ECONOMIC OPPORTUNITY

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Thank you for inviting me to speak here today. My topic will be economic opportunity – what it means, what determines it, and how economic policy can help increase it.

Economic opportunity exists when every person has a realistic chance to improve his or her economic condition through hard work, saving, entrepreneurship, and other productive activities. Economic opportunity has long been a hallmark of the United States and is a major reason why our country has always been and continues to be a magnet for immigrants from all over the world. Maintaining and expanding economic opportunity is critical not only to our identity as a nation but also for the continued strength of our economy. The efforts of ordinary people seeking to better their economic situations provide a powerful motive force for American economic growth and dynamism.

What determines the extent of economic opportunity? For meaningful economic opportunity to be available to everyone, two conditions must be met. First, the economy as a whole must be growing and developing in a healthy way. Without healthy economic growth, broad-based improvements in living standards are difficult or impossible to achieve. Second, meaningful economic opportunity requires that the benefits of economic growth and development are not reserved for a select few; there must be a reasonable expectation that anyone who plays by society's rules will share in the economy's gains, irrespective of factors such as race, religion, ethnicity, or family background. Let me address each of these points in the context of the contemporary United States, beginning with some remarks on the long-term performance of the U.S. economy.

Long-term Economic Performance in the United States

As my listeners know, since the earliest years of our nation the American record of economic growth has been an impressive one. Let's take the past twenty-five years as an example. Since 1980, the year that Ronald Reagan was elected president, U.S. real GDP has grown at an average rate of about 3.0% per year, or 1.9% per year on a per capita basis. During the same period, the economy accommodated a rapidly growing labor force by creating some 41.5 million net new payroll jobs. That sustained record of economic growth and development has been reflected in long-term gains in Americans' living standards. In 1980, real consumer spending per head was about $16,500 in 2005 dollars. Last year, by contrast, per capita consumption averaged about $29,000, an increase of 72% since 1980, a growth rate of 2.2% per year. Americans' discretionary incomes have accordingly risen; for example, the share of family budgets devoted to food purchases dropped from 20% in 1980 to 14% in 2004, while real per capita spending on recreation has nearly tripled since 1980. On the other hand, the share of aggregate consumption spending associated with health care (and here I include payments made by governments and employers on behalf of consumers as well as out-of-pocket spending) has risen significantly since 1980, from 12% to 20% of total spending on consumption. In part that increase reflects the rise in the cost of health care relative to other goods and services. The sources of that increase are complex and must be left as a topic for another day. I think it is uncontroversial to say, however, that the quality and technological sophistication of health care services and products have improved markedly in the past twenty-five years. I suspect that few people would trade the health care services and products available today for those of 1980, even at significantly lower prices.

Economic growth can usefully be broken down into two components: growth in productivity (output per labor hour or output per worker) and growth in employment. Both of these factors have played an important role in U.S. economic growth, both in the long historical perspective and in recent years. During the 1970s and 1980s, economists expressed concern and puzzlement about the so-called "productivity slowdown," a period during which productivity gains fell well below historic averages. However, spurred by advances in information and communications technologies and their creative application by American businesses and workers, productivity growth began to rise again in the 1990s. Productivity growth has been particularly rapid in recent years: Since the beginning of 2001, output per hour in the nonfarm business sector has grown at 3.5% per year, well above its forty-year average of 2.1 percent. Over the same period productivity growth in the manufacturing sector has risen at the remarkable rate of 5.6% per year. This productivity performance augurs well for growth in the economy and for improvements in living standards in coming years.

Over the long term, sustained growth in the labor force and in employment have also contributed importantly to overall economic growth. Let's again consider the recent record. The U.S. labor market was relatively weak in 2001 and 2002, reflecting a series of economic shocks—including a sharp decline in the stock market, a recession, the 9/11 terror attacks and the resulting geopolitical uncertainty, and a series of corporate scandals—that left firms risk-averse and reluctant to hire. However, multiple rounds of tax cuts proposed and passed under the Bush Administration, supportive monetary policies on the part of the Federal Reserve, and the inherent resilience of the economy all contributed to a vigorous economic rebound. From May 2003 through this past August, the U.S. economy added more than 4 million payroll jobs, and expanding employment became, along with productivity, a major source of overall economic growth. Indeed, in recent years, the U.S. economy has consistently surpassed other major industrial economies in terms of growth, productivity gains, and job creation.

As you know, the destruction wrought by hurricanes Katrina and Rita, among its many human and economic costs, has led to the loss of several hundred thousand jobs and to slower economic growth since Katrina made landfall six weeks ago. However, as the Gulf rebuilds, I am confident that those lost jobs will return or be replaced by new ones and that healthy growth in output and employment will resume at the national level.

Economic Growth: The Role of Economic Policy

Why has the U.S. economy performed so well over an extended period? Of course, the lion's share of the credit goes to the private sector—to the efforts of workers, savers, business owners, entrepreneurs, and innovators. To allow the economic creativity of Americans full scope, however, sound economic policies are essential. For achieving sustained economic growth and development, history has shown that the best economic policies are those that allow private individuals and firms, rather than the government, to make key economic decisions; that provide incentives for constructive economic behavior, such as work, saving, and entrepreneurship; that respect the power of free markets to allocate resources efficiently and to spur economic dynamism; and that reject economic isolationism. More so than most other advanced countries, over the long term the United States has been the beneficiary of political support for these principles, support that has extended beyond any single political party. For example, President Kennedy preceded President Reagan in pushing for significant cuts in marginal tax rates, and the 1986 tax reform, that simplified the tax code and created two tax brackets of 15 and 28 percent, was passed with bipartisan support. President Carter deserves considerable credit for his role in initiating a program of sensible deregulation, which was taken up by his successors and has allowed greater play for market forces in a range of key industries. Following the principle of rejecting economic isolationism, President Clinton achieved passage of the NAFTA trade agreement, negotiated by his predecessor, the first President Bush.

Our current President has consistently proposed and supported economic policies that meet these key principles, including among others the reduction of marginal tax rates, to improve economic incentives and to let people keep more of their own income; reductions in capital gains and dividend tax rates, to lower the cost of capital and stimulate private-sector investment; Social Security reforms and the creation of new tax-favored savings vehicles that promote ownership and private saving; a consumer-driven approach to health care intended to increase the use of market forces in that sector; legal reforms, to reduce the burden of excessive litigation on the economy; and a series of bilateral and multilateral agreements to expand Americans' international trade and investment opportunities. President Bush has also proposed to harness the power of the market and the private sector to help rebuild after Katrina and Rita, through policies such as the creation of the Gulf Opportunity Zone, which will provide tax incentives to promote hiring and new capital investment. Policies that promote competition and individual initiative in the context of free markets lead to maximal economic dynamism. I hope that current and future lawmakers will follow their predecessors in supporting policies that meet these key principles. Doing so will lead to stronger and more sustainable long-term economic growth and greater economic welfare for the average person.

Opportunity, Education, and Skills

The first prerequisite for economic opportunity is economic growth. But economic opportunity, to be meaningful, requires also that everyone who plays by society's rules and makes an economic contribution should have a fair chance to share the benefits of growth. Most

Americans believe that that opportunity exists: In a recent New York Times poll, for example, 80% of respondents answered affirmatively to the statement, “Do you think it’s still possible to start out poor in this country, work hard, and become rich?” A bit of confirmation of their confidence—from a small sample, but an interesting one—comes from Forbes magazine’s most recent survey of the 400 richest Americans. Traditionally, that list was dominated by the heirs of family fortunes, but of the 400 wealthy people named in 2005, 255 individuals (up from 165 in 1985) are largely “self-made” and did not inherit significant wealth.

Of course, few of us will ever join the Forbes 400, but upward economic mobility remains a reality in America, as I will discuss later. However, over the past few decades, the route to personal prosperity for most people has been changing in an important way. Remarkably, of the current Forbes 400, 129 (including the richest, Bill Gates) have no college degree. For today’s generation, however, more than ever before, improving one’s economic status is likely to require not only hard work but also the acquisition of substantial education and skills. To make another comparison with 1980: In that year, the average high school graduate earned 28% per year more than the typical worker without a high school degree; today (actually, in 2004, the latest year of available data) the difference is 49%. Likewise, in 1980, someone with a college degree (but no advanced degree) earned about 60% more than a high school graduate; today the college graduate’s earning advantage is about 80%. To look at the trends another way, the real earnings of workers with less than a high school degree are about the same today as in 1980, at about $19,200 in today’s dollars. In contrast, the real earnings of college-educated workers with no advanced degree have risen about 31% in the same time period, from $39,200 in 1980 to $51,600 today. The returns to education have been rising despite the fact that the supply of educated workers has also grown rapidly, suggesting that the demand for skills and education has grown even faster than the supply. The economic returns to individual skills and talents are harder to measure than the returns to education, but the evidence strongly suggests that those returns have risen as well. For example, relative earnings in highly skilled occupations have risen relative to those of low-skilled occupations.

Although many explanations for this increase in the value of education and skills have been suggested, economists generally agree that a key reason is the advent of new technologies that demand higher levels of skill. As jobs have become more complex and sophisticated, the economic return to skills – including generalized skills such as the ability to solve problems and think logically – has risen accordingly.[1]

Most people would agree, I think, that a society in which you are rewarded for what you know and what you can do – that is, a society in which earnings depend on one's education and skills – is an inherently fairer society than one in which earnings depend primarily on personal characteristics such as race, religion, ethnicity, or family background. However, the strengthening linkage of earnings and education results in something of a paradox, in that—in the absence of countervailing forces—an increase in the returns to education and skills may lead to *greater* inequality in earnings and income, rather than the opposite. To illustrate, if the share of the population with high school and college degrees does not change, then a rise in the earnings of the college-educated relative to those of those with high-school degrees will directly increase the overall level of inequality, by increasing still further the incomes of families with college-educated earners.

Have the increases in the returns to education and skills over the past twenty-five years or so led to greater economic inequality in practice? The question is harder to answer than it may seem at first, because statistical measures of inequality can be very sensitive to the horizon over which inequality is measured. The most short-run measures of inequality consider the distribution of earnings or income at a single point in time—that is, as a "snapshot" during a particular year. Inequality in this sense does seem to have increased in the past twenty-five years. For example, the ratio of earnings at the 90th percentile of the earnings distribution to earnings at the 10th percentile indicates a fairly steady increase in inequality since 1980. Various factors have contributed to this trend toward inequality, including changes in family composition and fluctuations in capital income, but changes in the return to education and skills as measured in wages clearly have been important.

Inequality of earnings at a point of time is of less concern if, over longer periods, people and families are able to move from lower to higher points in the income distribution. Economic mobility in this sense appears to be good in the United States, both within lifetimes and between generations. For example, a review of the literature issued by the Urban Institute in 1996 concluded that "there is substantial mobility – both short-term and long-term – over an average life-cycle in the United States. The studies reviewed…suggest that approximately one-quarter to one-third of the population moves into a new income quintile in any given year. Given a longer time horizon, an even greater percentage of individuals switch income quintiles – perhaps slightly less than one-half over a five-year period, and about 60 percent over a ten-year period."[2] The Urban Institute review also noted little evidence that rates of mobility across the income distribution have changed over time. A more recent study, released by the U.S. Census Bureau

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[1] For a recent empirical analysis of wage trends, see David Autor, Lawrence Katz, and Melissa Kearney, "Trends in U.S. Wage Inequality: Re-Assessing the Revisionists," National Bureau of Economic Research working paper no. 11627, September 2005.

[2] Daniel P. McMurrer and Isabel V. Sawhill, "Economic Mobility in the United States," Urban Institute, 1996.

in 2004, examined changes in family incomes over the three-year period from 1996 to 1999.[3] This study likewise found substantial mobility, reporting that 48 percent of households changed income quintiles within the three-year period, and 13 percent of households moved two income quintiles or more from their starting point during that time. Significantly, the Census study also found strong evidence that the greater the education of the family breadwinner, the more likely the family was to move up in the income distribution.

Looking to even longer horizons, researchers have studied the rate at which families move up or down the economic ladder from generation to generation. Good studies on intergenerational mobility are unfortunately rare, as obtaining reliable data for the earnings of multiple generations over forty years or more is quite difficult. For what it's worth, a typical finding in this literature is that, if (say) Mr. Jones's income is 10% higher than that of Mr. Smith, then on average Mr. Jones's son's income will be 3-5% higher than that of Mr. Smith's son. (Most studies have examined the relationship between the incomes of fathers and sons, as women have historically tended to have less attachment to the formal labor force than men.) Whether these estimates correspond to high or low rates of intergenerational mobility is in the eye of the beholder; they do imply substantial narrowing of inter-family differentials within two generations.

Most important for my theme today, however, is the common finding in this literature that the most significant barriers to greater intergenerational mobility relate to the intergenerational transmission of education and skills. Parents with higher education and skills, and consequently with higher incomes, are more likely to live in a good school district or to be able to afford a private school, to have many books in the home, to give their children special

[3] John J. Hispanick and Katherine G. Walker, "Dynamics of Economic Well-Being: Movements in the U.S. Income Distribution, 1996-1999," U.S. Census Bureau, July 2004.

learning opportunities such as travel or summer camp, and to be able to send their children to college. Through these means the advantages of education and skills may be transmitted from generation to generation. That educated parents provide their children with the advantages of learning is of course only a good thing; as I will discuss, the challenge is to provide similar opportunities to children of all backgrounds.

The concepts of mobility I have mentioned thus far are all relative measures; that is, mobility is defined as changing one's position in the overall income distribution. A case can be made, however, that what people seek is less to improve their relative position than to improve their absolute standard of living. Given the strong gains in average real incomes in the past few decades, individuals may well be significantly better off than their parents even if their position in the income distribution is similar to that of their parents. For example, in 1967 only about 9 % of households had real incomes in excess of $75,000, in 2004 dollars; by contrast, in 2004 about 27% of households reached that level. Americans understand that, on the whole, people are becoming better off economically over time. In the same New York Times poll I mentioned earlier, 18% of respondents agreed that, in childhood, they had been a member of the lower class; but only 7% said that they were currently of the lower class. Similarly, only 37% of respondents said that they were of the middle, upper middle, or upper class as a child, but 58% claimed to be in one of those categories today.

To summarize the evidence, economists have found that inequality in the short-run or "snapshot" sense has increased over the past twenty-five years. Greater returns to skills and education, which have induced a greater dispersion of wages among people of different backgrounds, have contributed to an important degree to this increase in short-run inequality. Over longer periods, the problem is mitigated somewhat by the fact that people are able to move from lower to higher positions in the income distribution, both within one's lifetime and between generations. However, the evidence clearly suggests as well that the rate of upward mobility itself is greater for people with higher levels of education and skills.

Policies to Increase Education and Training

These facts imply both a challenge and an opportunity. To maintain a high level of economic opportunity, including economic mobility within and between generations, while in the process making the U.S. economy more productive and competitive, it is becoming increasingly essential to increase the education and skill levels of our citizens. Particularly important is to provide access to these learning opportunities to those who are less advantaged and might otherwise not be able to acquire crucial skills. No other policy strategy is nearly so important for achieving the goal of spreading opportunity widely.

President Bush has made the promotion of education and training a high priority. For example, the No Child Left Behind Act, one of the very first pieces of major legislation he signed after taking office in 2001, requires that public schools demonstrate quantifiable progress in the achievement of elementary and middle-school children. No Child Left Behind sets tough standards for reading and mathematics, and it mandates corrective actions for schools that consistently fail to meet those standards. Evidence from state-mandated testing programs as well as the early years of No Child Left Behind suggests that increased accountability for schools can help to raise achievement. The No Child Left Behind law demands inclusiveness as well as accountability. For example, a school cannot meet its requirements under No Child Left Behind by achieving high scores on average; it must also show that students from poor families or who are members of ethnic minorities are making adequate progress. The President has asked Congress to extend the provisions of the No Child Left Behind Act to high schools as well.

Accountability is further strengthened when children and parents have the opportunity to vote with their feet and leave a failing school. The No Child Left Behind Act makes children in poorly-performing schools eligible to transfer to better-performing public schools, including charter schools, or to receive supplementary educational services. President Bush has also continued to support voucher-based school choice programs on a pilot or experimental basis, by proposing a $50 million Choice Incentive Fund in each of his last four budgets. Pilot programs allow us to learn more about what works, and they should be welcomed by all who have a sincere interest in better serving our students. The President has also proposed increasing Pell Grants and making them more flexible to help students from lower-income families—especially those willing to undertake rigorous academic programs—to attend college.

Childhood education is crucial, but given the pace of change in the modern economy, acquiring new job skills has become a lifetime endeavor. If recent patterns continue, the typical American worker will hold an average of 9 jobs between the ages of 18 and 34. Much job changing occurs as workers develop new skills and seek new opportunities, but in a dynamic economy in which firms and even whole industries are created and destroyed, some job changes are inevitably involuntary. Education and lifelong learning are essential both to allow the steady pursuit of greater economic opportunity and to help workers adapt to the changing economy. The government assists these efforts in many ways. In 2005 the federal government will disburse $16 billion in job training funds, with much of the money going to states for local programs, including the operation of One-Stop Career Centers, which provide training and job-matching services. In recognition of the important role played by vocational schools, technical colleges, and junior colleges in retraining the workforce, the President recently requested, and Congress approved, an extra $250 million in job training grants to be used in local communities.

Although current job training programs provide important services to workers and employers, we could improve outcomes by updating and rationalizing the current system. Currently, job training funds are disbursed among 41 different programs—each with separate rules, reports, and definitions. The system could be streamlined and made less bureaucratic, more worker-centered, and more focused on outcomes rather than inputs. To achieve these goals, the President has advanced a Job Training Reform Proposal. The Proposal would consolidate many of the programs as well as increase the flexibility that governors and other local officials have in using the funding. In exchange for increased flexibility, governors would guarantee not to reduce the number of participants in the programs and to meet increasingly rigorous performance measures for job retention and increased earnings by participants.

Many other programs and proposals address the need of displaced workers for re-training. I would particularly like to mention the President's proposal for Personal Re-employment Accounts, or PRAs. Under this proposal, unemployed Americans who face the greatest difficulty in finding new work would receive an account of up to $3,000 – over and above traditional unemployment insurance benefits – to use in job search, including paying for training, relocation, or other services. And if the worker finds a new job quickly, he or she would be able to keep the balance of the account as a re-employment bonus, which increases the worker's incentive to search actively. The Department of Labor is currently administering PRAs on a small scale in demonstration projects in seven states. The President has also proposed that Worker Recovery Accounts, modeled on PRAs but with a funding limit of $5,000 per worker, be used in the effort to help some workers displaced by hurricane Katrina find new jobs.

In short, the President has demonstrated his commitment to increasing the level of education and skills of American citizens. One summary indicator of that commitment is budgetary: Between fiscal years 2001 and 2005, federal expenditure on education, training, and employment and social services increased by 52%, or by more than $33 billion.

There is an old folk saying: "If you give a man a fish, you feed him for a day, but if you teach a man to fish, you feed him for a lifetime." In the spirit of this adage, the best way to help people to a better life is to provide real economic opportunity, the key components of which are a strong economy and a commitment to give people the chance to acquire the education and skills needed to be economically productive. This is not to deny that there are some who need additional help, however. Tax and transfer policies provide an additional tool to increase the incomes of the least advantaged, and these policies continue to play that role under the Bush Administration. For example, on the tax side, a comprehensive recent study found that federal income taxes paid by lower-income working families have declined sharply in recent years and indeed have become negative, because of an expansion in the refundable child tax credit, expansions of the Earned Income Tax Credit, lower marginal tax rates, and other factors.[4] To illustrate, the study reports that a married couple with two children and a total family income of $27,300 (all money values given here are in 2004 dollars) would have paid nearly $1,900 in federal income taxes in 1980. In 2000, in contrast, the same family's tax bill would have been *minus* $1,300, that is, they would have received refundable credits in excess of their tax liability of about $1,300. In 2004, as the result of changes to the tax code made under the Bush Administration, the same family would have received nearly $3,200 via the tax system, more than a $5,000 change in net federal income tax liability since 1980. Similarly, a single parent with two children and a before-tax income of $14,000 would have received net payments from the IRS of about $400 in 1980, compared with more than $4600 in 2004, a swing of more than

[4] Kevin Hassett and Anne Moore, "How Do Tax Policies Affect Low-Income Workers?", National Poverty Center working paper #05-16, September 2005.

$4000. On the transfer side, programs such as Medicaid, the State Children's Health Insurance Program, Supplemental Security Income (SSI), and food stamps have been funded at increasing levels in order to continue to help those with the greatest needs.[5]

<u>Conclusion</u>

I have argued today that maintaining a high level of economic opportunity rests on two conditions.   First, the economy as a whole must be growing at a healthy pace, so that broad-based gains in living standards are possible. The U.S. economy is currently in a strong and sustainable expansion, and prospects for growth look good.   Good economic policy helped the economy recover from the shocks of the early part of this decade, and good policy is key to keeping growth on track.

Second, economic opportunity rests on the premise that the benefits of economic growth extend broadly to those who work, save, innovate, and engage in other productive activities. We have seen that in today's economy, productivity and earnings depend crucially on people's ability to acquire education and skills. The need to adapt is particularly acute in the modern dynamic economy, with its constantly changing demands on workers. To achieve sustained growth and productivity, and to allow the benefits of growth to be distributed widely, policies should aim to give more people the chance to make the wisest possible investment – the investment in the human capital of themselves and their children.

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[5] See, for example, Congressional Budget Office, "Changes in Participation in Means-Tested Programs," Economic and Budget Issue Brief, April 20, 2005.