover, consolidated investment imposes less risk on retirees. Consolidated investing would allow financial risk to be spread both across the population at a point in time, and across generations. A system of individual accounts, on the other hand, puts the full consequences of financial risk on each investor. Some have proposed guaranteeing a minimum rate of return on individual accounts, but such a guarantee could prove extremely expensive for the government to redeem in the event of a major market downturn.

Some who have attacked this plan most harshly had similarly strong criticisms in 1993 of President Clinton's deficit reduction plan, warning that it would drive the economy into a recession, increase the unemployment rate and reduce government revenues. As we all know,

none of these predictions came to pass. Rather, today we are enjoying the longest peacetime expansion on record, an unemployment rate that has been below 5 percent for the last 19 months and is at its lowest level in 29 years, and an outlook for budget surpluses well into the next century.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:10-FEB-1999 14:36:53.00

SUBJECT: CEA brief on economics of climate change

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

WILLIAMS_A (WILLIAMS_A @ A1 @ CD @ VAXGTWY [UNKNOWN]) (WHO)

READ:UNKNOWN

TEXT:

Janet,

I plan on basing tomorrow's GCC briefing on the file
"Framptn3.brf", which contains some additional square-bracketed parts.
(We have charts too.)

JF----- Forwarded by Jeffrey A. Frankel/CEA/EOP on
02/10/99 02:29 PM -----

Jeffrey A. Frankel

02/10/99 02:28:34 PM

Record Type: Record

To: George T. Frampton/CEQ/EOP, Sally Katzen/OPD/EOP

cc: Wesley P. Warren/CEQ/EOP

Subject: CEA brief on economics of climate change

To: George Frampton, CEQ

From: Jeff Frankel, CEA

The attached file is four pages regarding our economic analysis of climate
change policies. I expect this to be the basis of our meeting scheduled
with you for tomorrow a.m.

===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D10]MAIL402817448.036 to ASCII,

The following is a HEX DUMP:

**Brief on Economic Analysis
of Policies to Address Global Climate Change**

**Council of Economic Advisers
February 11, 1999**

The economic cost of meeting the Kyoto targets purely through domestic reductions in GHG emissions would likely be quite high. (The criterion is political willingness to accept the implied increase in energy prices.)

- The SGM model of Battelle Labs says that achieving the target of “1990 minus 7%” in carbon dioxide would result in a price of carbon of \$224/ton.
- Our modification of the SGM model to take into account flexibility among all 6 gases says that the price would be \$193. This translates into price increases of 35 % in electricity, 46 % in natural gas, 73 % in fuel oil, and 46 cents/gal. of gasoline.
- Our estimate of resource costs is \$58 billion per year. Estimates of GDP losses among different models are far more dependent on methodological and other assumptions than (even) estimates of price effects. Thus we have given primary emphasis to price effects.
- Other reputable economic models have estimates that are higher (up to \$489/ton), or in 3 cases somewhat lower (as low as \$65/ton), than the SGM model. But the average of the nine models participating in the Stanford EMF model comparison exercise is \$241/ton, very close to SGM.
- These price increases are not that large compared, e.g., to gasoline taxes in other industrialized countries, and would be favored by many economists. But the political process seems to view them as much too large.

To bring down costs further, it is critical to achieve “where flexibility”, that is, to bring about some emission reductions in other countries where opportunities are cheaper, in place of doing it all at home.

- We estimate, using SGM, that trading among all Annex I countries would reduce the permit price by about half. Other economic models have estimated savings

quite similar.

- Virtually all the emission permit purchases come from Russia and the Ukraine. Of this, more than half is “hot air,” though genuine reductions are also important.
- If the major developing countries were to be persuaded to accept targets, then global trading would reduce prices by an estimated 80-87 %, compared to the no-trading case. Other models have similar results. We have explicitly relied heavily on this case in public testimony.
- The price of carbon in this global-trading case would be \$14-23/ton. This translates into price increases of 3-4% in electricity, 3-5% in natural gas, 5-9% in fuel oil, and 3-5 cents/gal. of gasoline.
- Resource costs in this global-trading case would be \$7-12 billion, including payments to other countries. This is equal to about 0.1% of GDP in 2010.
- This low-cost case entails buying about 75-83% of emission reductions abroad, and accomplishing only 17-25% at home. While we have not emphasized these numbers in public, many on the outside have been able to infer them, and some have objected.
- If the Europeans were to succeed in their proposals to limit international trading, costs could rise sharply. Relative to global trading, for example, a limit saying that 50% of reductions must be accomplished domestically could increase permit prices by more than 250%. Relative to Annex I trading, a limit set at 10% of our allocation could more than double the permit price.

The newspapers sometimes report estimates that are much higher or much lower than those reported here. These estimates generally do not come from reputable economic models, or else are based on assumptions that do not correspond to the actual policies contemplated by the President under Kyoto.

- The range of variation in price effects estimated by economic models is primarily due to different assumptions about the extent of international trading, as we have publicly emphasized. There are also other sources of differences, such as the ease of substitution among fuel sources.

- On the one hand, economic estimates that come up with very high prices tend to do so by assuming something less than full use of the flexibility mechanisms.
- On the other hand, reported estimates that come up with zero costs -- or in some cases actually predict net benefits -- either (i) assume that tax revenues will be generated and then recycled in a pro-capital manner, (ii) make assumptions about technological progress that economists view as unrealistic, or (iii) assume that inefficient policies, such as CAFE, national building codes, and technology standards do not have any costs to society.

There are several respects in which these estimates are optimistic

- For example, they assume ratification of the Kyoto Protocol early enough for firms to begin responding soon.
- They assume that other countries agree to international trading without caps, and in our most prominent case that developing countries agree to participate fully.
- They assume efficient implementation and costless enforcement, of both targets and trading, both at home and abroad. Adoption of command-and-control techniques and standards, for example, could result in far higher costs. This is equally true, and a greater danger, in other countries.

There are five respects in which these estimates are conservative, as we have publicly emphasized.

- Federal legislation to de-regulate electricity is estimated to save an extra \$20 billion per year in costs.
- Sinks could potentially make the targets much easier to meet, depending on definitions. One estimate is that sinks could account for as much as 100 MMTCE annually during the commitment period in the United States. This would reduce the permit price in the domestic-only case by 30%, and the permit price in the Annex I trading case by 23% (assuming no other countries have sink credits). If other countries have sink credits, the permit price would fall even further.
- Ancillary economic and health benefits of higher energy prices, such as reduced

traffic congestion and cleaner air, would reduce net costs by roughly 1/4.

- None of these estimates take into account the benefits of helping mitigate the dangers of global climate change. Preventing climate change could potentially have large economic benefits (though it is impossible to estimate the probability of the disaster scenarios, the damage that would result under them, or the appropriate degree of risk-aversion and discount rate to assign). It is important to keep in mind that the Kyoto targets, even if successfully achieved, would constitute only a very small first step in reducing GHG concentrations in the atmosphere below the path they are on.
- These estimates conservatively assume that there is little payoff *by 2010* to the President's proposed \$6.3 billion in spending and tax incentives for technological innovation and diffusion. Contentiously, some "technology optimists" claim that technology will solve the problem for free, perhaps even without the government having to adopt specific policies, beyond cheerleading.

In the view of CEA and other economists, it would be dangerous to rely heavily on the views of some technology optimists in making policy.

- Although technology is indeed key to the solution, only high energy prices can be relied on to give the necessary incentives to technology in the time frame under contemplation. Economists are optimistic about technological response to a given price signal, but are pessimistic about how much technology one gets by the act of signing a treaty or giving a speech.
- Our estimates, like SGM's and the EIA's, assume that in the absence of price changes or policy changes, the rate of Autonomous Energy Efficiency Improvement (AEEI) is about 1% per year. This estimate comes from historical data on energy use and income. It also takes into account, for example, that energy prices rose in the 1970s and have fallen over the last 10-15 years.
- Admittedly, the estimate of the AEEI is subject to a wide range of possible statistical error (like all these estimates). But even if the correct number is 1.25, Kyoto still raises energy prices by 4 - 9%. If the correct number is 0.75, the price increase is correspondingly higher.

- Finally, even if one does not like the technological assumptions built into the SGM and other leading economic models, the Administration is “stuck” with them, because they are explicitly the basis of congressional testimony and the Administration Economic Analysis that we released in July.

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- Resource costs in this global-trading case would be \$7-12 billion, including payments to other countries. This is equal to about 0.1% of GDP in 2010. [The total negative effect on GDP might be slightly higher, due to possible miscellaneous indirect costs estimated by a “general equilibrium” model.]
- This low-cost case entails buying about 75-83% of emission reductions abroad, and accomplishing only 17-25% at home. While we have not emphasized these numbers in public, many on the outside have been able to infer them, and some have objected.
- If the Europeans were to succeed in their proposals to limit international trading, costs could rise sharply. Relative to global trading, for example, a limit saying that 50% of reductions must be accomplished domestically could increase permit prices by more than 250% [from \$23/ton to \$59/ton]. Relative to Annex I trading, a limit set at 10% of our allocation could more than double the permit price [from \$54/ton to \$111/ton].

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- Sinks could potentially make the targets much easier to meet, depending on definitions. One estimate is that sinks could account for as much as 100 MMTCE annually during the commitment period in the United States. This would reduce the permit price in the domestic-only case by 30% [\$137/ton], and the permit price in the Annex I trading case by 23% [\$42/ton] (assuming no other countries have sink credits). If other countries have sink credits, the permit price would fall even further. [At \$42/ton and 100 MMTCE of sinks, the United States does about 55% of its required reductions domestically.]

- Ancillary economic and health benefits of higher energy prices, such as reduced traffic congestion and cleaner air, would reduce net costs by roughly 1/4.
- None of these estimates take into account the benefits of helping mitigate the dangers of global climate change. Preventing climate change could potentially have large economic benefits (though it is impossible to estimate the probability of the disaster scenarios, the damage that would result under them, or the appropriate degree of risk-aversion and discount rate to assign). It is important to keep in mind that the Kyoto targets, even if successfully achieved, would constitute only a very small first step in reducing GHG concentrations in the atmosphere below the path they are on.
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- Admittedly, the estimate of the AEEI is subject to a wide range of possible statistical error (like all these estimates). But even if the correct number is 1.25, Kyoto still raises energy prices by 4 - 9% [Annex I + Key LDCs goes from \$23/ton in 1.0 case to \$21/ton in 1.25 case; Annex I goes from \$54/ton in 1.0 case to \$50/ton in 1.25 case]. If the correct number is 0.75, the price increase is

correspondingly higher.

- Finally, even if one does not like the technological assumptions built into the SGM and other leading economic models, the Administration is “stuck” with them, because they are explicitly the basis of congressional testimony and the Administration Economic Analysis that we released in July.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Steven N. Braun (CN=Steven N. Braun/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:12-FEB-1999 18:45:30.00

SUBJECT: Is productivity growing faster in Mfg than elsewhere?

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Rebecca M. Blank (CN=Rebecca M. Blank/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Andrew R. Feldman (CN=Andrew R. Feldman/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Bert I. Huang (CN=Bert I. Huang/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Bert and Andy have consulted me about a project measuring productivity by sector. The official data which they are charting for you appears to show productivity growing dramatically faster in manufacturing than elsewhere. I, along with a shrinking minority of productivity researchers, am a disciple of Ed Denison on this issue (See his 1989 book, Estimates of Productivity Change by Industry). Denison argues that productivity measures by industry--measured on a consistent basis (that is by value added), are hopelessly beyond the capabilities of the Federal Statistical system. The primary problem is inadequate quality adjustment for the thousands of input and output flows in the economy's I-O matrix. Zvi Grilliches' presidential address from a few years ago dwelt on the problem of uncovering productivity in the face of varying quality adjustment across sectors.

The case for noncomparability between the BLS manufacturing measure and nonfarm business is particularly clear because of different definitions of output: Nonfarm business output is measured with a value-added concept while the current (but recently implemented) BLS methodology for manufacturing uses gross output. Thus the contribution of a business service that sells to manufacturing would appear in both the manufacturing and nonfarm sector output measures.

A research paper by Mike Harper (the chief of productivity research at the BLS) and Bill Gullickson measures productivity on a consistent gross output basis across sectors "shows" that productivity is lagging in Finance, Insurance, and Construction. (I don't approve of this methodology, but I respect Mike Harper.) But these authors are agnostic about whether productivity in these sectors is truly lagging or whether output is overdeflated; these possibilities are observationally

equivalent.

Mike Harper (with whom I just spoke) feels that productivity in manufacturing probably is growing faster than in other sectors, but not by nearly as much as the official data seem to show.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:12-FEB-1999 11:28:29.00

SUBJECT: Re: my Swarthmore e-mail

TO: Charles F. Stone (CN=Charles F. Stone/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Here is the outline that Jeff prepared. ===== ATTACHMENT 1 =====

ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:

Unable to convert ARMS_EXT:[ATTACH.D72]MAIL44173774P.036 to ASCII,

The following is a HEX DUMP:

Talking Points on the Roles of Manufacturing and Trade in the US Economy (for WH meeting with labor leaders)

- **The share of manufacturing in the economy:** While manufacturing output is growing, it is declining as a share of total GDP (e.g. from 18.0 % in 1990 to 17.4% in 1996 [-- Stat.Abstr.1998 no.716]). This is a very long-term trend that has persisted for 1__ years in U.S. history, and is consistent with the pattern in all industrialized countries. The offset: the large services sector is rising as a share of GDP.
 - There is tremendous diversity within each sector.
 - Within manufacturing, for example, high-tech (or aircraft)... while textiles and apparel (or footwear, toys...) ...
 - Within services, (construction, computer programmers, hamburger flippers...)
 - In many industries, US firms have made a come-back over the last six years, having restructured to remain competitive in the globalized world of the coming century.
 - Autos ...
 - Semi-conductors ...
 - Business investment has led the seven-year U.S. economic expansion...
 - Surveys of US “competitiveness”...
 - Productivity trends...
 - The flip side of higher productivity in the manufacturing sector (i.e., output per worker) is lower employment (workers per output).
 - Thus the downward trend in the manufacturing share of the economy is pronounced when one looks at employment.
 - Stats ...

- **The wage gap:** Another trend, which has held for 25 years, is the widening gap between wages of skilled and unskilled workers. Stats. It is not possible to pinpoint the causes for the widening gap, but most is thought to be associated with a rising return to education.
 - A small part may be due to factors such as decreased unionization. But most is attributed to an increase in the importance of education in a competitive world where workers are paid their marginal product.
 - The leading cause of the widened gap is thought to be increased demand for educated and skilled workers in a high-tech world.
 - Most estimates of the role of international trade assign it a share of only 5-30% responsibility.
 - This might understate the role of globalization, in that there is an interactive effect between the two factors: education and technology might not be as important as they are if the US were closed off from the rest of the world.
 - But Americans on average would have lower real incomes if we were closed off. Technological innovation and skills are our international comparative advantage; and international competition keeps industries like autos on their toes, which is why Detroit produces better and cheaper cars today than they did in the 1970s.
 - The increase in the wage gap may be leveling off. Most recent numbers...
 - A possible explanation is the large increase in the supply of highly educated workers that has responded to the demand for them.
 - Another explanation is that the economic expansion has progressed so far that even unskilled workers are in high demand.
- **The benefits of trade:** The U.S. economy derives important benefits from high levels of international trade.
 - The increase in exports from January 1993 until the East Asia crisis hit in mid-1997 contributed 1/3 of US growth over that period. Even including the period of the East Asia crisis, exports have contributed 1/4 of US growth (1993-98).

- In Commerce Department parlance, each \$1 million of exports supports 13.0 jobs. In CEA parlance, each \$1 million of exports is associated with 17.5 jobs. Thus the \$ __ billion increase in exports corresponds to __ - __ jobs.
- Imports have also increased strongly during this period -- by more than exports, implying an increase in the trade deficit. But it would be wrong to figure that without the increase in the trade deficit, the US economy would have grown much more rapidly than it did.
- Constraints of potential output and full employment... The alternative is crowding out (via inflation and interest rates) of domestic demand....
- Imports are increasing as a *result* of increasing incomes. That is why trade balances are counter-cyclical.
- The current account balance equals saving minus investment. Unlike the higher deficits in the 1980s, deficits are increasing in the 1990s because of the investment-led boom. It is thus less a source of concern.
- If we do not buy goods from other countries, they cannot earn the dollars they need to buy goods from us.
 - The current crisis in emerging market countries offers a dramatic illustration of this general principle. When investors suddenly cut East Asia off from capital inflows in 1997, they were no longer able to finance their trade deficits, and thus were forced to start running trade surpluses in 1998 and 1999. Hence the fall in US exports to the region.
 - Our response to the crisis, working with the IMF and the rest of the international community, has worked to limit the fall in our sales, and lay the groundwork for a return to the preceding pattern of growth in the East Asians' incomes and imports from us.
- A world in which everyone's levels of exports of imports are high and rising (as opposed to the difference between them) together is a world in which everyone is growing.
 - Research both theoretical and empirical shows that countries that are highly open to trade have higher income levels and growth rates. (Classical comparative advantage and modern dynamic benefits...)
 - One statistical estimate is that every one-percentage-point increase in openness (holding constant for such important determinants as investment

and education) raises income by .34 per cent. US openness (exports plus imports as a share of GDP) has increased by 12 points since 1950, implying an estimated effect on income of about 4%.

- Export jobs are good jobs. Workers in export-oriented firms earn 13-16% more than other workers [Commerce Dept. and Richardson]. Even after adjusting for various characteristics, workers in export-oriented firms earn more than others (10 % more within the category of skilled workers, 5% more within unskilled [Richardson-Rindahl]).
- Popular conceptions exaggerate the extent to which patterns of trade and investment are driven by the influence of cheap labor in poor countries. More than half of US trade and direct investment is undertaken with partners that have higher wages than us. Often they have more rigorous labor standards as well.
- **Difficulties of adjustment:** Despite the great benefits of trade, some sectors and individuals can be adversely affected.
 - The steel industry suffered a surge in imports in 1998. The latest figures suggest that the peak has passed and steel imports may in 1999 be returning toward more normal levels.
 - A number of sectors have lost out on the export side....
 - One might think that trade in general, even while raising average real incomes, increases adjustment costs as reflected in the number of job displacements. But increased exports reduces the number of displacements in export-oriented sectors at the same time that increased imports raises the number of displacements in import-competing sectors. One study of the 1980s estimates that these two effects were roughly equal, so that higher levels of trade had little or no effect on *total* displacements [Haveman].

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME:15-FEB-1999 17:19:05.00

SUBJECT: GCC letter to Melinda Kimble

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Quindi C. Franco (CN=Quindi C. Franco/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

CC: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])

READ:UNKNOWN

TEXT:

Janet,

You were cc'ed a letter from the Global Climate Coalition (GCC) to Melinda Kimble dated 2/10/99. This letter is a response to an offer from the State Dept to NGOs for their comments on various submissions countries are supposed to make to the UN for subsequent negotiations this year. The letter provides the GCC views on international emissions trading and compliance. FYI, the letter quotes your December response to Sensenbrenner: "...the Administration unambiguously supports the efficient implementation of the 'flexibility mechanism' [and will] continue to work over the coming years in bilateral and multilateral fora to develop rules that ensure such implementation." The GCC's comments are not necessarily newsworthy. If you would like a summary of their comments, let me know, and I will draft one for you.

Joe

Withdrawal/Redaction Marker

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DOCUMENT NO. AND TYPE	SUBJECT/TITLE	DATE	RESTRICTION
004. email	t.srinivasan to Janet L. Yellen at 14:11:04.00. Subject: Department of Economics Reunion. (2 pages)	02/15/1999	Personal Misfile

COLLECTION:

Clinton Presidential Records
Automated Records Management System [Email]
CEA ([Yellen])
OA/Box Number: 950000

FOLDER TITLE:

[02/02/1999 - 02/15/1999]

2013-0723-F
ab1294

RESTRICTION CODES

Presidential Records Act - [44 U.S.C. 2204(a)]

- P1 National Security Classified Information [(a)(1) of the PRA]
- P2 Relating to the appointment to Federal office [(a)(2) of the PRA]
- P3 Release would violate a Federal statute [(a)(3) of the PRA]
- P4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
- P5 Release would disclose confidential advice between the President and his advisors, or between such advisors [(a)(5) of the PRA]
- P6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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RR. Document will be reviewed upon request.

Freedom of Information Act - [5 U.S.C. 552(b)]

- b(1) National security classified information [(b)(1) of the FOIA]
- b(2) Release would disclose internal personnel rules and practices of an agency [(b)(2) of the FOIA]
- b(3) Release would violate a Federal statute [(b)(3) of the FOIA]
- b(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
- b(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
- b(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
- b(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
- b(9) Release would disclose geological or geophysical information concerning wells [(b)(9) of the FOIA]