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Investing for Growth: Thriving in the World Marketplace

A Summary of the 1992 Southwest Conference

Long-term economic growth depends on investment today. That message reverberated throughout the Federal Reserve Bank of Dallas' fifth annual conference on the Southwest economy. "The reality of free trade underscores potential weaknesses in the U.S. economy....As businesses in the United States become even more interwoven with businesses around the world, our success will be critically affected by the way we manage problems that reduce competitiveness," cautioned Dallas Fed President Robert D. McTeer, Jr.

Conference speakers expressed optimism about opportunities for growth when and if reforms under the North American Free Trade Agreement (NAFTA) and General Agreement on Tariffs and Trade (GATT) redefine the international marketplace. "The Southwest economy is in a position to benefit disproportionately from free trade," said Gerald P. O'Driscoll, Jr.

The health of the domestic economy, however, will determine the nation's future. To capitalize on the opportunities presented by a larger market, the United States must overcome domestic impediments that affect our growth potential. The future, Admiral Bobby Inman explained, depends on what we do to prepare this economy to compete more effectively.

Speakers identified several areas of the economy that would pay future dividends from investments in restructuring now. Ensuring free enterprise and improving human capital were the two most prominent examples. "For financial capital and entrepreneurship to be productive, there has to be investment in human capital, there has to be investment in...physical capital, infrastructure. There also has to be investment in...social capital, [in] developing the kind of society that enables an enterprise system to emerge," Ernesto Cortes said.

Investing in free enterprise

To maximize long-run U.S. economic growth, U.S. firms must thrive, which means they must take risks, innovate, and create. Rules and regulations, some speakers complained, have become a burden that inhibits innovation and risk-taking by distorting market incentives and encouraging rent-seeking behavior. "We are one of the few countries in the world not moving toward freer enterprise these days," McTeer said. He cited Mexico, on the other hand, as a nation that sparked a dramatic increase in economic growth by restoring free enterprise (see the box titled "Mexico's Investment in Free Enterprise").

To move back to free enterprise in the United States, policymakers must rethink economic incentives and government regulation. Conference participants proposed several strategies for reform: let domestic markets work, redefine government, make a commitment to long-term growth, establish credible policies, and allow free trade to let international markets work.

Let domestic markets work. Government regulations can be beneficial when they organize society or force firms and individuals to be socially respon-

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Mexico's Investment in Free Enterprise

Mexico is reaping the rewards of its commitment to free enterprise and its investment in long-run economic growth. "At a time when our own economic policies leave much to be desired, Mexico's policymakers are setting an example for the world," said Dallas Fed President Robert D. McTeer, Jr.

In 1982, Mexico was plagued by large fiscal deficits, unsustainable levels of external borrowing, a highly protected economy, rampant inflation, and heavy government regulation, explained Ariel Buira of Banco de Mexico, Mexico's central bank. Mexico has rebounded after restructuring its economy through such market-based reforms as fiscal and monetary discipline, privatization, deregulation, and trade liberalization.

Monetary Discipline

Mexico's success in reducing inflation expectations and long-term interest rates required a commitment to fiscal restraint. McTeer explained how Mexico benefited from international interdependence through the use of "external exchange rate discipline to reinforce...sound but temporarily painful domestic policies." Buira agreed that Mexico was attempting to import some price stability by pegging its currency to the dollar, which has helped establish a credible monetary policy. The peso, Buira said, "now moves in a fairly narrow band and within that band can fluctuate freely."

Fiscal Discipline

Mexico has successfully reduced its public debt and curbed its public spending. "The control of public finances has been the keystone of economic stabilization," said Buira. At the beginning of its debt crisis, Mexico's budget deficit was 17 percent of GDP. "Sustained efforts to correct a huge deficit led to an unprecedented fiscal adjustment of more than 15 percentage points of GDP in the period between 1982 and 1991." According to Buira, Mexico's fiscal adjustment is equivalent to five times that considered under the Gramm–Rudman–Hollings Act.

Privatization and Deregulation

Mexico's far-reaching privatization program shrunk the public sector and helped reduce the country's public debt burden. "The process of divestiture of state enterprises has been intensified since 1989, with the privati-

(Continued on the next page)

sible. The highway code, for example, organizes traffic to safeguard the public. Environmental regulations force firms to be accountable for pollution they may cause. Some regulations, however, inhibit decision-making, distort investment, and transfer resources from one group to another. In many cases, firms and individuals are able to profit by subverting market forces and lobbying the government, in effect, to regulate competitors out of business. Such rent-seeking behavior differs from productive investment because it does not create wealth. "At best," Harvey Rosenblum explained, "rent-seeking behavior redistributes wealth; at worst, it destroys wealth." Rosenblum advocated restructuring regulations to institute market-based incentives.

In banking, he said, regulation has often limited choice, increased costs, stifled innovation, and distorted investment. "The banking system has already felt the repercussions of regional shocks, yet geographic and product-line restrictions have limited banks' ability to diversify their

Mexico's Investment in Free Enterprise—*Continued*

zation of the two major airlines, major mining companies, sugar mills, fisheries, the telephone company, all the commercial banks and steel companies, and a number of others," Buira said.

The country also undertook major regulatory reforms. "Deregulation has advanced on a number of fronts," said Buira, citing the elimination of restrictions to entry and licensing requirements for telecommunications and land transportation and the simplifications of regulations in industries such as air transportation, mining, petrochemicals, and automobiles.

Trade Liberalization

Mexico's far-reaching program of trade liberalization demonstrates the benefits of letting international markets work. In 1985, Mexico joined GATT, opened its economy to foreign investment, and reformed the regulatory framework for economic activity. "This was a major change in philosophy. The idea was that we would not be able to export unless we were able to import freely," Buira explained.

"Liberalization has stimulated both imports and exports. In fact, the growth of total imports is explained to a very considerable extent by imports of capital goods and intermediate inputs for export-oriented industries. Exports of manufactured goods have replaced oil as the country's main foreign exchange earner," he said.

Buira was optimistic about the avenues that will be opened with NAFTA. "Since the liberalization of trade policy, trade between Mexico and the U.S. has more than doubled, to our mutual benefit. This will be further enhanced by the establishment of a free trade area in North America," he said.

"With implementation of this program of stabilization, structural adjustment, and liberalization, the economy has resumed growth after a decade of stagnation. These reforms have created the internal conditions for sustainable economic growth."

practices." Bankers risking their own capital will make better financial decisions than examiners, regulators, legislators, and other government bureaucrats, he said.

"The increased level of regulation that we have is not particularly conducive to better serving our customers in all cases," said Linnet Deily. Regulations add to the cost of the services people buy, she explained, adding, "I think that we have gone overboard in response to consumerist activity without keeping the broader range of public interest in place."

Redefining government. Regulations may not operate effectively because government is not working properly. "We have to get government to work," said Donald Shuffstall. Tom Luce explained that government has yet to undergo the dramatic restructuring that has kept many firms in business. "If my organization and your organization had not adapted, we would not be here today. The one institution…in our country that has not gone through that dramatic restructuring is government," he said.

Rosenblum noted that government often fails to focus on long-term economic growth: "Our country waits until problems are out of control before beginning to discuss solutions, then responds by applying Band-Aids to deal with symptoms rather than causes." And, Luce added, "Too often, compromise has lead to changes on the margins, which basically means that nothing fundamentally has been restructured and changed."

Special interests may be distracting government from decisions that would benefit long-run economic growth, Luce and Rosenblum suggested. Politicians are hesitant to adopt long-run strategies that require short-run sacrifice, Rosenblum said.

"The reason we have changes on the margin," Luce explained, "is because every special interest is represented, but very seldom is the common good represented in terms of a voice that says, 'Hey, what about the kids?' " He challenged people and business to get involved in the political process and to learn how to bring about change.

Government credibility. Governments that set long-term policies and stick to them establish credibility that benefits their economies. Credible policies encourage firms and individuals to make long-run plans. One important policy that must be credible is a government's stance on inflation. Said Rosenblum: "Inflation distorts prices, worries investors, and slows capital spending. Sound, stable, and credible macroeconomic rules that allow economic agents to take a long-term view support economic growth. Low-inflation countries with sound monetary policies tend to grow faster than countries with high inflation." (See the box titled "Exporting Credibility.")

The exchange value of a nation's currency depends on three things, Rosenblum explained: "One is the current interest rates in each country, relative to one another. Another is expected prices—expected inflation in each country. The third factor...is the expected growth rate of national income. Foreign exchange traders are betting every day on economic growth, on whether or not governments have a commitment to credible growth policies." The measure of Federal Reserve credibility, Rosenblum added, "is the gap between long-term interest rates and short-term interest rates. When long-term rates get well above short-term rates, the Fed may be suffering from a credibility gap....Any policy that lacks commitment and credibility, whether it be a government or corporate policy, is bound to fail."

The credibility of government policies is easily measured in the international marketplace. "In this world, central banks can run, but they can't hide. Their policies will be evaluated instantly on the world's computer screens and reflected instantly in currency prices," McTeer said. "That doesn't imply a loss of power based on fundamentals. It does imply a loss of the power to fool some of the people some of the time. The external value of a nation's currency will depend on the relative soundness of domestic monetary policies no matter what is said or done in the foreign exchange markets."

He suggested that the information revolution will lead to, "not a gold standard or a Bretton Woods standard but to an information standard for money where currency values instantly respond to each bit of new information in a global plebiscite."

Letting international markets work. A government's commitment to free trade must be credible. Countries have many incentives to open their borders to foreign markets. Free trade will stimulate economic growth, increase domestic demand, and allow firms and individuals to consume a greater variety of goods and services. In fact, free trade is "the only magic bullet on the horizon with the potential...to raise our living standards significantly," McTeer said, explaining that soon the world will operate as a single economy.

Quoting Walter Wriston in *The Twilight of Sovereignty*, McTeer said, "National sovereignty, including monetary sovereignty, is rapidly succumbing to the relentless pressure of computer and communications technology and to satellites and fax machines." This technology, McTeer noted, gives individuals all over the world instantaneous access to information and makes national borders increasingly irrelevant.

"An economy is more likely to grow if it has an open, competitive trade policy rather than high protectionist barriers," added Rosenblum. "Isolation is synonymous with poverty. Closing borders can be done only at a very extreme cost," he said, comparing nations whose principal difference is the openness of their trade policies, not their people or location. North Korea vs. South Korea, the former East Germany vs. West Germany, Hong Kong, Singapore, and Taiwan contrasted with mainland China are all examples.

Donald J. Carty agreed that free trade is essential, but he said that the manner in which a country opens its borders is also important for the long-run health of an economy. Carty said the United States has been slow to open trade, often implementing policies that sacrifice long-term competitive advantage for short-term political and economic gains. "While few U.S. companies can blame all their international problems on U.S. trade negotiations, I think it's fair to say that U.S. trade policy has contributed to our worldwide competitive difficulties in virtually every industry," he said.

The United States "has often given considerably more than we've gotten in trade negotia-

Exporting Credibility

As national economies become more integrated into a global economy, the Federal Reserve can contribute to improved living standards worldwide by providing an anchor for nations pursuing price stability, suggested Dallas Fed President Robert D. McTeer, Jr. "Economies that are trying to pursue price stability that may not have a long tradition of internal monetary discipline may wish to import some of that discipline or borrow some credibility by pegging to a more stable currency," he said.

"As international trade becomes more important to the U.S. economy, we have to consider the impact of foreign economic conditions on domestic economic conditions....A more integrated world economy with increased capital mobility has potential implications for our conduct of policy," he said.

A more formal exchange rate mechanism could be put into place after free trade and capital movements have spread to most of the Western Hemisphere. "After growth rates and inflation rates have converged and monetary and fiscal policies are reasonably compatible, then the Americas will need to have a look at alternative exchange rate mechanisms. Perhaps a tighter and more formal exchange rate relationship would be indicated," he said.

In the meantime, "Hopefully, the Federal Reserve System will conduct monetary policy in the next few years in a way that it may someday be regarded, as the Bundesbank has been in recent years, as an anchor of stability. If that could be the case, our contribution to world standards of living would dwarf any contribution we might make with occasional quarter-point jiggles in the fed funds rates or half-point changes in the discount rate," McTeer said.

tions," said Carty, observing that the United States approaches trade negotiations much differently than other countries. Most countries focus on creating a competitive advantage for their producers, while the United States has many other goals. The United States often begins negotiations with a sense of obligation to help less-fortunate countries. Then, believing in the superiority of domestic producers, the United States will support an agreement that opens trade opportunities, regardless of whether the agreement is imbalanced in favor of foreign producers. What's more, U.S. economic interests often have been secondary to security and geopolitical objectives, he said.

When entering bilateral agreements, the United States usually already has a highly developed industry that is ready for worldwide competition, "while most other nations want to limit competition to ensure their fledgling industry sufficient market share." As a consequence, most bilateral agreements "limit rather than encourage competition," Carty said.

Carty used the airline industry to illustrate the consequences of slow, uneven trade deregulation. The domestic airline industry, which was deregulated in 1978, has had difficulty integrating with the still heavily regulated international aviation market. Current trade agreements, according to Carty, give an advantage to foreign carriers that can partner with a domestic airline to create a global network, while U.S. airlines have much more difficulty acquiring access to international markets. Carty cited an open skies agreement recently negotiated with the Netherlands, "which gives KLM unrestricted rights within the United States in exchange for allowing the U.S. carriers to have unrestricted rights in the Netherlands." That agreement "will strengthen KLM at the expense of U.S. carriers," he said. Further, U.S. carriers operating abroad must deal with a host of nontariff barriers including, in some countries, requirements that U.S. carriers hire their competitors to provide customer service. "The restrictive instincts of most of the world's governments and the unwillingness of the U.S. government to exert its negotiating leverage have denied U.S. carriers not only dominance but even the level of leadership that should be the natural benefit of being based in the world's largest aviation market," said Carty.

The time has come, he said, for the United States to call for a worldwide, multilateral open skies agreement: "We can turn all the world's airlines loose to work the magic of competition in every market. But if other countries are not willing to support new opportunities for all, they must not be allowed to buy their way into U.S. markets to the detriment of U.S. producers....Most governments recognize...that workers and consumers are simply the same folks in different clothes."

Investing in human capital

Throughout most conference sessions, participants returned to the theme of investing in human capital—the people whose skill and labor make up a nation's work force. Inman pointed out that, while the United States is always at the forefront of creating new technologies, we have become increasingly laggard in turning that technology into commercial goods and services. Part of the reason, he suggested, is because we do not have the highly trained work force to operate sophisticated technologies.

"There was a day, not too long ago," said Paige Cassidy, "when any average high school graduate with basic mechanical aptitude could expect to find employment in industry. That day is gone. The value of unskilled labor is rapidly disappearing. In our workplace of the future, employees on the factory floor must be highly literate and computer friendly. And if industry is to be competitive and if our national economy is to be viable, we must have a skilled, highly trained work force."

Speakers suggested several ways to maximize the potential of America's human capital: encourage immigration, capitalize on cultural diversity, reinvigorate education, and reform health care. The need to control costs, reduce bureaucracy, and implement market-based reforms in the economy was a common theme. Our economy, they said, needs major structural reforms rather than tinkering at the margins.

Immigration. Opening our borders to both goods and people will boost our nation's human capital and stimulate economic growth. As Julian Simon explained: "Every time our system allows in one more immigrant, on average, the economic welfare of American citizens goes up, and every time we keep out one more immigrant, on balance, our economic welfare goes down....Additional immigrants, both the legal and the illegal, raise the standard of living of U.S. natives and have little or no negative impact on occupational or income class."

Since the turn of the century, the United States has become much bigger, wealthier, and better able to assimilate growing numbers of immigrants. But, Simon explained, both legal and illegal immigration have declined significantly, both in absolute numbers and as a proportion of the total population in the United States: "We have this phrase that we are a nation of immigrants; we are not a nation of immigrants now. Indeed, there are many countries in the world that we tend to think of as homogeneous that have a much larger proportion of immigration than we do. For example, Great Britain, Switzerland, France, and even Sweden have a much larger proportion of immigrants in the population than we do."

Misperceptions about immigrants hurt the economy, he said. "There is only one painless way of dealing with the deficit that does not mean the pain of...reducing services or increasing taxes, and that is to bring in more immigrants....Immigrants pay much more in taxes than the cost of the welfare services they use. Immigrants come when they are young, when they are strong, and when they are earning and contributing, not when they are old and are taking in."

Rather than displacing natives from jobs, immigrants create jobs through their purchases and by opening new businesses—small businesses, a main source of the nation's jobs. "Immigrants earn and they spend, and their spending provides jobs for others. Immigrants simply expand the economy," he said, explaining that immigration helps raise productivity, improves our competitiveness, and provides an invaluable network of communications abroad.

Simon suggested that immigration is often considered harmful because "it is very easy to identify the losers, much harder to see the winners....It is so commonsensical that immigrants push natives out of jobs, [but] the virtue of economics is it gives us anti-commonsensical, anti-intuitive answers to many questions."

Simon recommended a policy of phased, incremental increases in immigration: "Increase the level of immigration by a million people now, and watch what happens in the next three years. If anything unexpected happens, we could adjust for it." If the immigrants continued to assimilate nicely into the economy, he said, the United States could raise the limit by another million for another three years and continue in a "systematic and controlled way...to allow in more immigrants and make us a better country."

Capitalizing on our diversity. Racism and naiveté about other cultures cause some people to oppose immigration. But the key issue for policymakers should be how many human beings, not which ones, Simon said.

To benefit from the human capital open borders provide, the country must also learn to value fully all of the human capital that is already here. "Our greatest strength is our cultural diversity, but we are not using the full capability of all our work force," cautioned Major General Hugh Robinson.

Some corporations, Robinson explained, undervalue workers by applying stereotypes to women, African–Americans, Hispanics, Asians, and others. When people act as if these stereotypes are true, the country does not use its work force to its full capability. "We are talking about using the full capability of our work force and not devaluing some part of it for some unknown reason that nobody can figure out....It is a business decision to develop our work force so that all have the same opportunity," he said.

Cultural diversity is also an asset in the global marketplace because corporations must deal with the diversity that they will encounter in other nations. "Should we not put our best foot forward by utilizing the diversity we have here in this country?" Robinson asked. "It is a business decision to adjust the work force and to participate actively in this global environment."

Capitalizing on our diversity will become even more important as our population becomes more diverse. According to Robinson, "85 percent of the entrants into this country's work force in the year 2000 will be people of color and women. Furthermore, by the year 2050, projections show that whites will slip below 50 percent of the national total. If you look at the world in which we live, people of color are already and have long been the majority."

Robinson noted that while education is the key to our success as a nation, who does the teaching and what is taught are also very important: "We must really understand diverse peoples and cultures, and we must do it in a way that promotes a valuing of diversity. If we don't value diversity, it won't be a plus for us....In American education, as we move through the final decade of the twentieth century, we have the responsibility to move closer to the fundamental goal that underlies multiculturalism, pluralism and cultural diversity—the transformation of the American economy into a place where difference no longer makes a difference."

Education. Other speakers echoed Robinson's concern about the importance of education as a factor in America's competitiveness and long-term growth potential. "Education," McTeer said, "is key because the United States has a competitive advantage in producing goods and services that use our abundant human resources. Therefore, the more open we become to the world, the more serious will be the consequences of a flawed education system."

The U.S. system of higher education is competitively supplied, and it is the envy of the world. In contrast, McTeer pointed out, our primary and secondary systems are basically "local monopolies [that] not only are expensive; they don't consistently produce a quality product."

Education is one way to obtain "not only higher incomes, but a fairer or more equal distribution of income as well—clearly a win-win situation," suggested Rosenblum. Speakers criticized the current educational system for not adequately preparing our youth and for failing to implement successful reform despite years of talk. They called for fundamental change.

"Tinkering at the margins is not going to work," said Milton Goldberg. "If our schools are to be competitive in the twenty-first century, then nothing short of revolutionary change will have to occur. Despite almost a decade of talk about education reform, education reform has been disappointing." Often, educators have attempted only reforms that are easily implemented, rather than working on more complex, in-depth changes, he said.

"Look what happens when we don't make the investment in education," Robinson said. "We end up sending people to prison and having to support them there at some ridiculous cost of $30,000 or $40,000 per year. We send them to hospitals because their health isn't good. We send them to other places where our public funds are spent in a nonproductive fashion....If you think education is expensive, try ignorance," said Robinson, quoting former Harvard University President Derek Bok.

"If we merely put more money in the same system", Luce said, "we will get the same results. We have to begin to change the system." "How do we break from tradition? What is it going to take to break the mold to make a difference in terms of doing what is right for our young people?" asked Marvin Edwards.

Three strategies the speakers suggested to improve education were emphasizing parental involvement, restructuring the educational system to incorporate market-based incentives, and increasing the amount of time children are at school.

Parental involvement. According to Clint Bolick, "The one thing almost everyone in education will agree on is that parental participation is the single most crucial factor in terms of educational outcomes." Cassidy agreed: "If parents are not involved, everything slows down. When the parents are involved, things speed up very quickly....[But] we know many children in this country are not coming to school ready to learn." Many children are in an environment that does not prepare them to be good students, and some parents, Edwards said, "are not prepared to be parents and need to be trained."

Cassidy described several programs that would involve parents and the community as a team to help prepare children and facilitate the educational process. Many of these break-the-mold programs are being financed by the New American Schools Development Corporation.

"I think we have to do a much better job in American education of making it very clear...that the parent is the child's first and most influential teacher," Goldberg said. "I feel about parent responsibility as I do about student expectation. Our expectation for achievement in American schools generally has been very low; students have given us exactly what we have expected of them. High expectations never hurt anybody."

Incentives. Some speakers suggested that the education system, like the rest of government, would operate more effectively if it incorporated market-based incentives and were less regulated. "Our classroom teachers are the most regulated professionals in America. We need to treat our teachers as professionals. They must be empowered to function like other professionals, with the opportunity to adapt, change, create, and modify as they best judge," Cassidy said.

Luce concurred: "What we need to do is treat the teaching profession once again as a profession, not a guild. We have to break the cycle of across-the-board pay increases....We have to change the rules so that teachers who are not performing can be discharged." Luce suggested that the business community use its skills to develop procedures for the difficult task of evaluation and assessment. "I understand why many teachers do not want to be evaluated by the principal who, in their mind, is a fired football coach. But let me tell you something. We do have assessment in football. If we do not win in football, you are fired."

The current education system operates based on lobbying much like the rest of government, he said. "Do you know in Texas public schools, the last time I looked, there are 600,000 students taking agriculture vocational educational courses? Folks, there will not be 600,000 agriculture jobs in the state in the next five lifetimes available to kids. But we have 600,000 kids taking agriculture vocational education. Why? Because the agriculture vocational education lobby is strong as horseradish....We give a school more money to teach a vocational education course than we do to teach math and English," Luce said, adding that many schools spend more money on one-day processing of their football films than on their English department curriculum.

Restoring incentives would spur innovation in the educational system, Luce said, suggesting that, rather than pay schools for having children in class, it may be more effective to pay schools for graduating children. "Every child can learn, but every child learns in a different, unique, special way. And yet we are still conducting our classes as if they were assembly lines for a manufacturing model that disappeared many years ago." With an incentive program, Luce said, high school classes could grow to as large as 250 students. "One year later, they go to college and they have a class that big. Wouldn't it make more sense to do that and take that same money and spend it on a 3-year-old?...We should have prekindergarten programs so all children, of all races and financial groups, will have an equal opportunity to line up at the starting line in the first grade equally prepared and equally equipped," he said.

Choice. One way to introduce incentives into America's educational system is by making public schools compete with private schools. Several speakers noted that public schools are structurally different from private schools. Competition has helped keep down the size of private school administration. In large urban school systems, Bolick noted, about 50 cents of every dollar spent on education makes it to the classroom in terms of salaries and instruction; in private schools, about 95 cents of every dollar spent makes it to the classroom.

School choice, a proposal that would enable parents to apply state funds to either public or private schools, can help introduce incentives into the public education system because schools would have to compete for students. Bolick advocated a system in which public schools and private schools participate on a voluntary basis. School choice, he said, could provide the impetus for radical deregulation and decentralization of public schools: "Public schools will compete for kids they previously could take for granted, since these kids had nowhere else to go." Bolick would like a public school system "that exists because parents choose to send their children there, not because they have no alternative....Choice transfers power over basic educational decisions from bureaucrats to parents," he said, adding that parents have the greatest stake in their children's success.

Choice has worked at universities, Bolick said, because college students can take their financial aid anywhere. With choice, "if the schools do not attract enough students, they literally go out of business."

But proposals for choice leave a lot of questions unanswered, according to Edwards. "We have heard a lot about choice over the years....Is choice the ability to have any child choose any school anywhere? If so, are we going to provide transportation for any choice any child makes anywhere? So then we have a major, major, financial commitment."

Bolick countered: "In most instances you could have choice plans and provide transportation for low-income kids and still not spend as much money as the public schools are currently spending."

"I think we can probably make anything a success in a vacuum, in a small scale....Choice is not realistic unless choice is available for everybody. We have a lot of experiments in choice, but we do not have choice. No one has shown how choice can work in an entire state or an entire county or across lines of a school district," Edwards said. Choice "is an emotional response to a need on the part of the American people, because it sounds good, but no one is ready to define it. Until someone has the courage to really define it beyond emotion, we do not have an answer to this big dilemma."

Despite many good suggestions for reforming the education system, problems arise in implementing effective change, speakers noted. "We need to guard against quick fixes—ideas that simply sound good and capture people's emotion are not going to fix education," said Edwards, who recommended working within the current system to find reforms that can be effective.

Goldberg, however, restated the need for systemic reform that considers many variables if we are to improve the achievement of American children. He noted a problem in moving educational reform from pilot programs into mainstream reform. "American education is a graveyard of innovations that have worked. One of the most serious problems in American education is our inability to learn from experience."

Time and learning. Goldberg suggested that the United States rethink the way students spend their time. American students, he noted, spend less time on school work than students in most nations, and the time that is spent in the classroom and on homework is often used ineffectively.

Goldberg and Cortes recommend lengthening the school day to give teachers more time for planning and to help students be more motivated to learn. “Students will spend extra time in additional recess, additional lunchtime, and additional extracurricular activities....When the youngsters come into the classrooms, the work is intensive, direct, and heavy. The youngsters have already blown off steam,” said Goldberg, adding that teachers will be held accountable for planning and will have more time to work at their jobs.

“There are some very simple ways that time can be increased in American schools. For example, we have to reduce student absenteeism. A youngster who is not in school is not learning schoolwork. We can improve school management to make distractions in the classroom far fewer. We can improve classroom management so teachers know how to do the instructional work more efficiently. And we can do the most dramatic of all; we can restructure the school day and think about year-round schools. The research is very clear: there is a very direct correlation between time spent on homework and student achievement, particularly at the junior and senior high level,” Goldberg said.

Lengthening the school day will increase the productivity of our past investment in education, he said, explaining: “We have a capital investment of enormous proportions in the school buildings of this country. These fancy buildings that we built all over the country for hundreds of millions of dollars are being used for instruction 15 percent of the available instructional time.”

Health care. Another way to invest in human capital is to cure our nation’s sick health care system. Spiraling public and private health care costs have increased the expenses of employers and government and are limiting the availability of medical services. Taming health care costs is crucial to containing business costs and ensuring a quality work force.

Speakers addressed two problems: consumers cannot obtain the information necessary to make choices about the cost and quality of various health care options, and medical care is overconsumed because consumers do not pay the marginal cost of health care services. “There are strong reasons to believe that the additional medical services patients receive are not worth the additional costs,” William A. Niskanen suggested. Speakers called for a structural reorganization of the health care system to realign incentives and reduce costs.

“We need a major overhaul instead of marginal changes...that do not lead to overall savings,” Ron Anderson said.

Costs. Rising health care costs have placed a heavy burden on our economy. In the past 30 years, “total expenditures for medical care have increased from about 5 percent of GDP [gross domestic product] to now about 14 percent of GDP....The cost of health insurance is now the most rapidly increasing component of private payrolls, and payments for public medical programs are the most rapidly increasing component of government budgets,” Niskanen said.

Two causes of rising health care costs cited by participants were consumers’ and physicians’ lack of incentive to reduce expenditures in a system subsidized by insurance, government payments, and tax deductions; and a lack of competition that stems from the difficulty consumers experience in collecting information about the cost and quality of health care providers.

Under the current system, individuals who are most able to control costs have little incentive to limit expenditures. “The share of medical costs that are borne directly by the patient has declined from about 50 percent to under 20 percent,” explained Niskanen. “Neither patients nor physicians have an adequate incentive to control the costs of medical care.” Health care is subsidized by tax deductions and insurance; consumers do not pay the true price of medical care. Frequently, consumers do not even see the true price because a third party—government or private insurance—pays the bills.

“The common phrase ‘health insurance’ is a double misnomer. The event that is insured is not some adverse change in health status but is the payment for some specific medical service. The basic concept of insurance is to reduce the variance of cost among groups with the same prior risks. Most plans, however, include people with very different prior risks in the same premium pool. What we call health insurance in this country would be much better described as a medical prepayment plan. These plans redistribute income from people who use few medical services to people who use many medical services,” Niskanen said.

Subsidizing health care costs results in an overutilization of health services beyond the level that is optimal for society. The use of technology in medicine illustrates the breakdown between health care incentives and costs. "The technological revolution," Douglas Werner explained, "be it therapeutics or diagnostics or combinations thereof, is the major cost driver [in medicine]."

"The people who make decisions on the types of technology to use do not pay the bills. In basically all other sectors, improvements in technology have led to reduction of relative costs, not increases in relative costs," Niskanen commented. Hospitals can afford to purchase amenities such as chandeliers or another CAT scan or another MRI because "someone else is paying for that. They are not really making the hard decisions because they pass those costs on to someone else," Anderson said.

Consumers have no idea if they are buying chandeliers or superior medical care because they lack information about the cost and quality of health care services. Individuals needing health care rarely call and ask a hospital's room rate or mortality rate, for example. "We have a system driven by utilization," said Anderson, adding that there is no measure for health care quality and "people don't know what they're buying." Harper agreed and noted that hospitals and doctors respond to these incentives: "The reward system has been wrong. Rewards have been based on utilization, on quantity and not on quality of care."

The lack of incentive for cost or quality control has encouraged the growth of an expensive health care bureaucracy. According to Anderson, 23 percent of health care costs may be the result of the bureaucracy, which, he believes, is making the health care system incoherent. "It should not drive patients and doctors and nurses and everyone crazy because it is irrational," he said.

Panelists disagreed on the most effective reform. Managed care, in which the public or private sector decides which doctors consumers should use and which illnesses will be paid for, could help control health care costs. Market-based reforms, including the elimination of subsidies to reduce demand, were also suggested. Panelists disagreed on how reforms should be implemented but generally agreed that consumers need more information about the cost and quality of health care providers, along with incentives to control costs.

Increasing information. Measuring health care quality and cost and making that information accessible to the public could help individuals make decisions about health care purchases. "I think competition will work if the purchasers of health care really know what they are buying," said Robert Shoemaker. "The system needs information to identify high-quality, cost-efficient providers of services," explained Dwain Harper. "If you look at the literature, [there is little] agreement on what is a measurement of quality....There is going to have to be some investment put into developing the technologies to measure these results," he said.

The Cleveland Health Quality program, the state of Oregon, and others have attempted to improve health care productivity by using technology to bridge the information gap and help consumers measure quality. The Cleveland group abstracts information manually off the records of thirty-one hospitals and places it on a database. Insurance companies can then easily compare information about hospitals that is risk-adjusted for outcomes and patient satisfaction. According to Harper, this program helps determine the "highest quality outcomes and the most reasonable costs."

Providing incentives to control costs. Even if more information about the cost of health care services were available, consumers would still need an incentive to base decisions on what they know. One suggestion for creating such an incentive is to require consumers to pay the marginal cost of consuming medical care. For example, curbing tax deductions for private and public health insurance could reduce the stimulant on the demand for medical services. According to Niskanen, "The reduction of tax-subsidized medical prepayment plans is a necessary condition to reduce the growth of demand for medical care."

He advocated an income test to limit tax deductions for medical services and insurance and adding deductions for set levels of preventative care. "It is important to recognize that a substantial part of tax-subsidized health insurance accrues to higher income people. Higher income people are more likely to be privately insured, and the value of that insurance is a function of their marginal tax rate. Similarly, the people on Medicare with the highest incomes are the ones who likely live the longest, and the value of Medicare increases with the marginal tax rate. Clearly, the amount of tax-subsidized health insurance could be substantially reduced without much change in the insurance available to the poor."

Niskanen also recommended that the current prepayment form of medical plans be restructured as indemnity insurance, similar to auto insurance. "Patients would be paid a fixed amount above some deductible per illness or accident but would bear the sole marginal cost of whatever medical services they elect," he said.

Managed care. Managed-care programs reduce costs by providing a fixed level of care at a reduced price. Under managed care, a company or government agency decides which types of illnesses to treat and where consumers can obtain medical care. Costs can be reduced by having a network of physicians under contract with agreements on rates, patient volume, and quality, Werner said. He noted that managed-care programs are estimated to reduce costs by 15 to 25 percent. "It is time for somebody to address the costs, even if it means capping reimbursement," Anderson commented.

The state of Oregon and several private insurance companies are attempting to control costs through managed care. The Oregon plan, Shoemaker explained, categorizes groups of people and determines which medical procedures will be covered and at what price for each group. The program estimates the providers' costs and adds "a reasonable level of compensation." Shoemaker stressed that "emphasis is placed on preventive care," but "people will get an adequate, but not an excessive, level of care."

Anderson suggested that a managed-care program should be combined with indemnity insurance and operated with a single-reimbursement system. Such a system, he said, would be understandable, portable, and would stop cost-shifting. "I believe it can be a social insurance program with competition for quality, delivering care that is patient-centered," he said. Werner, however, complained that a single-payer system would be expensive because it would lack competition on the administrative costs of health care.

Werner suggested managed care as a viable strategy to use in a transition period, until "we get better control of measuring quality, providing quality, and understanding the economic benefit of quality medical services." Niskanen countered that while managed care costs less than care in which people select their own physicians, it is a different standard of service that "does not prove to be effective in reducing the rate of increase in total cost."

Conference participants, concerned about the availability of health insurance, noted that it is cheaper to provide preventative care than emergency care for people without insurance. Shoemaker advocated that employers be required to either make health insurance available to employees or pay a tax that will give them access to an insurance pool, a system frequently referred to as play or pay. Anderson and Niskanen expressed concern that a play-or-pay system would force employers to cut back on employees or wages. "Pay or play is merely a transition to national health insurance," Niskanen said.

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Investing in Human Capital—Reforming Health Care (A Panel Discussion)
Moderator
Michael R. Levy, Publisher, *Texas Monthly*, Austin, Texas

Panelists
Ron J. Anderson, President and Chief Executive Officer, Parkland Memorial Hospital, Dallas, Texas

Panelists—*Continued*

Dwain L. Harper, Executive Director, Cleveland Health Quality Choice Coalition, Cleveland, Ohio

William A. Niskanen, Chairman, CATO Institute, Washington, D.C.

Robert C. Shoemaker, Jr., State Senator and Chairman—Health Insurance and Bioethics Committee, Portland, Oregon

Douglas C. Werner, Senior Vice President—South Central Market Area, Aetna Health Plans, Richardson, Texas

Economic Principles vs. Political Agendas

Harvey Rosenblum, Senior Vice President and Director of Research, Federal Reserve Bank of Dallas, Dallas, Texas

Investing in the Southwest Economy (A Panel Discussion)

Moderator

Michael R. Levy, Publisher, *Texas Monthly*, Austin, Texas

Panelists

Ernesto J. Cortes, Jr., Southwest Regional Director, Industrial Areas Foundation, Austin, Texas

Linnet F. Deily, Chairman, President and Chief Executive Officer, First Interstate Bank of Texas, N.A., Houston, Texas

Tom Luce, Partner, Hughes and Luce, Dallas, Texas

Donald C. Shuffstall, President, Don Shuffstall International, El Paso, Texas

International Aviation: Opportunities If...

Donald J. Carty, Executive Vice President—Finance and Planning, AMR Corp. and American Airlines, Inc., Dallas–Fort Worth, Texas