PROMOTING LONG-TERM PROSPERITY

THIRD REPORT TO
THE PRESIDENT
AND CONGRESS

MAY 1994

COMPETITIVENESS POLICY COUNCIL

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COMPETITIVENESS POLICY COUNCIL

WASHINGTON, DC

May 1, 1994

The Honorable William J. Clinton
President of the United States
The White House
Washington, DC 20500

Dear Mr. President:

The Competitiveness Policy Council is pleased to deliver its Third Report to the President and Congress. In it we discuss the current state of US competitiveness and make recommendations for needed policy changes.

In its first report, the Council called for a comprehensive strategy to address the steady erosion in America's competitiveness. In its second report, the Council presented detailed policy recommendations in the areas of capital formation, corporate governance and financial markets, critical technologies, education, manufacturing, public infrastructure, trade policy and training. During the past year, the Council has focused on key specific policy issues and how they relate to US competitiveness, and has worked with the Administration and Congress in seeking implementation of the Council's previous recommendations.

In addition to commenting on recent developments in education, training, technology, public infrastructure and trade policy, this year's report focuses on the impact of health care reform on the nation's competitiveness and ways of improving how the government budgets for public investment.

The Report represents a consensus of the Council members though not every member agrees with every word in the text. The Council members have been appointed as individuals and their concurrence in this report does not necessarily reflect the position of the institutions with which they are associated.

The Honorable William J. Clinton
Page 2

The Competitiveness Policy Council is a 12-member federal advisory committee with representatives from business, labor, government (both state and federal) and the public. The group is comprised equally of Democrats and Republicans. All of our meetings are open to the public. One-third of our members were appointed by the President, one-third by the Speaker and the Minority Leader of the US House of Representatives acting jointly, and one-third by the Majority and Minority Leaders of the US Senate acting jointly. The Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418), as amended by the Customs and Trade Act of 1990 (P.L. 101-382), created the Council "to develop recommendations for national strategies and on specific policies intended to enhance the productivity and international competitiveness of United States industries."

The Council looks forward to discussing the findings and recommendations of this report with you as we all seek to build a more competitive nation.

Sincerely,

C. Fred Bergsten
Chairman

Enclosure

NOTE: Identical letters were sent to Albert Gore, Jr., President of the Senate, and Thomas S. Foley, Speaker of the House of Representatives.

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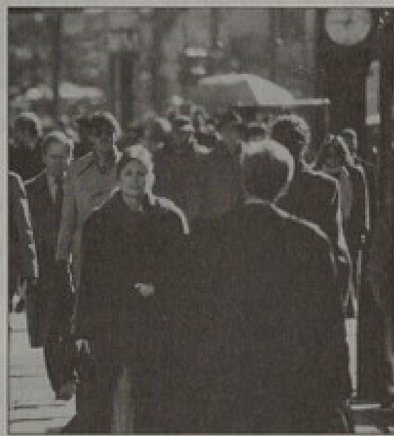
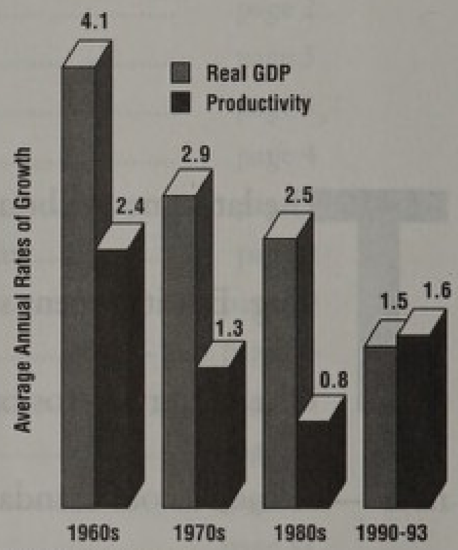


The latest news about the US economy is encouraging. But its recent strength is not enough to reverse the long run erosion in the nation's competitiveness — defined as our standard of living. There has been improvement in some of the macroeconomic indicators but little progress is evident in many of the underlying economic fundamentals that are critical to improving our competitiveness: saving and investment, research and development, and education and training. Without improvement in these fundamentals, we are unlikely to translate the current pickup into long-term gains in our standard of living.

On the other hand, the current environment provides a good framework from which to attack our long-run needs. Between 1972 and 1987, after taking cyclical factors into account, productivity grew by only 1.3 percent per year, compared with an average of 2.5 percent during the previous twenty years. Between 1987 and 1993, productivity growth was still only 1.2 percent per year.[1] The higher numbers in the early 1990s are largely due to the normal productivity recovery from the recession. As the Council indicated in its First Report in 1992, high productivity and economic growth rates are critical ingredients for enhancing the nation's competitiveness. In order to improve our standard of living we need to return to the productivity growth rates that we experienced prior to 1973. [Figure 1]

Productivity growth is a necessary, but not sufficient, condition for improving US competitiveness. Higher economic growth is needed to reemploy the human resources freed up by increased productivity.

Figure 1
Growth of Real GDP and Productivity



Source: Department of Commerce

Accordingly, the Council set a second goal of achieving a lasting growth rate of 3 to 3.5 percent for the overall economy by the end of the decade. The US economy surpassed this target in 1993, posting 4 percent growth. In response, unemployment, which has been too high for too long, fell from 7.7 percent in June 1992 to 6.4 percent by the end of 1993. This pickup in economic growth in 1993 was highly welcome.

But we are doubtful that such rapid growth can be maintained. Although net private investment moved up slightly to 4 percent of gross domestic product (GDP) in 1993, it is still well below its 1973 level of 8 percent of GDP and continues to be the lowest of all the industrialized nations. Investment

The "Competitiveness" Debate

In its First Report to the President and Congress, the Council defined competitiveness as the "ability to produce goods and services that meet the test of international markets while our citizens earn a standard of living that is both rising and sustainable over the long run." The Council has consistently relied upon this broad definition, as opposed to more narrow ones based on the trade deficit or market shares that are used by others. Nations are not corporations and thus should not be judged in the same manner. A nation's primary economic objective is to provide a rising standard of living for all its citizens.

Increasing economic integration is making national economies more interdependent. In spite of this increased economic integration, improvement in our competitiveness need not come at the expense of others. On the contrary, nations can raise their living standards simultaneously, just as occurred during the 1950s and 1960s. The global economy serves as the source of future economic growth.

Productivity growth is the key to long-term improvement in our standard of living. Investment in plant and equipment, R&D and infrastructure, and education and training are critical ingredients to improving productivity growth. Earning the resources with which to make these investments, rather than borrowing them, will insure that the resulting increases in living standards are sustainable over the long term.

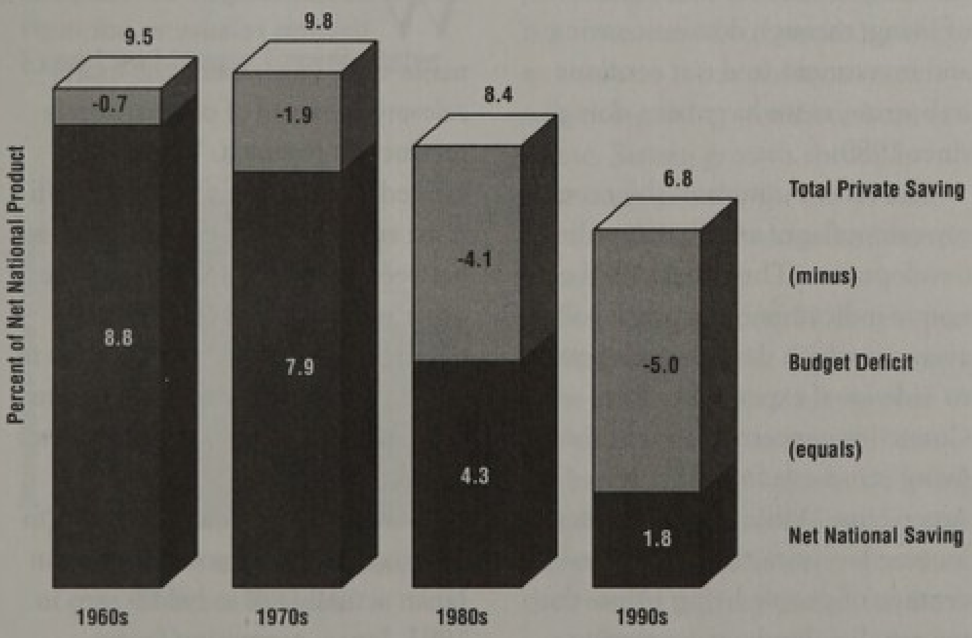
in plant and equipment, which has the highest payout in terms of productivity, also remained relatively flat at 9 percent of GDP in 1993, its lowest level in over 30 years. The Council calculates that national investment would have to increase by at least 4 to 6 percentage points of GDP, or about $300 billion annually at current prices, for the economy to achieve our ambitious productivity target and thus maintain economic growth at 3 to 3.5 percent per year.

In order to finance the needed increase in national investment without additional foreign borrowing, the national saving rate would have to rise by 5 to 7 percentage points of GDP, restoring national saving to the level that prevailed prior to 1973. One of the most troubling developments in 1993 was that net national saving (gross saving minus federal and state government deficits) fell to 1.5 percent of net national product (NNP), continuing its downward trend from 11 percent of NNP in 1973. [Figure 2]

This fall in net national saving occurred in spite of the Administration's success in securing Congressional approval of a five-year budget reduction package. The Congressional Budget Office (CBO) recently reported that, due in large part to the agreed package, the federal budget deficit is expected to fall to approximately 2.5 percent of GDP by 1998, down from close to 5 percent of GDP in 1992. [Figure 3] This is a substantial move in the right direction but goes only half way to eliminating the deficit. Under current policies, moreover, the budget deficit is expected to begin increasing again after 1999.

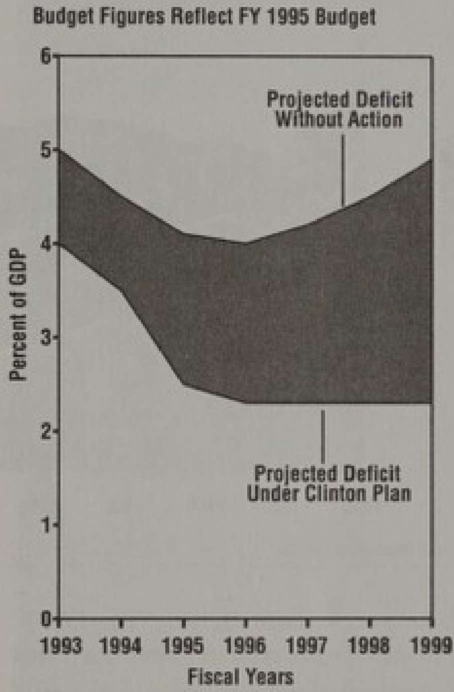
Total private saving fell one percentage point of NNP, caused in large part by a large drop in household saving from a peak of 7 percent of NNP in 1973 to a historic low of 3 percent of NNP in 1993.[2] As the Council noted last year, increases in private saving, while desirable, are

Figure 2
US National Saving



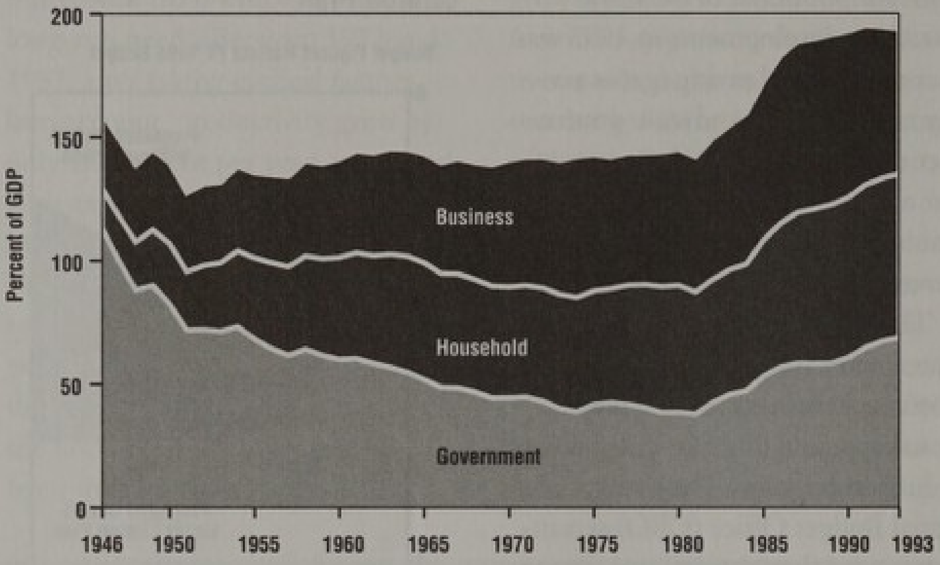
Source: Department of Commerce

Figure 3
Deficit Reduction Under the Clinton Plan



Source: Office of Management and Budget and Congressional Budget Office

Figure 4
Level and Composition of US Debt



Source: Federal Reserve System

extremely difficult to engender; thus most of the improvement in national saving will have to come from correcting the federal budget deficit.

Increases in public and private saving are critical to achieving a sustainable improvement in US living standards. Economic improvements built on debt-financed consumption will not translate into permanent gains. Aggregate non-financial debt is almost twice the nation's GDP, higher than any time since the Second World War. [Figure 4] In spite of the fact that the economy has been improving, government and household debt has continued to grow to record levels. Business debt has returned to its mid-1980s level, but remains at almost 60 percent of GDP. The only way we can hope to achieve lasting improvements in our economy is to *earn* our standard of living, through domestic saving and investment, and not continue to borrow, as we have been doing since 1980.

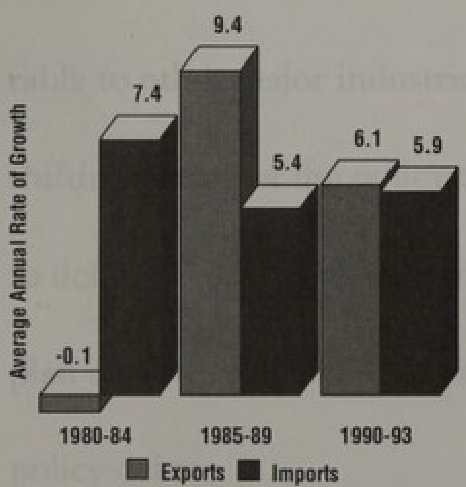
The recent upturn in the economy camouflages another troubling development. The widely cited economic indicators report national averages which do not correspond to individual experience. The Council is concerned about raising living standards for *all* groups of Americans. While average personal income has been rising, the percentage of people living below the poverty line has been increasing. Furthermore, the average annual growth of mean family income has been falling in the lowest two quintiles, has held basically constant in the third quintile, and has been rising only in the top two quintiles. The worsening distribution of income is not only a manifestation of our competitiveness problem but also contributes to many of the problems plaguing our society today. More job creation and investment in education and job training are necessary to help American workers achieve rising living standards.

How is the United States Performing Relative to Others?

When looking at US competitiveness relative to our major trading partners, the most relevant measure of comparison is productivity growth. While the United States remains the most efficient economy in the world, the gap between the United States and the other industrialized countries is closing. Productivity growth rates in Japan and Germany have tended to be above those for the United States until recently.

However, productivity growth in Germany fell to almost zero and in Japan actually fell to below zero in 1992. Japan, correcting for its investment bubble in the 1980s and having failed to take the necessary expansionary measures, experienced a decline of half a percent of GDP in 1993. Germany, which has yet to fully adjust to the challenges of unification and new realities in the international economy, experienced a decline of 1.5 percent of GDP in 1993. In turn, the US merchandise trade deficit expanded by 40 percent, reaching approximately $132 billion in 1993, and causing the current account deficit to grow to $109 billion. Export growth fell to 2 percent in 1993, primarily due to slow growth in the industrialized countries, and imports grew by 8 percent, reflecting the economic recovery here in the United States. [Figure 5] A steady strengthening of the dollar against all major currencies except the yen will further exacerbate the deterioration of the US trade deficit.

Figure 5
Export and Import Growth Rates



Source: Organization for Economics Cooperation and Development

The fact that the US economy outperformed Germany and Japan in 1993 has led some observers to suggest that the United States has solved its competitiveness problem. The Council does not share this optimism predicated upon a narrow view of competitiveness. We should not take comfort from the fact that other nations are performing worse economically than the United States. Nations can and should seek to raise their living standards simultaneously, as was the case for most of the period following World War II. Furthermore, declines in European or Japanese growth rates do not imply that the US economy is operating more efficiently. The best measure of our nation's ability to compete is our ability to maintain rising living standards here at home. Strong growth abroad is necessary in order for US producers to sell their products and hence boost US income.

Between 1870 and 1973, real per capita income in the United States grew at an average of 1.9 percent per year, enabling incomes to double every thirty-two years. US living standards in 1973, measured by real income, were ten times greater than they were a century earlier. At the current anemic growth rate of 3 percent per year between 1973

"The key to stemming the erosion of US competitiveness lies with reversing recent trends in long-run economic fundamentals. Although the current economic recovery does not in itself achieve this, it does provide an excellent opportunity to act decisively in shifting national priorities toward investing in human and physical capital."

and 1993, it will take another fifty-six years, until the year 2050, to double current incomes. The key to stemming the erosion of US competitiveness lies with reversing recent trends in long-run economic fundamentals. Although the current economic recovery does not in itself achieve this, it does provide an excellent opportunity to act decisively in shifting national priorities toward investing in human and physical capital. It is precisely during times of economic growth that we should begin saving and investing for the future.

The Council's Role

The Competitiveness Policy Council was established by Congress in 1988 to address the long-run decline in the nation's standard of living. The Council brings together representatives of business, government, labor, and the public — both Democrats and Republicans — to analyze the causes of the erosion in our competitiveness and to make recommendations to reverse this trend. In its First Report to the President and Congress, issued in 1992, the Council stated that "America's economic competitiveness . . . is eroding slowly but steadily in spite of the fact that the United States continues to maintain the highest living standards and levels of productivity in the world." In its initial report, the Council identified six issues relating to improving US competitiveness deserving of priority attention: saving and investment, education, technology, corporate governance and financial markets, health care costs and trade policy. In 1993, the Council presented detailed recommendations in each of these and other areas. Many of these recommendations, especially in the areas of technology, trade policy, education and worker training, have already been adopted by the Clinton Administration and enacted by the Congress. This year's report focuses on the implications for America's competitiveness of health care reform, public investment in technology, education, training, and infrastructure and trade policy. This report also outlines the Council's recommendations on investment budgeting and its current work program in the areas of capital allocation and social issues.

Health Care Reform and US Competitiveness

As a sector responsible for 14 percent of GDP, health care influences every aspect of the US economy. Accordingly, in its First Report, the Council identified health care reform as an area deserving priority attention. Because of its enormous and growing impact on the economy and the federal budget, the Council concluded that the "national objective should be the achievement of world-class health care for all Americans at a cost to the economy that is comparable to other major industrial countries."[3] Given the rapidly shifting nature of the policy discussion, the Council decided to defer its consideration until the Administration's reform plan and other detailed proposals were presented for policy debate.[4]

The Council is interested in the impact of health care reform on the economy as a whole as well as on the labor market, the trade balance, and particular industries. Each of these is discussed below.[5]

Health Care and the Economy

Health care costs in the United States are higher and are rising more rapidly than in all of our major trading partners. Unfortunately, there is no evidence that the nation's more expensive health care system is buying better health. Although there is no apparent relationship between health care expenditures and predicted life expectancy among the industrialized countries, the United States is a clear exception with extremely high health care expenditures and lower than average predicted life expectancy.[6]

This leads the Council to believe that health care costs are diverting resources from other parts of the private economy where they could be used more productively and thereby improve the nation's overall competitiveness. In the absence of reform, the health care share of GDP is projected to rise from its current 14 percent level to around 17 percent in 2000. None of the reform proposals being discussed, including the Administration's, promise to freeze the current share of GDP devoted to health care. They would only *slow the rate of growth* beginning in 2000, resulting in a lower health share of GDP after 2000 than would occur under present law. This would be a significant achievement, but the Council believes that the nation may want to aim to *reduce* the share of GDP devoted to health care. In addition, all budget estimates on health care reform are subject to a great degree of uncertainty.

Evaluating the impact of health care reform requires a consideration of both the short term and the long term. In the short term, the federal deficit is likely to rise slightly higher with reform aimed at providing universal coverage than it would under the current system. This could further reduce national saving. In the long run (after 2004), the various plans being discussed aim to reduce the federal deficit below the current-law baseline and contribute to raising national saving and investment. As we stated in our First and Second Reports, federal policy often has a built-in bias against long run considerations. For health care reform, we believe that the proper target is getting control of the system's costs over the long run. Therefore, in comparing reform alternatives, the Congress and the American people should give more weight to the long-term deficit implications than to the impact on the deficit over the next few years.

If health care costs were frozen at approximately the current level of spending, averting a projected increase to 16 percent of GDP by 1997, $125 billion (in 1997 dollars) could be redeployed to non-health purposes. Such a reduction in projected health care spending would not change national income but the "reform dividend" could have a significant positive effect on competitiveness, depending on the extent to which the freed-up resources were reallocated to more productivity-enhancing investment. Companies could invest some of their reform dividend in research, while individuals could devote some of their ensuing higher wages to personal saving. The reduction in the share of employee compensation attributed to health care could be matched by an increase in the share going to pensions, further increasing national saving. Lower federal spending on health care could enable the federal government to reduce the deficit, leading to a further improvement in national saving. Lower health care costs could also make the United States more attractive to job-creating foreign investors.[7]

In the absence of changes in individual saving, business investment, or government dissaving, large effects on competitiveness cannot be anticipated. But the way in which the reform is carried out could lead

COMPETITIVENESS POLICY COUNCIL

1726 M Street NW • Suite 300 • Washington, DC 20036 • Tel: (202) 632-1307 • FAX: (202) 632-1350

NEWS RELEASE

May 12, 1994

Contact: Howard Rosen (202) 632-1307

CURRENT RECOVERY NOT SUFFICIENT TO REVERSE LONG-TERM EROSION OF US COMPETITIVENESS

HEARINGS BEFORE SUBCOMMITTEE ON ECONOMIC GROWTH AND CREDIT FORMATION OF THE HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE: 2:00 pm, Room 2220 Rayburn House Office Building

EMBARGO; May 12, 1994, 2:00 pm, E.S.T.

Washington, May 12---The current economic recovery is encouraging but will not be enough to reverse the twenty year erosion in the nation's competitiveness, according to the Competitiveness Policy Council's Third Report to the President and Congress. In spite of the good news about the economy, the Council remains concerned about the lack of improvement in several key economic fundamentals: America's saving rate remains the lowest among the industrialized countries and continues to fall, our students and workers continue to lag behind other countries in educational achievement and the nation's investment in plant and equipment, R&D and public infrastructure is insufficient. "Without improvement in these fundamentals, we cannot hope to translate the current pickup into long-term gains in our standard of living," the Report says.

The Competitiveness Policy Council is a twelve-member, bipartisan national commission created by Congress. It includes three corporate leaders, three labor union presidents, three senior government (federal and state) officials and three representatives of the public. The members were appointed by the President and by the joint leadership of the Senate and House of Representatives. The Council is chaired by Dr. C. Fred Bergsten, Director of the Institute for International Economics. President Clinton appointed Dr. Laura D'Andrea Tyson, Chair of the Council of Economic Advisers, as the federal government representative last September.

"Promoting Long-Term Prosperity" is the Council's third report to the President and Congress reviewing the state of US competitiveness and making policy recommendations on how to improve national living standards. In its first report, in 1992, the Council called for "a comprehensive competitiveness strategy" to address the steady erosion in the nation's competitiveness. In its second report, in 1993, the Council proposed national goals for saving, investment and economic growth aimed at doubling productivity growth by the end of the decade and presented detailed policy recommendations in the areas of capital formation, corporate governance and financial markets, critical technologies, education, manufacturing, public infrastructure, trade policy and training.

In this year's report, the Council reviews progress made during the first year of the Clinton Administration in implementing its initial proposals and suggests additional steps which need to be taken. In addressing the current debate over whether the United States still has a competitiveness "problem," the Council notes that in spite of the current improvements in economic growth, unemployment and inflation, there remains a stagnation or even decline in real wages and total compensation -- the best measures of a nation's standard of living. "Some people view the cyclical recovery in the United States and poor economic performance in Europe and Japan as indicators that we have solved our competitiveness problem," notes Dr. Bergsten, the Council's Chairman. "We reject such a narrow definition of competitiveness. America cannot be viewed as competitive as long as our standard of living fails to rise. In addition, we cannot ignore the fact that our trade deficit is soaring toward a record level."

In addition to reviewing recent developments in technology, education and training and public infrastructure, the Council's new report focuses on the impact of health care reform on US competitiveness and the need for improvements in how the federal government budgets for investment. The Council also presents its future agenda in the area of capital allocation and social issues. The following are some highlights from the Council's 1994 report.

Health Care Reform

The nation currently spends 14 percent of GDP on health care, more than any other country in the world, yet there is no evidence that our citizens are that much healthier. The nation's current health care system affects our competitiveness in two major ways. First, growing health care inefficiency is diverting resources which could instead be invested in education, technology and infrastructure. Second, under our current system, workers pay the lion's share of the nation's health care bill through lower take-home wages and declining quality of health care.

In the short run, health care reform is likely to raise the federal deficit slightly higher than under the current system, further curtailing national saving. In the long run (after 2004), some of the plans being discussed, including the Administration's, could reduce the federal deficit below the current baseline and contribute to raising national saving and investment. In comparing reform alternatives, Congress and the American people should give more weight to the long-term implications than to the impact on the deficit over the next few years.

Most analysts now agree that the burden of the current employer-based health care system is borne primarily by workers in the form of lower wages. Increases in health care costs in recent years have eaten into employee wages and other benefits (Figure 1). In fact, rising health care costs may help explain much of the stagnation or decline in real wages over the same period. In addition to its impact on wages, the current health care system has contributed to a two-tier job market. To avoid incurring current and future health care obligations, many employers often hire new workers as temporaries or via temporary worker services. This has contributed to a significant increase in temporary workers, which can also take away from creating high performance workplaces.

The present system of rising, uncontrolled health care costs falls most heavily on large firms, many of which are strong exporters. Our analysis suggests that under the Clinton health care reform proposal, manufacturing industries would save almost $100 per worker, and up to $439 per worker in the top twenty exporters, as opposed to an average net cost per worker of $319 for all firms. However, the reform should improve the international trade component of America's competitiveness problem.

Public Investment

Public investment in education and training, R&D and infrastructure amounted to 25 percent of non-defense outlays and 2.5 percent of GDP in 1965. By 1995, based on current budget projections, this public investment is expected to be only 11 percent of non-defense outlays and 1.9 percent of GDP (Figures 2 and 3). The Council reiterates the importance of public investment in education and training, R&D and public infrastructure in order to raise productivity growth and American living standards. The Council strongly supports the Clinton Administration in its efforts to increase federal investment but it urges the development of a more coherent investment plan. The Council calls on the Administration to establish an investment budget as a first step. The following are additional steps which need to be taken:

Federal Budget: The spending caps enacted in 1990 and re-extended in 1993 have been a helpful management tool to Congress but may have outlived their usefulness. If continued beyond FY 1995, these caps will require very large cuts from the budget baseline. But reducing the deficit does not require a freeze in discretionary spending. While the Council strongly reaffirms the need to continue lowering the federal deficit, we believe that consideration should be given to amending the Budget Enforcement Act to permit entitlement cuts or revenue increases to be used to pay for increases in federal investment.

Competitiveness Impact Statements: Under the Omnibus Trade and Competitiveness Act of 1988, the President and heads of agencies are required to submit to Congress "Competitiveness Impact Statements" (CIS) as part of all legislative proposals which may affect the ability of American firms to compete in international commerce. This law has been ignored over the last six years and is now about to expire. The Council recommends that the Congress renew the law, although limiting the requirement to prepare a CIS on only those proposals deemed to have a significant impact on competitiveness, and assigning that responsibility to an independent agency like the US International Trade Commission or the Congressional Budget Office.

Education and Training

In its Second Report, the Council called for establishing a system of life-long learning, including improving the nation's basic education, better facilitating the school-to-work transition, increasing job-related training, and expanding retraining programs for dislocated workers. The Council applauds the Administration and Congress for the passage and signing of Goals 2000, which takes the first step toward establishing rigorous content and performance standards for what students should know and be able to do as a result of their schooling. The Council is also pleased that the Administration's school-to-work program, reflecting its Training Subcouncil recommendations, has also recently been passed and signed by the President.

In its Second Report, the Council also recommended that the government encourage firms to increase job-related training through grants, tax credits or payroll requirements. Unfortunately, the Administration has not yet put forward its proposal to promote greater job-based training and the Council encourages it to do soon.

The Administration's recent proposal to improve government programs designed to assist workers adjust to new economic realities reflects many of the Council's previous recommendations. Under the proposed Reemployment Act of 1994, individuals would be eligible for longer-term benefits. The Council is concerned that, by improving the quality of benefits, the Administration's program may limit the number of workers who might receive benefits. The Council urges the Administration and Congress to provide a guaranteed funding source to insure that adequate benefits are available for all those in need.

Critical Technologies

The Administration has begun to implement a new technology policy largely reflecting the Council's recommendations for shifting emphasis from defense to civilian R&D and focusing on projects which will promote commercial technologies. The Council urges the Congress to appropriate funds for programmatic increases in the President's budget request in FY 1995. Given the caps enacted in the 1993 budget agreement, the President and Congress will need to maintain their commitments to this new technology policy in the FY 1996 and FY 1997 budgets. In addition, the government and private sector must work together to ensure that the new and expanded programs work as intended, and that they are evaluated and modified as necessary.

Public Infrastructure

The Council is encouraged by the positive attention given to investment in transportation infrastructure in the President's proposed FY 1995 budget. Recognizing the importance of public infrastructure in the national economy, the budget requests full funding of highway programs at the levels authorized in the Intermodal Surface Transportation Efficiency Act of 1991. The proposed increase in Amtrak's capital improvement funds is also long overdue.

Although the budget proposals for FY 1995 and beyond reflect a renewed attention to capital investment in infrastructure, the increases are barely large enough to make a dent in the decades-old deterioration of infrastructure. Chief among these problems is the practice of state and local officials of deferring maintenance on infrastructure to the indefinite future. The practice is so widespread that the category of "deferred maintenance" has taken on the connotation of an actual program item in state and local budgets. But deferred maintenance is not a program, it is a liability, and the public needs to be continually aware of the deferral of its responsibilities to maintain its own economic lifelines.

Trade Policy

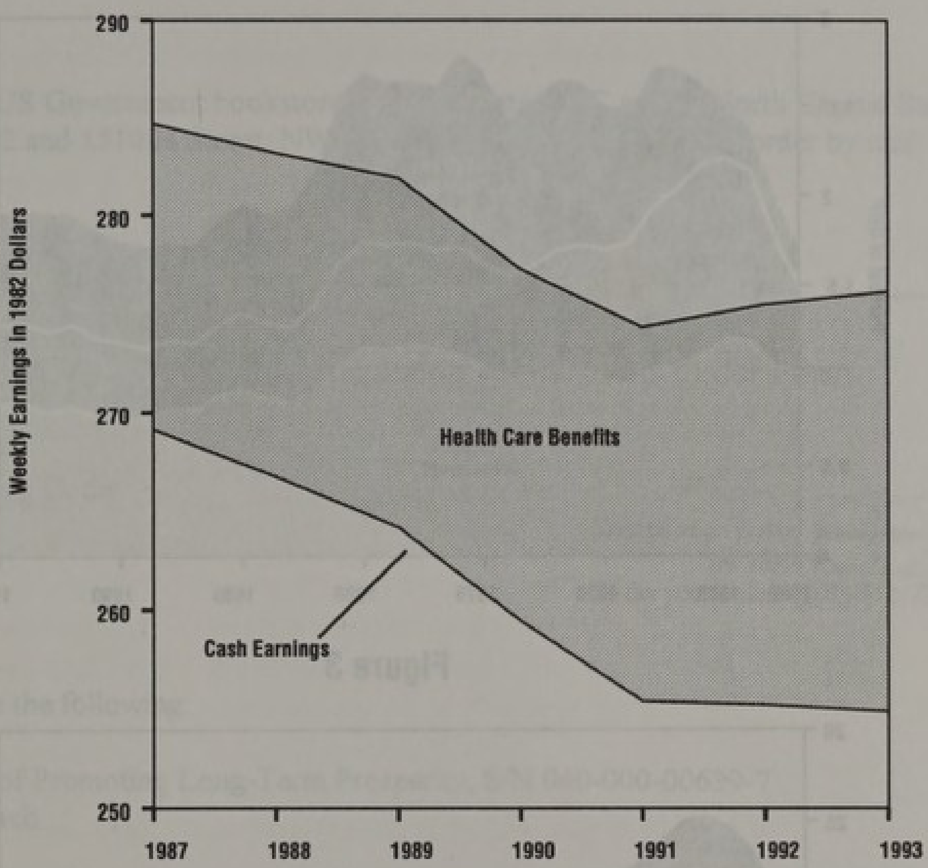
The Administration, and in particular the Commerce Department, has made significant progress in coordinating export policy and removing disincentives to US exports, as called for in the Council's Second Report. The Council commends the Administration's recent decision to remove the requirement for advanced approval for virtually all civilian telecommunications and computers exports to China and the countries of the former Soviet Union. Although the Council's previous recommendation for a unified budget function has not yet been followed, the Office of Management and Budget has created a table of Export-Related Expenditures. We are encouraged by the prospect that a unified budget function may be employed in FY 1996.

The Council urges the Administration to submit legislation implementing the recently signed GATT agreement as soon as possible and urges the Congress to renew the President's trade negotiating authority (which expired on December 15) for new multilateral, regional and bilateral trade agreements.

The Council's Third Report, "Promoting Long Term Prosperity" is available from the Government Printing Office. Copies of other reports and commissioned studies are available from the Council.

Figure 1

Wages and Employer-Paid Health Insurance



Source: Bureau of Labor Statistics

Figure 2

Federal Non-Defense Investment

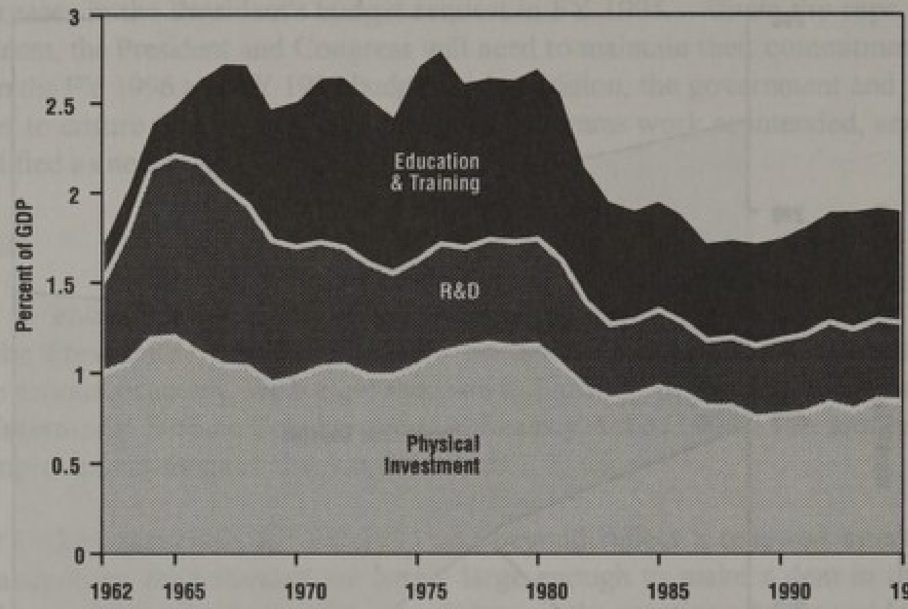
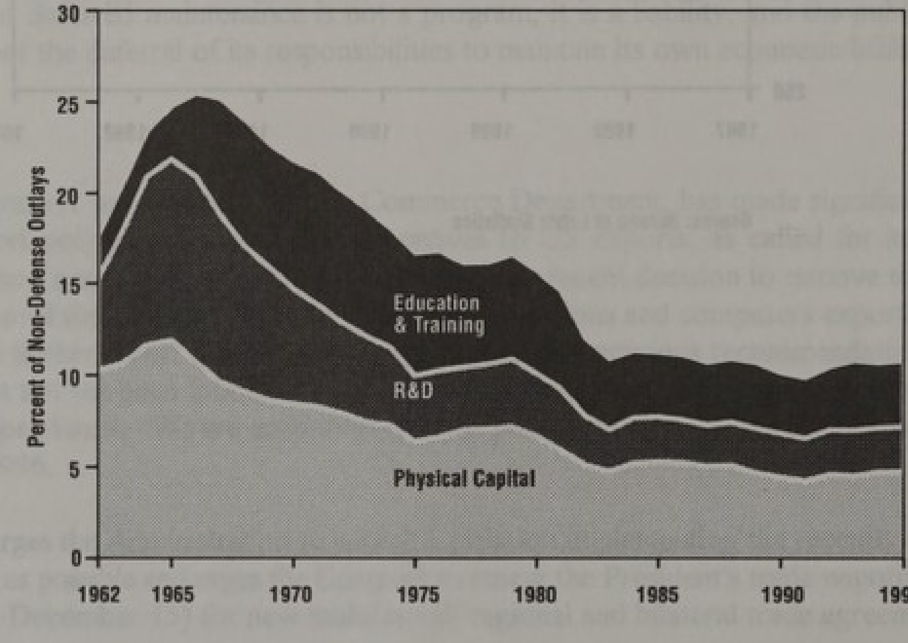


Figure 3



Source: Office of Management and Budget

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Figure 2

Federal Non-Defense Investment

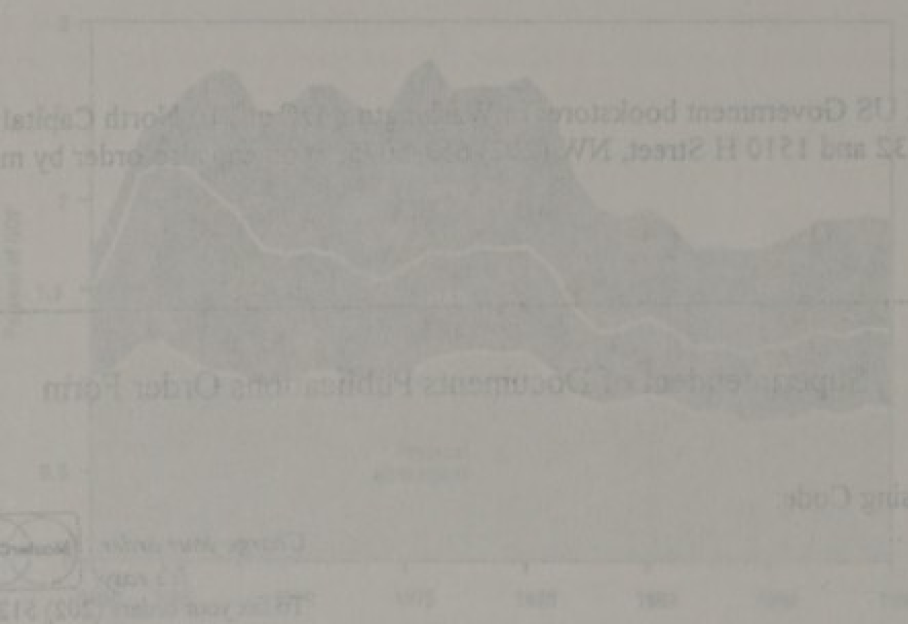
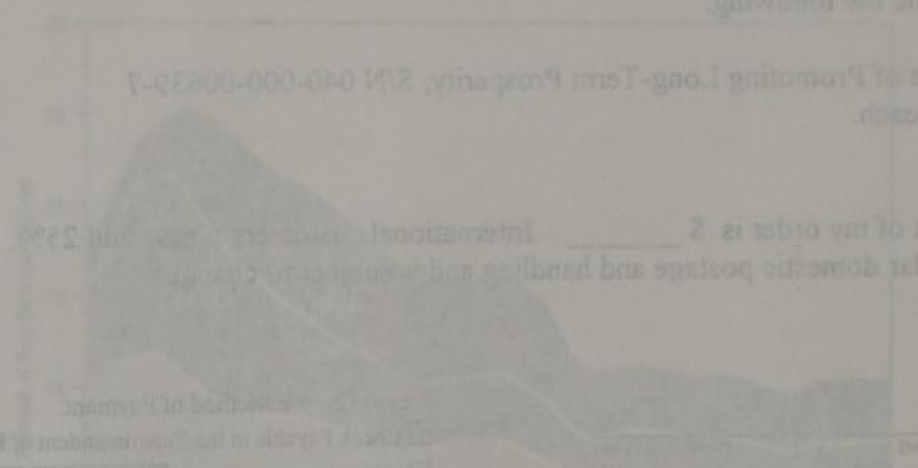


Figure 3



to some effects on competitiveness. Given the large size of the health care sector, even small effects can be significant when amplified across the economy.

Health Care and the Labor Market

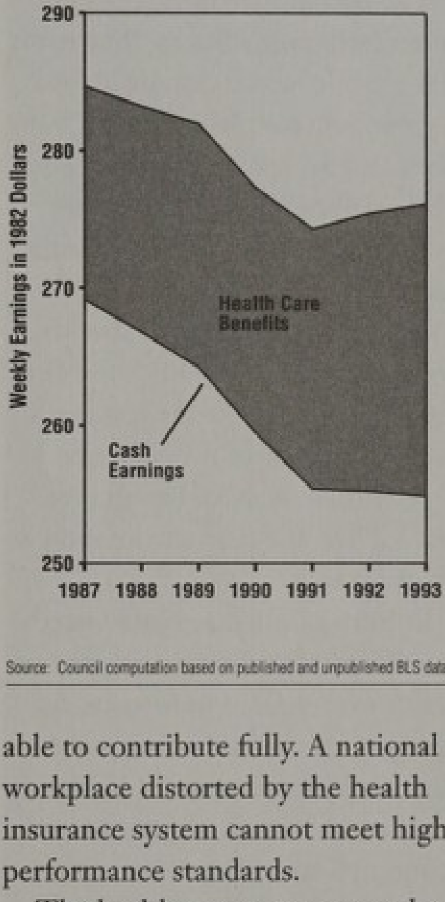
The biggest stake workers have in health care reform is in gaining access to quality health care. There is enormous benefit to such health security, both to workers and to the long-term efficiency and flexibility of the US economy as a result of the greater mobility of workers no longer dependent on their current employers for health care benefits. The Administration and Congress need to ensure that any further health insurance subsidies provided for low-income individuals do not create new disincentives preventing the poor from taking jobs.

If the rate of increase in total health costs is reined in, workers will also benefit as consumers. Health care reform may also permit unionized workers and management to shift their focus to other workplace issues; disputes over health care benefits have been a leading cause of labor-management disputes and strikes.

Most analysts now agree that the burden of the current employer-based health care system is borne primarily by workers in the form of lower wages. Increases in health care costs in recent years have eaten into employee wages and other benefits.[8] In fact, rising health care costs in recent years may help explain some of the decline in real wages over the same period. Had employer spending on health care been considered as "imputed income," the fall in cash earnings would not have been as steep. [Figure 6]

In addition to its impact on wages, the current health care system has contributed to a two-tier job market. While employers are not currently required to provide health insurance, many do. To avoid incurring greater costs, employers sometimes hire new workers as temporaries or via temporary worker services to avoid incurring current and future health care obligations. The increased use of temporary workers can be a result of many factors, such as industry restructuring, a desire for more flexible work teams or the choice of individuals who do not wish to work full time. But to the extent that health insurance plays a role, the reliance on temporary workers is a negative factor for the labor market as a whole. In addition to working with little security and few benefits, temporary workers often do not receive adequate training, are not fully integrated into the workplace, and therefore are not able to contribute fully. A national workplace distorted by the health insurance system cannot meet high performance standards.

Figure 6
Cash Earnings and Employer-Paid Health Care Benefits



Source: Council computation based on published and unpublished BLS data

The health care system may also exacerbate problems with the current welfare system. Under the existing system, some low-income individuals may face a perverse disincentive, preventing them from taking a job lest they lose their Medicaid benefits. According to the CBO, the Administration's proposal is projected to increase the labor force participation of welfare recipients. Such a "liberating" effect could assist in the welfare reform process. On the other hand, an employer mandate, by raising labor costs (at least temporarily), could reduce the demand for workers.

The current health care system causes large cost shifting. The firms that provide health care insurance pay not only for their workers, but often also for spouses working elsewhere without health care insurance. In addition, small companies that provide insurance may pay very high rates due to the absence of community rating. Both forms of cost shifting may distort competitiveness in favor of firms that do not pay their share of health care costs. Thus, the current situation is unsustainable.

Reform of the magnitude needed will certainly have an impact on health care-related industries, for example, the health care equipment and pharmaceutical industries, which are among the economy's strongest export industries. The Council believes therefore that the competitiveness impact of systemic reform on the health care industry must also be considered.

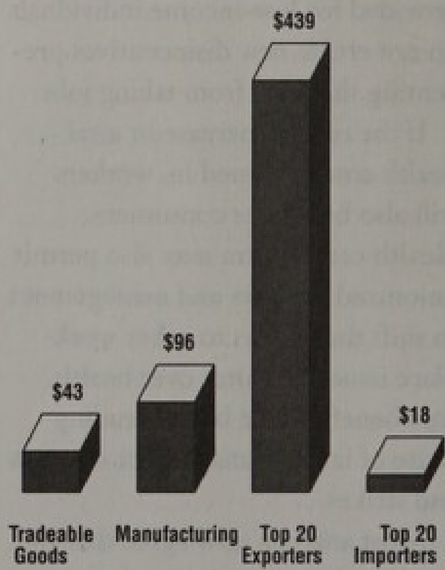
Health Care and International Trade

The effect of health care reform on international trade will occur mainly through its impact on federal spending and national saving. If health care reform prevents the budget deficit from rising in future years, that will boost saving which should improve the balance of trade. If, as analysis suggests, increases in health care costs are borne primarily by workers, then US exports should not carry a higher price due to health care costs.[9]

In addition to any overall effect on the trade deficit, the composition of the economy and trade could change under reform. The present system of rising, uncontrolled health care costs falls most heavily on large firms, many of which are strong exporters. Industries such as primary metals, motor vehicles, aircraft, chemical products and scientific equipment spend at least one third more than the national average on health care costs per worker.[10] Reform of our current health care system could help ease the burden being placed on these industries.

Most of the cost savings resulting from reform are concentrated in the top twenty export industries, where firms could gain an average of $439 per worker. Manufacturers that currently offer insurance would gain an average of $263 per worker, as many of these industries already provide health care coverage both to their own workers and to their workers' relatives who are not covered by smaller employers. Manufacturing firms which do not currently insure their workers will have to pay an additional $1,726 per worker. This is compared to the average net cost per worker for all firms, which is estimated to be $319.[11] It is not clear what effect health care reform will have on health care-related export industries such as equipment and pharmaceuticals which may benefit from the increasing spending on health services and may be hurt by utilization controls. Import-sensitive industries are expected to experience a modest cost saving under the Administration's plan. [Figure 7]

Figure 7
Net Savings Per Worker Under Health Care Reform



Source: Lewin-VHI, Inc.

Council's Observations

Although the Council has not taken a position on pending health care reform bills, there are several points that it wants to make about the current debate.

First, the Council supports the availability of affordable high quality medical services for all Americans. The current system whereby some people cannot obtain coverage has negative economic, health, and social implications. Any serious health care reform must address the problem of cost shifting and aim toward a more equitable distribution of the costs of providing health care for all Americans.

Second, many of the reform proposals, including the Administration's, are projected to achieve a lower growth path of long-run federal health care spending (despite a higher path in the short run) than the current course. Cost containment through efficiency gains and true cost reductions, while preserving the ability of the industry to continue innovating, is key to insuring that reform does not come at the expense of our competitiveness. By better controlling the share of government spending going to health, the reform would free up public resources for important public investments and/or lowering the federal deficit. Either of these outcomes would contribute to improving US competitiveness.

Third, the current health care system is not a static entity. Too many analysts assume that the features that they like about the current system are fixed and therefore find fault with some features of the Administration's reform model. The public should compare the various reform plans not to the current system but rather to what the current system will evolve into if left unmanaged. The problem of medical overspending and inflation is a national problem requiring a national solution. At present, employers who do provide health insurance have to spend an inordinate amount of time trying to reduce their costs to the extent possible.[12] Many employers have cut back health care services and without reform more will do so. The Council does not believe that the present system can cure itself without changes in the law.

Fourth, the Council has adopted no position on whether employers should be required to pay a portion of wages or salaries in the form of health care, but we are very troubled with the current system whereby some employers provide health care and others do not. This leads to distortions in our labor markets, the structure of our economy, and our medical system. Ultimately it is the worker who pays for most of the health care system, through lower wages and quality of

"Health care costs are diverting resources from other parts of the private economy where they could be used more productively and thereby improve the overall competitiveness of the country."

health care received; thus the competitiveness concerns over an employer mandate may be exaggerated.[13] Many of the large companies involved in the tradeable goods sector are already providing health care to their employees. An employer mandate would not hurt these companies; indeed it might help iron out some of the distortions which disadvantage these companies and may reduce future costs of providing health care insurance.[14]

Mandating firms which do not currently provide health care coverage may result in some short-run effects for these firms, but these can be softened in a variety of ways. Thus, the Council believes that the proposal for an employer mandate should be decided on other grounds such as practicality, equity, ease of administration, and most importantly, its contribution to improving productivity and US living standards. An employer mandate would not necessarily hurt our firms as they compete in international markets.

Fifth, the Council is concerned about proposals which would treat small and large firms differently. Government policies should avoid creating incentives for firms to be small, stay small or become small. Of course, the current system puts many small firms that provide health benefits at a disadvantage relative to larger firms because the costs per worker are disproportionately large due to the absence of large group rates.

Sixth, the Council believes that whatever financing system is chosen should attempt to improve access and utilization of preventive health care services. By employing more cost effective preventive measures, we can avoid higher costs of treating illnesses. In spite of this, childhood immunization rates for certain diseases have actually fallen in recent years. A significant part of our current health care expenditures are directly affected by drug abuse, smoking, violence, AIDS, teen-age pregnancies, premature births and other life-style and behavioral issues. Ultimately, preventive health measures can go a long way toward achieving the difficult goal of containing costs.

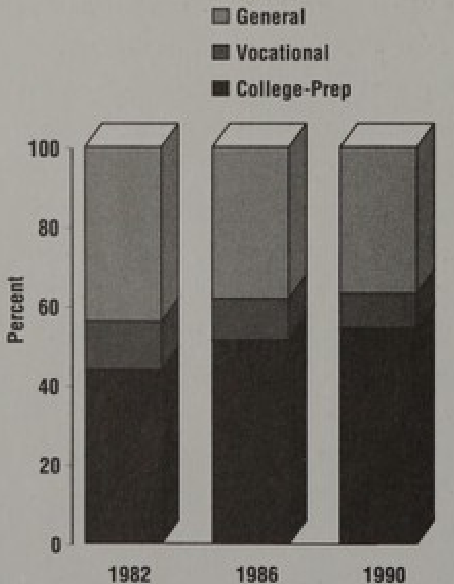
Education and Training

The US economy has proven to be significantly more successful than other industrialized countries in creating jobs. The United States created over 40 million jobs over the past twenty years. Most of these new jobs were filled by new entrants into the labor force, including women, immigrants and members of the baby-boom generation. This enormous growth in jobs was also accompanied by changes in the composition and structure of employment in the United States. Virtually all of the new jobs created over the last twenty years were in the service sector (96 percent). In fact, employment in the service sector almost doubled from 47 million in 1970 to 88 million in 1993, while manufacturing employment declined from 19.4 million to 17.7 million over the same period. At the same time that the economy was creating jobs in order to absorb these new entrants into the labor market, real wages for production workers actually declined. Real average weekly wages for production workers were $254.66 in 1993, 24 percent below their 1973 level of $315.38 per year.[15]

The United States has an enviable track record in job creation and absorbing new entrants into the labor force. But the economy has difficulty assisting people move from one job to another. Structural change, defense conversion, and trade liberalization have resulted in large numbers of dislocated workers over the past two decades. The high cost of moving these workers into more productive and growing sectors in the economy places large burdens on workers and communities. A flexible labor market benefits the economy as a whole, but we cannot ignore the costs which may result from such flexibility. The challenge is to preserve the benefits for the many without ignoring the costs to the few. If our aim is to improve living standards, we must be concerned with the quality, as well as the quantity, of jobs we create. In addition to creating high productivity, high income jobs, we must also make the proper investment to prepare our workers so that they can perform well in them.

The Council made a series of recommendations in its 1993 Report to improve the competitiveness of the US labor market within the context of a system of life-long learning. There are four major aspects: basic education, school-to-work transition, active worker training and reemployment of dislocated workers. Each builds upon the others. Our ability to train students and workers for high skilled jobs depends on a solid foundation of basic education. Devoting additional resources to worker training will only be efficacious if we improve the quality of our basic education system.

Figure 8
Composition of the Student Body



Source: Department of Education

Basic Education

President Clinton recently signed the Goals 2000: Educate America Act, which establishes eight national education goals (see box) and a process for stimulating the nation, states and localities to achieve these goals. The Act codifies a bipartisan National Educational Goals Panel (NEGP) responsible for building a national consensus for improvement in education, reporting on progress made in reaching the goals, and reviewing standards and assessment criteria. It also establishes a National Education Standards and Improvement Council (NESIC) responsible for certifying national content, student performance and opportunity-to-learn standards. All these standards are voluntary; states may adopt NESIC-certified standards, submit their own standards for certification, or choose not to submit their standards to the NESIC. However, in order to receive some of the $400 million in Goals 2000 school improvement funds, states must submit plans to the Secretary of Education that address content and student performance standards and opportunity-to-learn strategies based on these standards.

Also included in the Act is the creation of a National Skill Standards Board made up of business, labor, education and training, government and community representatives. This Board is charged with developing a framework for a national system of voluntary standards for the knowledge and skills needed to perform successfully in the workplace.

As we noted in our Second Report, improving the education system must begin with the establishment of rigorous standards for what students should know and be able to do as a result of their schooling — standards for academic content and student performance. The Council therefore applauds passage of Goals 2000 in accordance with the recommendation included in its Second Report. Expectations must change from minimum competency to high achievement both for students who go on to college and for those who go directly to work. We strongly urge all states and local school districts to adopt the National Education Goals and to use them as the basis for curriculum and assessment, textbook and other materials adoption, teacher licensing and professional development requirements and accountability systems.

We also strongly urge that NESIC adopt a rigorous standards-certification process, that states either adopt those standards or submit their own standards to NESIC, and that the quality of this process and its effects on improving education be closely monitored.

National Education Goals

Goals 2000 had its origins in a meeting of the nation's governors convened in September 1989. In March 1990, President Bush and the governors announced eight education goals for the year 2000 and created an Education Goals Panel to develop indicators for measuring progress and issue an annual report card on the nation's progress in meeting the goals. The eight national education goals included in the bill signed by President Clinton prescribe that by 2000:

- All children will start school ready to learn.
- At least 90 percent of students will finish high school.
- Students will leave grades four, eight and twelve with demonstrated competence in English, math, science, foreign languages, civics and government, economics, arts, history and geography.
- Teachers will have access to programs for the continued improvement of their skills.
- The United States will be first in the world in math and science achievement.
- Every adult will be literate and possess the skills to compete in a global economy.
- Every school will be free of drugs and violence.
- Every school will promote involvement of parents in their children's education.

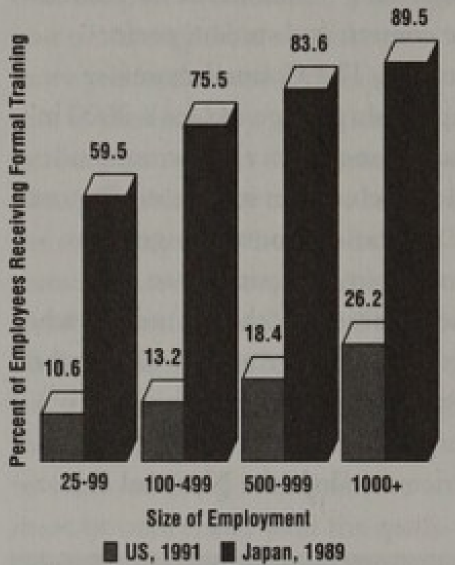
School-to-Work

President Clinton also recently signed the School-to-Work Opportunities Act, which reflects many of the Council's recommendations in this area. The Act provides $300 million in FY 1995 as seed money to states and local school systems to develop school-to-work transition programs. Aimed squarely at reclaiming the "forgotten half" of American youth who do not go on to college [Figure 8], this initiative includes many of the elements that the Council recommended as essential components: mentorship and jobs provided by employers; integration of academic and vocational learning; provision of wages to protect against exploitation of student-workers; and provision of certificates of occupational skill mastery upon completion. Particularly gratifying is the spread of interest in this program on the part of an increasing number of states which are developing their own approaches, including apprenticeships, tech-prep education, cooperative education, and career academies. The Council applauds the cooperative efforts of the Departments of Labor and Education in making $100 million in funds available this fiscal year for the program and in working together to move this initiative forward.

Training

Active worker training is the one area within labor market policies in which the United States lags behind its trading partners and there has been no progress. [Figure 9] During the campaign, President Clinton suggested a "play or pay" scheme, which would have required firms to spend at least 1.5 percent of payroll on training of active workers, or else pay that amount into a government training fund. Concern from the business community caused the Administration to back off from this proposal. In its Second Report, the Council recommended that the government encourage firms to increase job-related training through grants, tax credits or payroll requirements. The Administration has not yet put forward its proposal to promote greater job-based training, and the Council encourages it to do so soon.

Figure 9
Private Sector Training



Source: Organization for Economic Cooperation and Development

Reemployment of Dislocated Workers

The Administration recently proposed to overhaul the nation's programs for dislocated workers. The proposed Reemployment Act of 1994 makes several innovations in the confusing web of current labor programs. First and foremost, the Administration proposes a single program for all workers, regardless of the cause of their dislocation. Second, the new program would expand opportunities available to dislocated workers to improve their skills and find new jobs. Individuals could participate in long-term meaningful training and receive income support for up to two years while they are enrolled in training. The Administration also wants to create a system of "one-stop" centers for providing services and improve the collection and dissemination of labor market information to make it easier for people to find new jobs.

The Council supports the Administration's efforts to improve government programs designed to help workers adjust to the new economic realities. The Council also has several concerns in light of the Administration's proposal.

The Reemployment Act aims to eventually terminate Trade Adjustment Assistance (TAA), a program dating back to 1962, aimed at assisting those workers who lose their jobs due to trade. While there are strong arguments in favor of maintaining a program tailored for trade-impacted workers, the major objection to rolling this program into a general program is that it would result in a net reduction of benefits provided for those workers.

A core issue in the debate over dislocated worker programs is whether these programs should provide guaranteed benefits (an entitlement) or have spending limits. Currently, TAA is an entitlement and general assistance for all dislocated workers (under the Economic Dislocated Worker Adjustment Assistance program) has a spending cap. The Administration has attempted to make some inroads in this debate. On the one hand, the Administration is concerned that the quality of benefits may be compromised under strict spending limits. On the other hand, the Administration realizes that longer training and income maintenance for those in training are critical to promote serious adjustment. The Reemployment Act proposes extended income support for those undertaking training, but does not go far enough in ensuring adequate benefits for *all* workers in need. Furthermore, there is insufficient effort at designing a secure funding base to insure the long-term viability of the program.

Most people agree on the importance of training the nation's workers, both while employed and between jobs. Yet during a time of limited public resources, there is heightened awareness of the costs of such programs. We need to better spend the resources we currently devote to training while at the same time expand these programs to encourage more labor market flexibility.

"If our aim is to improve the living standards for all Americans, we must be concerned with the quality, as well as the quantity, of the jobs we create. In addition to creating high productivity, high income jobs, we must also make the proper investment to prepare our workers so that they can perform well in them."

Critical Technologies

In its Second Report published last year, the Council recommended that the Administration adopt a new technology policy to improve US competitiveness. The main features of this policy, as developed by our Critical Technologies Subcouncil, chaired by Erich Bloch, a former Director of the National Science Foundation, include:

- Moving $4 to $7 billion per year from defense R&D to civilian and dual-use R&D. [Figure 10]
- Significantly increase funding for industry-driven R&D programs (where industry shares in the cost and sets the direction of the R&D).

Figure 10
Civilian/Dual Use Industrial Technology Programs

	FY93	FY94	FY95	Percent Change FY94-FY95
		($ in millions)		
Advanced Technology Program (NIST)	68	200	451	128
Technology Reinvestment Project (ARPA)	472	554	625	13
Manufacturing Extension Program (NIST)	18	30	61	103
Technology Transfer (CRADAs, several agencies)	384	551	865	57

Percentage Distribution of Civilian and Defense R&D

	FY93	FY94	FY95
Dual Use Counted as Defense			
Civilian R&D	41	44	44
Defense R&D	59	56	56
Dual Use Counted as Civilian			
Civilian R&D	43	47	46
Defense R&D	57	53	53

Source: Budget of the United States, Fiscal Year 1995

- Focusing federal procurement and R&D projects in areas that would help drive commercial technologies, such as in defense procurement and initiatives to develop a national information infrastructure or intelligent vehicle/highway system.
- Improving the financing of the commercialization of technology.
- Improving the infrastructure for manufacturing and technology commercialization, including programs to help small manufacturers modernize.
- Restructuring the priority setting and management of federal R&D, and increasing private sector input to this process.

The Administration has begun to implement a new technology policy largely reflecting the Council's recommendations. These steps are promising, but many of the changes needed to develop an effective US technology policy are structural in nature and cannot be fixed in a single year. For our technology recommendations to accomplish their goals several things must happen over the next several years:

- Congress must appropriate funds for programmatic increases in the President's budget request in FY 1995.
- The work must continue, both in the Administration and the Congress, in the FY 1996 and FY 1997 budgets. This promises to become increasingly difficult under the caps in the budget agreement.
- The government and private sector must work together to ensure that the new and expanded programs work as intended, and that they are evaluated and modified as necessary.

Although the Administration has adopted an ambitious new approach to managing its R&D budget, the nation will not have a well-managed R&D program until comparable, and more difficult steps are taken to improve the management of science and technology in the Congress.

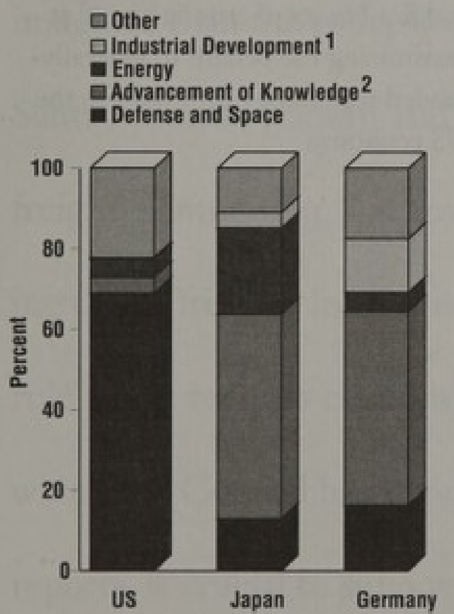
The R&D budget is highly fragmented in Congress, divided among nine appropriations subcommittees. The authorizing committee that has the clearest focus on the R&D budget, the House Committee on Science, Space, and Technology, authorizes less than 30 percent of the R&D budget. This fragmentation makes it very difficult to set priorities, especially for multi-agency programs.

In its recommendations last year, the Council noted the need to establish a more streamlined process in Congress for making decisions on science and technology, such as realigning appropriations subcommittees to bring more key technology programs under a smaller number of subcommittees, or by establishing a process by which authorizing and appropriating committees together can examine the whole R&D budget. These recommendations are increasingly important.

The Council is encouraged by the recent passage of technology legislation by the House and Senate. The legislation includes many of the Council's recommendations. We hope that Congress will act promptly in addressing the differences in the two versions. The legislation would establish a program by which the federal government would make loans to technology development finance corporations, which would then invest in early stage financing for new technology ventures. Although there is support for the federal government helping to correct market failures in the financing of technology, the Critical Technologies Subcouncil has two concerns with the specific proposals.

First, the Subcouncil believes that although there may be a need for increased early stage financing, the main problem is in later stage financing for capital-intensive projects. A variety of federal, state, and private sources currently provide funding for early stage development, although more funds could be used. Funding is very limited,

Figure 11
Composition of Federally Funded R&D



1 The US spends 0.3 percent of its R&D on industrial development.

2 Includes only research for the US. The US does not have general university funds.

Source: National Science Foundation, OECD, National Sources

"The Administration has begun to implement a new technology policy largely reflecting the Council's recommendations. These steps are promising, but many of the changes needed to develop an effective US technology policy are structural in nature and cannot be fixed in a single year."

however, for capital-intensive projects. Venture capital funds can individually support projects that require $3 to 4 million; several funds working cooperatively can support ventures of up to $30 million. Some technologies, however, require significantly greater amounts of funding to become successful, and it is in some of these technologies (such as flat panel displays or lithography for semiconductor manufacturing) where US industrial competitiveness is the weakest.

Second, venture capital firms, as currently structured, may have difficulty taking advantage of the loan provisions in the House version. Venture capital firms can not transfer liabilities across investment projects, since it would expose the partners to a liability greater than their initial investment. This makes it particularly difficult for venture capital firms to receive government loans. The Council continues to strongly support prompt final passage of this legislation and hopes that the Department of Commerce will seek private sector input as it refines this proposal, as called for in the current legislation.

The federal government's role in promoting research primarily through the tax code has been recently supplemented by serving as a more active participant in promoting American leadership in emerging technologies. This expanded role raises the question of what eligibility criteria should govern participation by US and foreign firms in federally-funded technology programs. Presently, different federal R&D programs have different, and sometimes ambiguous, criteria. In actuality, it would be difficult to develop a rigid set of requirements applicable in every situation. For example, some firms may perform their R&D at home even though they manufacture their products abroad. It may be counterproductive to deny such companies the opportunity to participate in federally-funded R&D.

The Council has asked the Critical Technologies Subcouncil to take a careful look at recent developments in this area. The Subcouncil is studying the various criteria currently being employed and will recommend guidelines for developing a coherent and flexible set of criteria aimed at maximizing the benefit of federally-funded technology programs to the US economy.

Public Infrastructure

The devastating impacts of the earthquake in Los Angeles provide another example of how dependent our economy is on the nation's infrastructure and how much we take that infrastructure for granted. No more glaring example of transportation's impact on the economy could be imagined than the collapse of the nation's busiest highway, the Santa Monica Freeway, and the attendant losses related to freight, commuting, and commerce. The astonishing rebuilding of the freeway in six weeks time also points to its enormous role in the region's economy. Investment in infrastructure, which the Council has strongly recommended in its earlier reports, is crucial to support and enhance economic value, create jobs, and sustain the long-term competitiveness of the national economy.

The LA earthquake showed in the starkest of terms how infrastructure serves as an economic life-line linking communities, states, and the nation. In light of the central role infrastructure plays in productivity, economic growth, urban renewal, and job creation, and in light of the overlapping interests in infrastructure on the part of numerous government agencies, the creation of a White House committee or federal interagency task force on infrastructure is needed to coordinate a national strategy for infrastructure renewal and responses to high priority infrastructure needs.

Budget Proposals

The Council is encouraged by the positive attention given to investment in transportation infrastructure in the President's proposed FY 1995 budget. Recognizing the importance of public infrastructure in the national economy, the budget requests full funding of highway programs at the levels authorized in the Intermodal Surface Transportation Efficiency Act of 1991 (ISTEA).[16] The proposed increase in Amtrak's capital improvement funds is also long overdue.

In its Second Report, the Council noted its concern with the "pork barrel" approach to infrastructure embodied in a series of Congressionally-mandated highway demonstration projects. These projects are singled out for special treatment by federal officials and lawmakers rather than competing at the state level for the limited resources available. We are pleased therefore to see the Administration's proposed rescission of funding for these highway demonstration projects.

Financing Proposal

Although the budget proposals for FY 1995 and beyond reflect a renewed attention to capital investment in infrastructure, the increases are barely large enough to make a dent in the decades-old deterioration of the nation's infrastructure. Chief among these problems is the practice by state and local officials of deferring maintenance on infrastructure to the indefinite future. The practice is so widespread that the category of "deferred maintenance" has taken on the connotation of an actual program item in state and local budgets. But deferred maintenance is not a program, it is a liability, and the public needs to be continually aware of the deferral of its responsibilities to maintain its own economic lifelines.

To tackle these problems head-on, Edward Regan, a member of the Competitiveness Policy Council recently proposed a large, fiscally sound, public infrastructure investment program.[17] The program includes the following components:

- A one-time major upgrading and renovation of the nation's deferred maintenance needs, on the order of $80 billion over a two-year period.
- Creation of taxable state and local infrastructure bonds to finance the program; such bonds would be able to attract investments from pension funds as well as other sources.
- Federal subsidies of the interest payments on these bonds over a 15-year period.
- Use of bond covenants that are enforceable in the courts and that require preventive maintenance of the infrastructure, thus locking in the benefits of the program.

There are several advantages of this proposal. First, it concentrates on preventive maintenance of existing infrastructure, a continuing priority for our nation. Second, it advocates paying for long-term infrastructure investment through appropriate long-term debt instruments, rather than through increases in operating funds. Third, this proposal would only minimally impact the federal deficit. It would require state and local governments to share in the costs, and it would schedule the federal share over the useful life of the projects. The federal government would collect taxes on the interest payments on the taxable bonds, thus offsetting some of the costs of these interest payments. Finally, the program would create tens of thousands of jobs, a highly beneficial public purpose. The Council commends this proposal for serious consideration on the part of Congress and the Administration.

National Transportation System

Congress has the opportunity to establish a strategic basis for the nation's highways and transportation system as a whole and to link the transportation system to the goal of improving US competitiveness. The occasion for this is the submittal by the Department of Transportation in December 1993 of a proposed National Highway System (NHS) to Congress for review and adoption.[18] The proposed system of 158,000 miles of highways carries over 70 percent of the nation's commercial traffic, and connects to hundreds of ports, airports, terminals, and border crossings.

In announcing the NHS, the Secretary of Transportation placed it within the context of the development of a National Transportation System intended to fully integrate passenger travel and freight movement by air, rail, water, pipeline, and transit.

Congress has until September 30, 1995 to complete the adoption of the NHS. In the event that Congress does not act, the Department of Transportation will not be able to distribute FY 1996 funds in the NHS category and the NHS concept will disappear.

We urge Congress and the Department of Transportation to avoid this possibility, and go further in the direction of strengthening the NHS. This would mean extending to the NHS the high safety and quality standards of the Interstate system and enhancing the ability of the NHS — and the larger National Transportation System — to serve the nation's strategic competitiveness interests. One clear example of the strategic directions to be taken is the need — already identified by the Department of Transportation — to address infrastructure problems associated with the movement of international trade. Reaping the full benefits from the commercial opportunities resulting from the North American Free Trade Agreement will require improvements in waterborne highway, aviation and rail systems and their multiple connections in order to reduce border bottlenecks. More generally, the

"Investment in infrastructure, which the Council has strongly recommended in its earlier reports, is crucial to support and enhance economic value, create jobs, and sustain the long-term competitiveness of the national economy."

National Transportation System may become an appropriate framework for the reauthorization of federal transportation programs after ISTEA expires in 1997. Ultimately it could serve as a strategic basis for integrating not only transportation modes but also related communications systems.

Trade Policy

The Council notes that many of its specific recommendations on trade policy made in the Second Report have been implemented by the Administration.

In particular, the Council welcomes the conclusion of the Uruguay Round trade negotiations of the General Agreement on Tariffs and Trade (GATT). Taken as a whole, the new trade agreement and the institutional reforms in the GATT will provide real economic stimulus to the United States and all countries which trade. The Administration, and in particular the Commerce Department, is doing a good job in coordinating export policy. Although there were delays in making several key appointments, the mechanisms being used — in particular the Trade Promotion Coordinating Committee — now seem to be working well.

We commend the Administration's recent decision to remove the requirement for shipment-by-shipment advanced approval for virtually all civilian telecommunications and computers exports to China and the countries of the former Soviet Union. This action is in accordance with the Council's recommendation to remove unilateral export controls. We hope that the Administration will continue working to eliminate all remaining export disincentives and that the Administration and Congress will agree on reform and rationalization of the Export Administration Act soon.

We note that the Administration is seeking higher budget authority for many export-related programs and we applaud this shift in priority. Although the Administration does not envision the Export-Import Bank program reaching as high as the $20 billion level recommended by the Council, the Administration estimates that it will increase from $16.7 to $17.5 billion in FY 1995.[19] The Council's recommendation for a unified budget function has not yet been followed, but the Office of Management and Budget (OMB) has put together a table of Export-Related Expenditures (Table 3B-13 in the FY 1995 Budget). We are encouraged by the prospect that a unified budget function may be employed in FY 1996.

With regard to international trade, the Council recommends the following: First, we urge the Administration to submit the GATT implementing legislation as soon as possible now that the GATT Agreement has been signed.

Second, we urge the Congress to renew the President's trade negotiating authority (which expired on December 15) for new multilateral, regional and bilateral agreements. The President should not be handicapped in foreign economic policy in a rapidly changing world.

Third, we again reiterate the importance of assuring a competitive exchange rate for the dollar. Maintenance of the recent appreciation of the yen is an essential element in reducing Japan's huge and disruptive global surplus.

Improving the Policy Process

In our earlier reports, the Council called for more effective approaches at the federal level to design and implement a national competitiveness strategy. We note that some progress has been made in the past year, but we believe that further steps are needed. This section will discuss four relevant areas in the federal budget process: (1) investment budgeting; (2) budget caps; (3) competitiveness impact statements; and (4) industry baselines.

Investment Budgeting

The federal budget process lacks any systematic way of assessing the appropriate trade-off between current consumption and investment. The President's budget is put together with recommendations from each department. The Congressional budget committees review the budget according to CBO function categories and aggregate outlays and deficit. The House and Senate appropriations committees divide the budget up by subcommittees, usually along agency lines. Even though the budget is assembled in three different ways, none of these ways directly analyzes compositional issues such as investment versus consumption.

In prior reports, the Council has recommended that the US government establish an investment budget to highlight the share of federal spending going to public investment and to permit careful consideration of whether that share is adequate. By an investment budget, the Council is not referring to a capital budget that separates physical capital and credit flows from the rest of the budget. An investment budget is a far simpler reform to accomplish.

Defining Investment

There is no simple definition of public investment. Generally, these are government programs to purchase goods and services which provide significant positive externalities over a long period of time.[19] Investments typically have lengthy payoffs and produce tangible results. They lengthen the productive life or increase the productivity of labor and/or capital.

The General Accounting Office (GAO) has suggested that any investment budget should probably exclude most defense expenditures (but include defense R&D), most federal civilian buildings, and major equipment for carrying out federal functions. OMB has taken a broader view in its analysis of investment. There will never be complete agreement about the definition of public investment. Since our proposal does not relax budget disciplines (as a capital budget might), there is no need for full agreement as long as the investment budget is clear about what it includes and is consistent over time.

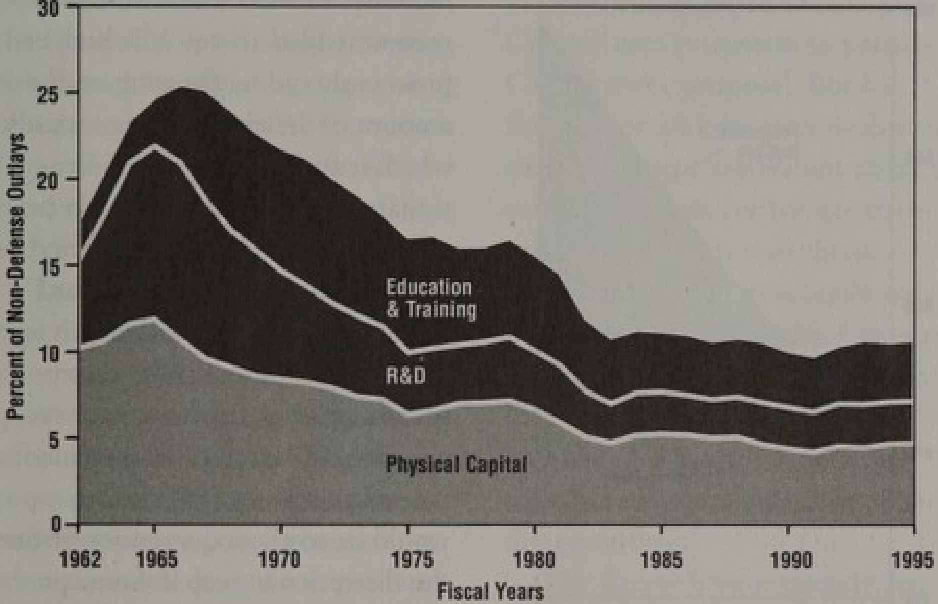
The value of an investment budget lies not only in knowing the percent of spending that goes for investment, but also in looking at trends and using the data to establish investment targets. There would also be great benefit in estimating how much investment is needed in future years so that the US government would be able to consider in advance whether sufficient funding will be available.

The Council strongly supports the Clinton Administration in its efforts to increase federal investment but we urge further action. By making the consideration of investment an explicit part of the budget process, the Administration can develop a more coherent investment plan. By monitoring public investment more transparently, the Administration and Congress may have an easier time persuading the public that such investments must be preserved and, if possible, increased.

For many years the President's budget has included a breakout of investment expenditures, including physical and non-physical investment, and both defense and non-defense investment. But there is no evidence that this presentation influences decisionmaking. It appears that it is put together by the OMB after all of the individual budget decisions are made. No Congressional committee uses it for policy making. There is little public attention to these numbers.

Based on OMB's categorization of investment programs, the Council has examined federal investment levels over the past thirty years. [Figure 12] We note that the Clinton Administration's FY 1995 budget does call for an increase in non-defense investment over last year's level. But taking a thirty-year perspective, we find that the share of non-defense outlays going to investment has steadily declined.[20] The current level of investment is down substantially from a generation ago. Federal investment (including physical capital, research, education and training) is lower

Figure 12
Composition of Federal Non-Defense Investment



Source: Office of Management and Budget

both as a share of non-defense budget outlays and as a share of GDP.[21] In 1965, federal investment constituted approximately 25 percent of non-defense outlays and 2.5 percent of GDP. In 1995, federal investment is projected to be approximately 11 percent of non-defense outlays and 1.9 percent of GDP. The Council believes that we need to increase public investment in these areas, as well as make better use of the dollars we are currently spending.

The Council has also worked with GAO to analyze the FY 1995 budget based on GAO's definition of investment which looks at federal programs that lead to long-run productivity improvements in the private sector. This is narrower than the above measure in some ways (excluding federal structures for the operation of government) and broader in others. Based on the GAO definition, we find that the Clinton budget does not succeed in increasing investment above the 1993 level. In 1993, such investment was 1.7 percent of GDP, slightly higher than the expected FY 1995 level.

The Council's Proposal

The federal government needs to do a better job of tracking public investment which is so important to raising long-run productivity. The budget process we envision would start with a "soft target" from the National Economic Council for the percent of the total budget that should go for public investment. After the President makes his budget decisions, OMB would prepare an investment budget for the Congress. Specifically, investment would be subdivided by budget function and class, and then totalled.[22] The total should be shown as a percent of total civilian federal spending and as a percent of GDP.

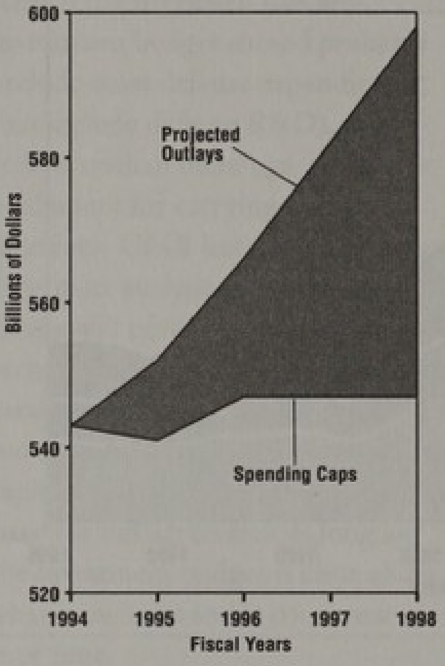
The Congress might ask CBO to develop comparable investment figures for other countries. Ideally, the budget resolution would include an explicit statement on the appropriate level of federal investment. There might also be Congressional hearings on the adequacy of the investment share and level, as compared to other countries. In addition to budget-year numbers, the OMB tables should include projections of what the Administration intends to invest over a five-year period. The budget resolution should specifically consider the adequacy of the five-year numbers and the likelihood that such investments will fit within discretionary spending ceilings. Overall, the Council suggests a soft non-defense investment target of 12 percent of total non-defense outlays (or 2.1 percent of GDP in 1993). This would require an additional $16 billion shift into public investment in the FY 1995 budget, from $134 billion to $150 billion.

Budget Caps on Discretionary Spending

In its Second Report, the Council endorsed strong efforts to reduce the deficit on the scale proposed and later largely achieved by the Administration. We pointed out that such deficit reduction was the linchpin to a competitiveness strategy. The Council is pleased that the economy is currently stronger than many of us might have predicted a year ago. This good economic news, although tempered by remaining unemployment and falling real wages, provides all the more reason for the Administration and Congress to stay the course on deficit reduction. As we noted in our First Report, the eventual goal should be to move the budget into surplus. The current recovery is a good time to accommodate structural reforms and to think about the long term.

The discretionary spending caps enacted in 1990 and re-extended in 1993 have been a helpful management tool to Congress, but may now have outlived their usefulness. If continued beyond FY 1995, these caps will require very large cuts from the budget baseline. [Figure 13] We are doubtful that the necessary increases in public investment can be made under the constraint of these budget caps.

Figure 13
Projected Discretionary Spending



Source: Congressional Budget Office

Reducing the deficit does not require a freeze in discretionary spending. There is no reason why the United States should put itself in a straightjacket on many categories of government spending, including defense. Thus, while the Council strongly reaffirms the need to continue lowering the federal deficit, we believe that consideration should be given to amending the Budget Enforcement Act to permit entitlement cuts or revenue increases to be used to pay for increases in federal investment as recommended above. The budget process should be focusing on the amount of deficit-spending, not on whether such spending is discretionary or mandatory. It might be noted that the Congress has tried caps on the deficit (Gramm-Rudman) which did not work and it is now using caps on discretionary spending which do work but have negative side effects. An intermediate solution — not yet tried — would be to allow derogations from the discretionary cap if done in a deficit neutral manner. More attention should be given to making cuts in entitlements and tax expenditures for affluent Americans.

Competitiveness Impact Statements

Under the Omnibus Trade and Competitiveness Act of 1988 (2 U.S.C. 194b), the President and heads of agencies are required to prepare a "Competitiveness Impact Statement" (CIS) on all legislative proposals which may affect the ability of American firms to compete in international commerce. The statement is supposed to be submitted to the Congress along with the legislative proposal.

Unfortunately, neither the Reagan, Bush, nor Clinton Administration has carried out this law. In both its First and Second Reports, the Council pointed out the Executive Branch's continuing responsibilities under this law. As far as the Council is aware, no specific CIS reports have been filed by the Clinton Administration.

The Council endorses the concept of a competitiveness impact statement. All too often the federal government enacts legislation or adopts new policies that impair US competitiveness (e.g. export controls for foreign policy reasons). In some cases, the loss of competitiveness may be a trade-off for some other social good. But in many cases, the impact on competitiveness is an unintended side effect. The Council believes that by incorporating the potential competitiveness effects into the lawmaking and regulatory process, policymakers might be sensitized to the impact of their decisions on our standard of living.

Given the political difficulties of effecting any major policy reform (e.g. health care), the President should arm himself with the best possible arguments. For many proposals, the competitiveness linkage is key and may help the Administration achieve reform.

The Council recognizes that what may look like useful analysis may be seen by busy policy officials as unnecessary paperwork. The Council sees no reason to prepare a CIS on every proposal. But for those 10 or 20 initiatives each year that may have a significant effect on competitiveness, we believe that such an analysis is warranted.

When the Congress legislated this requirement in 1988, a six-year sunset was established. Thus, the CIS law will expire in August 1994 without ever being tested. This analytical experiment has proved disappointing.

The Council recommends that the Congress enact a new CIS requirement, but with two changes from the current law. First, the responsibility should be assigned elsewhere than the agency originating the proposal — such as an independent agency like the US International Trade Commission (ITC), or perhaps the Congressional Budget Office.[23] Second, the CIS requirement should be narrowed to just those new proposals by the Administration with a significant impact on competitiveness. Some preliminary analysis would be needed to determine when a proposal's effects cross a threshold of significance.

"The federal government needs to do a better job of tracking public investment which is so important to raising long-run productivity."

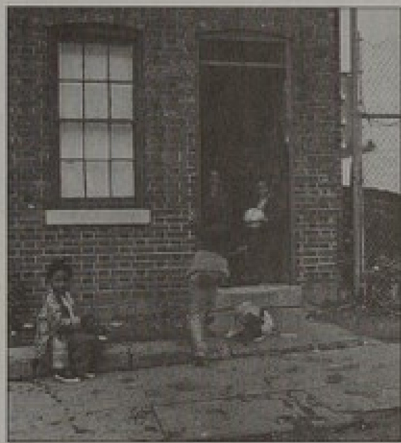
Industry Baselines

In its First Report, the Council urged that the President designate a lead agency on competitiveness issues and assign it the task of raising the nation's awareness of the problem. The Clinton Administration has designed a new policy coordination structure including the National Economic Council and the National Science and Technology Council. While these institutions are far more proactive than previous White House institutions, the Council thinks more can be done to focus on competitiveness both in decisionmaking and in educating the public about the need for economic change.

One of the Council's specific recommendations was that a federal agency begin assessing the likely course of key American industries. This would provide a baseline against which to judge specific competitiveness problems in the future.

Last year, the Council reported that the ITC was planning to create an Office of Competitiveness to undertake such analyses. The ITC has since decided to postpone creating the office, but has begun performing baseline studies of a limited number of industries. The Department of Commerce is just beginning an effort of developing industry benchmarks. It is still too early to know how extensive this effort will be. The Council urges the President and Congress to give renewed consideration to the importance of industry baselines and who should prepare them. Given their existing capabilities, we continue to believe that the Congress should provide a mandate and adequate funding to the ITC or the Department of Commerce for this purpose. The ITC might be given the task of performing both these baseline studies and the competitiveness impact statements.

Social Issues



Last year, the Council identified social issues as a competitiveness concern and began to lay out an agenda for further consideration.[24] At the request of the Council, James Renier, former CEO of Honeywell, prepared a preliminary paper directing the Council's attention toward the critical issues of children's readiness to learn and preparedness for school, as well as the social mandates borne by schools.

What is the relationship between social issues and competitiveness? A competitive economy must be defined more broadly than by its balance of trade. Competitiveness requires a rising and sustainable standard of living, primarily but not exclusively defined in economic terms. Moreover, this standard of living or quality of life must extend to all groups of Americans, not merely the privileged few or the broad middle class.

No one who picks up a newspaper or turns on a television in modern day America can fail to notice that a substantial segment of society is not sharing in the current recovery from the recession. The poor are falling increasingly behind. Indeed, poverty and its insidious effects go beyond the boundaries of disadvantaged communities to weaken the fabric of society in ways our society is only beginning to understand. Certainly the competitive potential of the economy as a whole is diminished by our inability to tap the full potential of all members of society.

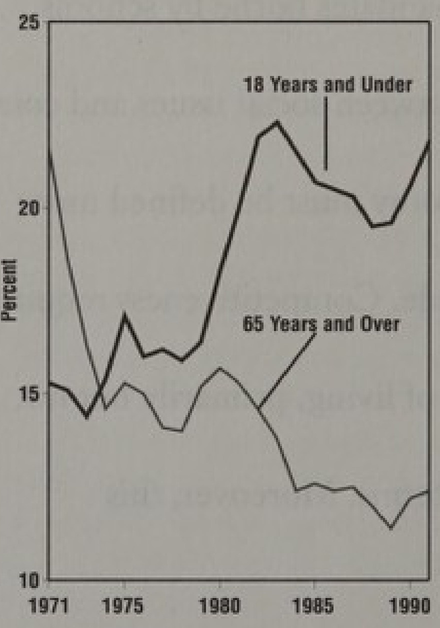
The social issues confronting the nation — crime and violence, poverty, unemployment, substance abuse, inadequate education, infant mortality, family breakdown, homelessness, etc. — are intensified in the inner cores of the nation's largest cities, once the source of significant industrial activity. Here the legacy of racial discrimination has combined with disappearing economic opportunities in a devastating cycle of poverty and violence. But similar problems are found in other parts of the country, including a great many rural areas that have been left behind in the race for economic progress.

Most disturbing — and perhaps serving as a much-needed wakeup call — is the realization that has slowly dawned on the nation over the last five years: the neglect of social issues is scarring the next generation of Americans. As a society we are throwing away the future productive capacities of a growing portion of our people.

More children are living in poverty in the 1990s than in the last twenty years. [Figure 14] Twenty percent of all American children are living in poverty; among minorities, poverty rates are even higher: 38 percent of Hispanic children, and 44 percent of African-American children.[25]

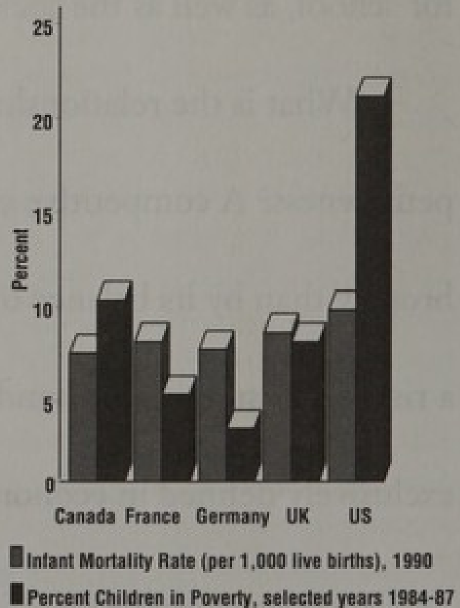
The Carnegie Foundation for the Advancement of Teaching has found that one third of children entering kindergarten are not equipped mentally or physically to start the learning process.[26] More recently, the Carnegie Task Force on Meeting the Needs of Young Children issued a warning that the youngest children of America — those under age three — are living in a "quiet crisis." The Task Force noted that "a staggering number are affected by one or more risk factors that undermine healthy development."[27] The gap between children from different social backgrounds is substantial at a young

Figure 14
Poverty Rates for Young and Old



Source: Department of Commerce

Figure 15
International Comparison of Child Well-Being



Source: Kids Count Data Book, 1993

age, and grows steadily larger as children get older.

Moreover, research is showing that the effects of poverty, poor learning and academic performance, and unstable family life are long-lasting, affecting an individual's prospects for job and marital stability well into adulthood.[28] Those, for example, who drop out of high school are plagued by the consequences of this act over their entire careers. White and black males age 25 to 34 who do not finish high school earn on average 27 percent less than those who do finish school. For white and black females, the disadvantage is even larger — 39 to 42 percent less than high school graduates.[29]

On a variety of indicators, American families and children are faring poorly compared to other industrialized nations. [Figure 15] Some researchers attribute more than half the increase in child poverty over the last decade in the United States to changes in US family structure.[30] One in four children today lives in a single-parent family, a 9 percent increase just since 1985.[31] Children in one-parent families are up to ten times more likely to experience poverty in childhood for seven years or more compared to children in two-parent families, and two or three times as likely to have emotional and behavioral problems.[32]

Children grow up to be the nation's workers. The link between the social problems affecting our youth today and our future competitiveness is easy enough to draw. Social problems weaken American competitiveness, both now and in the future, in both obvious and subtle ways.

Reducing the size of the workforce. Intractable social problems rob the nation of the productive capacities of a sizable percentage of the population. This may include criminals, addicts, the homeless, single parents, and others, who have dropped out of, or never joined, the labor force. These people represent resources lost to the economy. Those without a high school diploma are being steadily edged out of the workforce. Although the high school dropout rate has improved slightly in the last two decades, labor force participation rates among 25 to 34 year old males with less than 12 years of school dropped 9 percentage points between 1971 and 1991.[33]

Young people in disadvantaged communities do not want to be permanently sidelined from the workforce, but they are particularly sensitive to the state of the local labor market. A study of out-of-school young men in a number of urban areas in the 1980s concluded that local labor market shortages greatly improved the employment opportunities of disadvantaged

"The neglect of social issues is scarring the next generation of Americans. As a society we are throwing away the future productive capacities of a growing portion of our people."

young men, particularly black youths, substantially reducing their unemployment rate and increasing their hourly earnings.[34]

Conversely, a lack of work during crucial periods in a person's career development can lead to permanent disadvantage, as youths lose ground to peers who are better trained and better integrated into the workforce. A steady prevalence of unemployment can lead some to give up on finding work and permanently exclude them from the labor force. Persistent pockets of severe unemployment, reaching levels of 37 to 40 percent among black male and female 16 to 19 year olds,[35] can discourage job-seeking and deny youths the entry-level experience and skill development needed to build successful work paths. Some 5 percent of youths age 16-19 (9 percent of black youths, 8 percent of Hispanics) report no productive role in society: they are not in school, in the labor force, or in the military, and they do not describe themselves as homemakers.[36]

Reducing the skill level of the workforce. Poverty and other problems interfere with the ability to learn, producing workers who are poorly equipped for the workplace. Numerous studies have found a strong correlation between measures of academic achievement in mathematics, reading, science, and problem solving, and subsequent productivity on the job.[37] Yet at age 17, fewer than half of American students have the skills and basic knowledge required for college or many entry-level jobs.[38] Government and business bear the costs of remedial education and training, the need for which continues to escalate. Other social problems also affect performance on the job — ranging from substance abuse to poor health status to a lack of support for family emergencies.

High cost of crime. Violent crime has risen steadily in the last decade, and the costs to society has been escalating as well. A recent tally of the costs associated with crime — including the costs of the criminal justice system, public police and security systems, private security systems, damage to urban economies, medical care, property losses, and lost work years and reduced productivity associated with crime — amounted to a total annual drain on the US economy of over $400 billion.[39] And yet even this staggering sum cannot make the victims of crime whole, as anyone who has experienced the ravages of crime will attest.

Drain on government expenditures. In addition to public security and criminal justice expenditures, a growing portion of federal, state, and local government budgets is devoted to ameliorating social problems, including public assistance, health care, and social services. With this type of spending we are running as fast as we can just to stay in place. In a time of limited public resources, this spending hampers our ability to invest in people and the economy, which would improve productivity and contribute to a broad-based rise in living standards. Preventing problems from occurring rather than spending money in a futile attempt to prevent them from getting worse is a cheaper and ultimately more effective solution.

The Clinton Administration Agenda

The Clinton Administration has identified social problems as a priority for its domestic agenda. We commend the Administration and Congress for taking some first steps in this direction; the expansion in the earned income tax credit (EITC) is particularly noteworthy. The EITC will help reward people for working, at least to the extent of keeping working families out of poverty. Another promising effort is the Administration's community development initiative, combining tax benefits, social service grants, and improved program coordination in nine "empowerment zones" and 95 "enterprise communities." Even more significant will be action in the areas of crime and welfare reform, two stated priorities of the Administration this year.

Some analysts point to the experience of certain European countries and argue that building a too-generous safety net detracts from the beneficiaries' incentives to take jobs and society's ability to create jobs. Others point to the constructive elements of these programs in upgrading workers' skills and sharing the benefits of economic growth. One of the useful elements of the current debate on welfare reform is the attention being paid to the unintended consequences and incentives created by the welfare system on its recipients' levels of dependency, work and lifestyle choices.

Nevertheless, there are numerous areas where government expenditures, as well as the active involvement of the private sector, can make a difference. Studies are showing that increased expenditures on policing, particularly community policing, could make a major dent in violent crime. Expenditures on rehabilitation may be the only way to effectively turn around drug abuse. Preventive spending in health care, community development, and youth and family services is still sorely underutilized. Early intervention programs such as Head Start can be highly cost-effective, but only when they are done well. Programs that seem to work tend to be those that feature adequately funded and trained staff, that intervene deeply and at the appropriate time, and that have continuity.

Social problems can rarely be solved in isolation. We have too many fragmented programs and benefits, aimed at correcting one particular problem, such as drug abuse, in isolation from other interventions. The notion of "one-stop shopping" being put forward in training and other programs should be applied more broadly as well. Whenever feasible, a common aim for many of our social problems should be to get people back into the labor force as productive participants in the economy. Emphasizing society's interest in a productive workforce — and a competitive nation — is neither heartless nor imprudent. In the long run, it will serve individuals, their communities, and the nation well.

In some cases — such as the nation's elementary schools — we are heading toward more integration of services, but without adequate funding of the mandates. Schools are now called on to provide social services ranging from "health programs, day care, drug education, parental education, counseling for teenage parents and dropouts, AIDS instruction, suicide prevention and services for children from birth through age three."[40] Yet

"A strong economy and a healthy society support each other. The strength of one builds the strength of the other. And competitive power depends on both."

—James Renier

our schools are not given the resources to deal with these mandates, while their primary mission of education is crowded out by other demands.

The current debate over social problems has developed into the usual stand-off between liberals calling for more money to be spent and conservatives calling for cultural changes that will restore traditional values to disadvantaged communities. The Council sees both sides as offering an important piece of the whole: more money must be invested *and* more responsibility must be nurtured and shared across our communities. Past experience with educational programs and welfare reform should provide us with at least a few lessons learned well. Whatever the approach taken and however much money is authorized in Washington, a lack of actual funding and indifferent implementation at every level can render any initiative dead on arrival. Effective implementation of programs is the only way to restore the belief that our social problems can be tackled successfully.

James Renier has pointed out, "A strong economy and a healthy society support each other. The strength of one builds the strength of the other. And competitive power depends on both."[41] America cannot realize its full economic potential if we abandon our disadvantaged populations. Finding the will and the means to weave the social fabric into a tighter, more inclusive bond is one of the most important tasks we can undertake. The Council sees its own contribution in this area over the next year as focusing on issues related to child readiness to learn, the effectiveness of pre-school and supplementary school programs, and youth dropout, unemployment, and labor force participation

Capital Allocation

In its Second Report, the Council noted that the United States has the lowest investment rate among major industrial countries, half that of most and one third that of Japan. Most of the increase in national investment necessary to meet the Council's goal of raising living standards will have to come from the private sector.

Last year the Council reported that "there is a need to develop a whole new approach to defining the value of a corporation and to measuring long-term corporate performance." As part of this effort, the Council asked Robert Denham, Chairman of Salomon, Inc., and Professor Michael Porter, of the Harvard Business School, to co-chair a Subcouncil on Capital Allocation.

Over the past few years, a series of reports have been written providing a rich analysis of the strengths and weaknesses of our financial system. Their most prominent common theme is that the economy could significantly benefit from the development of more patient relationships between investors and the companies in their portfolios. In particular, the climate for long-term capital investment may be enhanced when stockholders hold significant stakes for longer periods and play a more active role in monitoring company performance.

Such "relationship investing" increases the incentive for investors to acquire a better understanding of the company's strategic direction and the effectiveness of its board of directors. It also increases the incentive for management to be accountable to owners in order to maintain their confidence in the company's strategic vision. Better investor understanding of long-term company strategy and enhanced management accountability to financial markets hold the promise of improving both the magnitude and efficiency of domestic private investment.

There has been significant evidence of progress in this direction during the past two years. In October 1992, the Securities and Exchange Commission adopted new regulations which considerably reduced restrictions on communication among shareholders. This limited deregulation has improved the effectiveness of shareholder efforts to monitor boards of directors and the performance of companies. During 1992 and 1993, boards of directors of a number of large, poorly performing companies removed their chief executives. These high profile dismissals appear to have stimulated the boards of many other companies to play a more active and independent role in overseeing management.

While these are positive developments, the test of long-term relationship investing is not simply its capacity to respond to a crisis of failing managers and boards. More important is its capacity to preempt such crises through an ongoing process of oversight. This process must foster not only a culture of accountability, but also a climate in which managers routinely make the long-term investments necessary for their companies to compete effectively in world markets.

Research suggests that US companies have not been adequately investing for the long-term. Net private investment as a share of GDP has declined considerably since the 1960s and 1970s and is well below the level of many of our industrialized country competitors. And while these aggregate statistics reflect primarily the macroeconomic climate — including private saving rates, fiscal deficits, inflation and interest rates — studies have also produced worrisome evidence concerning the composition of private investment:

- R&D spending as a share of GDP declined considerably from 1986 to 1992.
- The hurdle rates American firms use to assess investment projects are higher in relation to the cost of capital than anticipated by financial theory.
- Surveys of American and foreign CEOs reveal that both perceive the investment time horizons in US companies to be shorter than those of their major competitors.
- American companies appear to invest at lower rates than their foreign counterparts in intangible assets such as workforce training, new market development and supplier relationships.

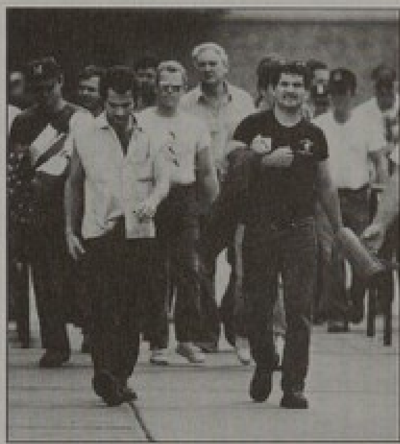
The Capital Allocation Subcouncil is developing policy recommendations to improve the contribution of private investment to the nation's rate of productivity growth and the creation of good jobs. The Subcouncil is building on previous research by seeking to identify whether there are specific changes in federal laws or regulations which might remove impediments to, or otherwise promote, long-term relationship investing. The Subcouncil includes representatives of the financial and corporate communities, relevant federal agencies, labor and the public interest, including a range of recognized non-governmental experts in securities law, taxation, accounting and economics [see list of members on page 49].

The Subcouncil is focusing on the following seven areas:

- Creating incentives for long-term equity holdings and significantly reducing the debt bias of the tax code;
- Encouraging closer monitoring of boards of directors and management by shareholders;
- Encouraging larger holdings in individual companies by shareholders;
- Improving information available for assessing long-term shareholder value;
- Encouraging long-term employee and management ownership;
- Reducing unnecessary costs of shareholder litigation which inhibit corporate disclosure; and
- Improving small business access to debt and equity finance.

"American companies appear to invest at lower rates than their foreign counterparts in intangible assets such as workforce training, new market development and supplier relationships."

Conclusion



As the Council noted in its First Report, the nation's economic policies suffer from "short-termism." We allow economic and social problems to fester until they become unbearable, and then we are unwilling to make the necessary sacrifices to solve them. Too often the federal government begins the process of reform (welfare reform, energy policy, national health care insurance are but a few examples), but then refrains from making real change. The Clinton Administration is to be commended for its willingness to address some of the nation's problems in all of their complexity.

The economic recovery of 1993 has already led some observers to say that America has solved its competitiveness problem. The Council respectfully disagrees; there is little evidence to suggest that the current economic pickup will lead to substantial long-run improvement in our standard of living. Nevertheless, the current recovery does provide an opportunity to seriously evaluate our priorities, increase national saving, and invest more in plant and equipment, R&D, infrastructure, education and training. This may require changes in federal budget rules.

The changes that we are recommending will take many years to implement. As the European Commission noted in its recent White Paper, "the most serious challenge facing policy makers will be to maintain the awareness of the need to implement appropriate macro-economic and structural policies even when the recession is over."[42] This, too, is the challenge facing our policymakers in America. The Council hopes that in offering these views to the President, the Congress and the American people, it will raise awareness of the challenges confronting the nation and ways to address them.

Notes

1. Robert J. Gordon, "Wishful Thinking," *Forecast*, January/February 1994. Professor Gordon estimates that the cyclically adjusted productivity growth for 1993 was approximately 1.3 percent.

2. In its Second Report, the Council noted that "increases in private saving are highly desirable but difficult to achieve." The Council continues to believe that we are not doing enough to encourage individuals to save more. A national campaign, led by the President, could contribute to achieving this goal.

3. *Building A Competitive America*, Competitiveness Policy Council, March 1992, p. 25.

4. The reform proposals differ on several points. One is whether there should be a mandate for insurance for everyone or whether the government should try to reduce barriers to obtaining coverage. Another is whether employers should be required to make insurance available and, if so, what percentage they should pay. A third consideration is how much assistance should be given to small employers or lower income individuals. A fourth is the extent to which health utilization should be governed by standards or left to the discretion of patients and doctors.

5. This section draws primarily from two pieces of research commissioned by the Council: Henry Aaron and Barry Bosworth, "Health Care Financing and International Competitiveness," February 10, 1994, and Lewin-VHI, Inc., "The Impact of the Health Security Act on Firms Competing in International Markets," January 12, 1994.

6. There are numerous problems using life expectancy as a proxy for health. Life expectancy covers all causes of death. This is particularly important in the case of the United States, since it has the highest death rate due to crime among all the industrialized countries. Every health indicator has its own limitation, which hampers this type of analysis. The broader point still remains that the United States spends significantly more on health care than the other industrialized countries and Americans do not appear to be proportionally healthier.

7. If health care reform does not result in higher individual saving, higher business investments, and lower federal deficits, and the "reform dividend" is redeployed to other types of consumption, the reform will not have any significant impact on the nation's competitiveness.

8. Aaron and Bosworth suggest that at least 80 percent of the increase in health care costs is shifted back to workers. The Council realizes that this may not always be the case. If health costs are not predicted well, employers may have to temporarily absorb some of the costs themselves. In industries that are strongly unionized, additional health care costs may result in lower profits or higher prices. Still, the most likely result of rising health insurance costs is lower wages.

9. If one views the employer as the payer, there will be a first round reduction in competitiveness, but as the dollar falls, exports would rebound.

10. See Aaron and Bosworth, Table 7. Based on full-time equivalents.

11. Lewin-VHI Inc., Table 7.

12. Eighty-two percent of all large companies are self-insured.

13. A corollary to this point is that if health care spending is controlled, workers may expect those savings to be translated into higher wages.

14. Of course, to the extent that health care costs are not fully absorbed by employees, they will be passed to stockholders and consumers, through lost sales, higher prices or lower profit margins.

15. Annualized data for production and nonsupervisory workers in private nonagricultural industries. These BLS data may in fact over-estimate the decline in real wages. First, the real wage series does not include all workers. Second, experts such as Barry Bosworth have suggested that the deflator used overstates the decline. Third, Frank Levy has argued that real wage data track different people over time and therefore average family income data are preferred. Although average family incomes have been rising, it should be noted that more families are now dependent on two wage earners.

16. In the President's budget request for FY 1995, core formula programs of ISTEA will be fully funded with a highway obligation ceiling of $20 billion and transit formula grants at $2.9 billion.

17. Edward V. Regan, "Investment, Jobs, and Economic Growth," The Jerome Levy Economics Institute, October 1993.

18. Like its predecessor, the Interstate Highway System built in the 1950s and 1960s, the purpose of the National Highway System as envisioned in ISTEA is to help meet national defense requirements and serve interstate and interregional travel.

19. Thus, income maintenance to a needy person, however worthy, is not an investment, as it does not increase the capital stock per person.

20. These figures include three categories of public investment — education and training, research and development, and public infrastructure. OMB reports several additional categories (e.g. commodities), which are excluded from this analysis. Using the broader measure yields a similar conclusion. The Council also examined investment as a percent of non-defense outlays excluding interest payments, and found a similar result.

21. When state government spending on education, training and highways is added, the decline is less dramatic, from approximately 10 percent of GDP in 1975 to approximately 8.5 percent of GDP in 1991.

22. The functions might include: education and training, transportation, environment and health. The classes might include: equipment, structures, payments to individuals and grants to states.

23. The current law is already mandatory, so it cannot be even more so. One alternative would be to maintain the responsibility with the Executive Branch but to remove the provision barring judicial enforcement of the CIS requirement. But the Council does not want to promote such litigation.

24. At the time of this report, the Council had just begun its work on this topic. The following section was drafted by the Council's staff, and will serve as a basis for further work by the Council.

25. *Kids Count Data Book*, Center for the Study of Social Policy, Washington, D.C. 1993.

26. *Just the Facts, A Summary of Recent Information on America's Children and Their Families*, National Commission on Children, Washington, D.C. 1993.

27. *Starting Points: Meeting the Needs of Our Youngest Children*, Carnegie Corporation of New York, April 1994, p. xiii.

28. Barbara Dafoe Whitehead, "Dan Quayle was Right," *The Atlantic*, April 1993.

29. US Department of Education, National Center for Education Statistics. *The Condition of Education 1992*, Washington D.C. 1992.

30. *Just the Facts*, p. 7.

31. *Kids Count Data Book*, p. 14.

32. Whitehead, p. 47.

33. *The Condition of Education 1992*, Table 30-1.

34. Richard B. Freeman, "Employment and Earnings of Disadvantaged Young Men in a Labor Shortage Economy," in *The Urban Underclass*, Christopher Jencks and Paul E. Peterson, eds. Brookings, Washington, D.C. 1991.

35. Bureau of Labor Statistics Civilian Unemployment Rate, Table B-41.

36. *Kids Count Data Book.*

37. John H. Bishop, "Why the Apathy in American High Schools?" *Educational Researcher*, Jan-Feb 1989.

38. *Just the Facts*, p. 85.

39. "The Economics of Crime," *Business Week*, December 13, 1993.

40. James Renier, "Education and Competitive Strength," paper prepared for the Competitiveness Policy Council, 1993.

41. Renier, 1993.

42. European Community, "Growth, Competitiveness and Employment," White Paper, 1993.

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About Our Members

RAND V. ARASKOG has been Chairman, President and Chief Executive Officer of the ITT Corporation since 1980. Mr. Araskog is a director of several corporations, the New York Stock Exchange, Dayton Hudson Corporation, Shell Oil, Dow Jones, and Alcatel Alsthom. He is a member of the Business Council, the Business Roundtable and author of *The ITT Wars*. He spent five years at the Department of Defense during the late 1950s.

JOHN J. BARRY is International President of the International Brotherhood of Electrical Workers, a position he has held since 1986. He started as an apprentice in the electrical construction industry and has held numerous elected positions in organized labor since 1962. He is a Vice President and Executive Council Member of the AFL-CIO. He serves on many boards including the US Council for Energy Awareness and the American Productivity Center.

C. FRED BERGSTEN, Chairman of the Council, is Director of the Institute for International Economics, which he founded in 1981. He is also chairman of the Eminent Persons Groups created by the Asia Pacific Economic Cooperation Forum (APEC) in 1993 to advise its member governments on trade and investment liberalization in the region. He was Assistant Secretary of the Treasury for International Affairs from 1977-1981 and served on the senior staff of the National Security Council from 1969-1971. Dr. Bergsten is the author of 22 books on a wide range of international economic issues, most recently *Reconcilable Differences? United States-Japan Economic Conflict.*

WILLIAM GRAVES is Secretary of State of Kansas. He was first elected in 1986 and is now serving his second term. He is a member of the board of the National Association of Secretaries of State and of Leadership Kansas. He is also a member of the American Council of Young Political Leaders and has served as an election observer in Taiwan. Mr. Graves is active in numerous civic organizations including the Kansas Chamber of Commerce and Industry.

JOHN J. MURPHY has been Chairman, President and Chief Executive Officer of Dresser Industries, Inc. since 1983. He has been associated with Dresser since 1952 and has held numerous management positions at the company during that period. Mr. Murphy serves on the boards of a number of outside organizations, including the U.S.-Russia Business Council, PepsiCo, Inc., NationsBank Corporation, Kerr-McGee Corporation, Southern Methodist University, and St. Bonaventure University. He is also a member of the Business Council.

EDWARD V. REGAN is President of The Jerome Levy Economics Institute of Bard College, a non-partisan research organization which develops public policy alternatives. Before joining The Levy Institute in 1993, Mr. Regan served 14 years as New York State Comptroller. He was a former member of the President's Commission on Industrial Competitiveness (1983-1985). Mr. Regan is a frequent lecturer and author on the economy, government, institutional investments and financial markets.

BRUCE R. SCOTT is the Paul W. Cherington Professor of Business Administration at the Harvard Business School, where he has taught since 1962. Mr. Scott teaches a course in comparative economic strategies of countries and has co-authored a study of industrial policy in France, an analysis of the Venezuelan economy, and more recently a study of the prospects for transition in South Africa. He is co-author (with George Lodge) of *U.S. Competitiveness in the World Economy.*

ALBERT SHANKER is President of the American Federation of Teachers, a post he has been elected to since 1974. He has taught in the New York City public schools and at the graduate level. His is a Vice President and Executive Council Member of the AFL-CIO. Mr. Shanker serves on numerous boards including the National Academy of Education and the National Council on Education Standards and Testing. His weekly column, "Where We Stand," has appeared regularly for over 21 years.

ALEXANDER TROWBRIDGE is President of Trowbridge Partners, Inc. which he founded in 1990 following ten years as president of the National Association of Manufacturers. He has held a number of positions in the public and private sectors including US Secretary of Commerce from 1967-1968, President of the Conference Board, and Vice Chairman of Allied Chemical Corp. He serves on numerous corporate boards and is a charter trustee of Phillips Academy in Andover, Massachusetts.

LAURA D'ANDREA TYSON is Chair of the President's Council of Economic Advisers and a Member of the President's Cabinet. She is currently on leave from the University of California at Berkeley, where she was Professor of Economics and Business Administration, Director of the Institute of International Studies, and Research Director of the Berkeley Roundtable on International Economy (BRIE). She was a member of the Cuomo Commission on Trade and Competitiveness. Dr. Tyson is the author of several books and articles on US trade and competitiveness issues, including most recently, *Who's Bashing Whom? Trade Conflict in High Technology Industries.*

EDWARD O. VETTER is President of Edward O. Vetter & Associates. He previously held a number of positions at Texas Instruments including Executive Vice President and Chief Financial Officer. Since retiring from Texas Instruments, Mr. Vetter has served as Undersecretary of Commerce (1976-1977), Energy Adviser to the Governor of Texas (1979-1983), and Chairman of the Texas Department of Commerce (1987-1991). He is a retired director of several New York Stock Exchange corporations, advisor to several venture funds, and a trustee of the Massachusetts Institute of Technology.

LYNN R. WILLIAMS until recently served as International President of the United Steelworkers of America, a position he held since 1983. He was also Vice President and Executive Council Member both of the AFL-CIO and of its Industrial Union Department. Mr. Williams is a member of numerous organizations including the Collective Bargaining Forum, the National Committee for Full Employment, the Committee for National Health Insurance, the National Planning Association, the National Institute for Dispute Resolution and the Economic Policy Institute.

The Competitiveness Policy Council's Mandate

The Competitiveness Policy Council was created by the Omnibus Trade and Competitiveness Act of 1988. It is charged with making recommendations to the President and Congress on how to improve the nation's competitiveness. The Council's objectives, as stated in Public Law 100-418 (Section 5204), are to:

(1) develop recommendations for national strategies and on specific policies intended to enhance the productivity and international competitiveness of United States industries;

(2) provide comments, when appropriate, and through any existing comment procedure, on—

(A) private sector requests for governmental assistance or relief, specifically as to whether the applicant is likely, by receiving the assistance or relief, to become internationally competitive; and

(B) what actions should be taken by the applicant as a condition of such assistance or relief to ensure that the applicant is likely to become internationally competitive;

(3) analyze information concerning current and future United States economic competitiveness useful to decision making in government and industry;

(4) create a forum where national leaders with experience and background in business, labor, academia, public interest activities, and government shall identify and develop recommendations to address problems affecting the economic competitiveness of the United States;

(5) evaluate Federal policies, regulations, and unclassified international agreements on trade, science, and technology to which the United States is a party with respect to the impact on United States competitiveness;

(6) provide policy recommendations to the Congress, the President, and the Federal departments and agencies regarding specific issues concerning competitiveness strategies;

(7) monitor the changing nature of research, science, and technology in the United States and the changing nature of the Untied States economy and its capacity—

(A) to provide marketable, high quality goods and services in domestic and international markets; and

(B) to respond to international competition;

(8) identify—

(A) Federal and private sector resources devoted to increased competitiveness; and

(B) State and local government programs devised to enhance competitiveness, including joint ventures between universities and corporations;

(9) establish, when appropriate, subcouncils of public and private leaders to develop recommendations on long-term strategies for sectors of the economy and for specific competitiveness issues;

(10) review policy recommendations developed by the subcouncils and transmit such recommendations to the Federal agencies responsible for the implementation of such recommendations;

(11) prepare, publish, and distribute reports containing the recommendations of the Council; and

(12) publish their analysis and recommendations in the form of an annual report to the President and the Congress which also comments on the overall competitiveness of the American economy.

Council Reports and Commissioned Studies

Building a Competitive America, First Annual Report to the President and Congress, March 1, 1992

A Competitiveness Strategy for America, Second Report to the President and Congress, March 1993

Enhancing American Competitiveness: A Progress Report to the President and Congress, October 1993

Reports of the Subcouncils, March 1993

A Trade Policy for a More Competitive America, Report of the Trade Policy Subcouncil to the Competitiveness Policy Council, March 1993

Building High-Performance Workplaces, Report of the Training Subcouncil to the Competitiveness Policy Council, March 1993

Building a Standards-Based School System, Report of the Education Subcouncil to the Competitiveness Policy Council, March 1993

Forging the Future: Policy for American Manufacturing, Report of the Manufacturing Subcouncil to the Competitiveness Policy Council, March 1993

Investing in our Future, Report of the Public Infrastructure Subcouncil to the Competitiveness Policy Council, March 1993

Technology Policy for a Competitive America, Report of the Critical Technologies Subcouncil to the Competitiveness Policy Council, March 1993

Health Care Reform and US Competitiveness, Working Papers Commissioned by the Competitiveness Policy Council, May 1994

Implementing a New Technology Policy, Report of the Critical Technologies Subcouncil to the Competitiveness Policy Council, May 1994

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Competitiveness Policy Council
1726 M Street, NW, Suite 300
Washington, D.C. 20036
Telephone 202-632-1307
Facsimile 202-632-1350

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Howard Rosen
Executive Director

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Capital Allocation
Robert Denham
Chairman
Salomon, Inc.

Michael Porter
Professor
Harvard Business School

Capital Formation
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Chairman
The Blackstone Group

Corporate Governance and Financial Markets
Edward V. Regan
Former Comptroller
State of New York

Critical Technologies
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Distinguished Fellow
Council on Competitiveness

Education
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President
American Federation of Teachers

Manufacturing
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Gerald L. Baliles
Partner
Hunton & Williams

Trade Policy
John J. Murphy
Chairman and CEO
Dresser Industries, Inc.

Training
Lynn R. Williams
Retired President
United Steelworkers of America

COMPETITIVENESS
POLICY COUNCIL

1726 M Street NW
Suite 300
Washington, DC 20036

Telephone: (202) 632-1307
Facsimile: (202) 632-1350