TESTIMONY
OF
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Chairman Saxton, Vice Chairman Reed, and members of the Committee, it is a pleasure to appear before you today to discuss the release of the *Economic Report of the President*, along with the economic outlook for the United States and the Administration's policy agenda.

The events of 2001 brought new challenges for the U.S. economy and for economic policy. The war against terrorism has increased the demands on our economy, and we must do everything in our power to build our economic strength to meet these demands. At the same time, we must take pains to ensure that the benefits of economic growth are shared as widely as possible, both within and beyond our borders.

Economic growth is not an end in itself. As it raises standards of living—consumption, in the language of economists—growth also provides resources that may be devoted to a variety of activities beyond the traditional marketplace. Growth can fund environmental protection, the work of charitable organizations, and many other activities of interest and value to the United States, other industrialized economies, and developing economies alike.

RESTORING PROSPERITY

The economy entered 2001 growing slowly, and growth continued to decelerate through most of the year. After expanding at an annual rate of 5.7 percent in the second quarter of 2000, gross domestic product (GDP)—a standard measure of economy-wide production—began to falter later in the year, and the weakness persisted into 2001. Some sectors stumbled into outright decline; for example, industrial production peaked in June 2000, and then entered a prolonged slump. Although the National Bureau of Economic Research has said that the recession—the first in ten years—officially began in March 2001, the terrorist attacks of September 11 delivered a further blow to the economy. The experiences of 2001 have emphasized the importance of timely economic information, with one area deserving considerable attention being the need for readily accessible real-time data. Investment in sources of these data could yield handsome dividends, especially at key junctures in the business cycle.

Moreover, the quality of existing statistics is far from perfect and could be enhanced with further investment. Even real GDP, generally thought of as a reliable measure of overall activity in the U.S. economy, is susceptible to considerable revisions. For example, in the third quarter of 2000, real GDP was first estimated to have grown 2.7 percent at an annual rate—a subpar but respectable growth rate. That rate was then revised downward to 2.4 percent and then again to 2.2 percent. Seven months later it was further revised downward to 1.3 percent, providing evidence that the economy had begun to slow dramatically at that time. A key component of the revision came from revised data on gross private domestic investment, initially estimated to have risen 3.2 percent but later revised to show a contraction of 2.8 percent. Such revisions lead to uncertainty for both government and private decisionmakers, which can cause costly delays. Although most revisions are not that large, the average quarterly revision of real GDP growth over the last decade was about one percentage point, while real GDP growth averaged 3.2 percent. This amounts to a revision of about one-half the standard deviation of the quarterly growth rate of real GDP.

A number of steps can be taken to improve the accuracy and timeliness of economic statistics. One cost-effective measure would be to ease the current restrictions on the sharing of confidential statistical data among Federal statistical agencies. Such data sharing, which would be done solely for statistical purposes, is currently hindered by lack of a uniform confidentiality policy. Confidentiality is of key importance to all agencies and to the individuals and businesses who participate in Federal surveys, but a uniform confidentiality policy would allow agencies such as the Bureau of Economic Analysis, the Bureau of Labor Statistics, and the Bureau of the Census to compare and improve the quality of their published statistics while preserving confidentiality. In the past, attempts have been made to pass legislation, together with a conforming bill to modify the Internal Revenue Code, allowing such data sharing under carefully crafted agreements between or among statistical agencies. Meaningful data-sharing legislation still offers the opportunity to improve the quality and effectiveness of Federal statistical programs.

In addition to data-sharing legislation, the Administration is proposing new and continued funding for the development of better and more timely measures to reflect recent changes in the economy. For example, these resources would allow for tracking the effects of the growth in e-commerce, software, and other key services, and for developing better estimates of employee compensation. The latter are increasingly important given the expansion in the use of stock options as a form of executive compensation, as well as for tracking the creation and dissolution of businesses, given the importance of business turnover in a constantly evolving economy. Improved quality-adjusted price indexes for high-technology products are also an important area for future research. As the economy continues to change and grow, the need persists to create and develop such new measures, to provide decisionmakers with better tools with which to track the economy as accurately as possible.

The Near-Term Recovery

The Administration expects real GDP growth to resume early in 2002. The pace is expected to be slow initially, followed by a pickup thereafter; over the four quarters of 2002 real GDP is expected to grow 2.7 percent. The unemployment rate – currently 5.6 percent--is projected to rise through the middle of 2002, when it is expected to peak around 6 percent.

The decline in aggregate demand during the past year was concentrated in inventory investment, business fixed investment, and exports. Of these downward pressures, inventory draw downs are anticipated to reverse course soonest and most rapidly, moving from liquidation to accumulation in the first quarter of 2002. Thus the initial source of the recovery of growth will likely take the form of the accumulation phase of an inventory cycle.

Growth in business investment and exports is likely to take longer to develop. Nonresidential investment fell sharply in 2001, and some downward momentum may still remain. Still, the financial foundations for investment remain positive: Real short-term interest rates are relatively low, prices of computers are falling, and equity prices moved up during the fourth quarter. Perhaps due to these factors there was an upturn in new orders for non-defense capital goods in the fourth quarter, a promising sign for the outlook for business fixed investment.

Personal consumption expenditure grew quite rapidly in the fourth quarter – a 5.4 percent annual rate – driven in large part by purchases of motor vehicles. While auto purchases may have been influenced by special financial considerations, the overall strength of household spending in the fourth quarter suggests a strong impact of the tax cut passed by Congress and signed by the President last spring. During the fourth quarter consumption of non-durables and services increased $39.5 billion despite the fact that personal income rose only $0.2 billion, suggesting that purchases were financed in part by the downpayment on the tax relief mailed out during the third quarter. This interpretation of the data is entirely consistent with the reaction of households to a permanent tax cut, as a temporary tax cut would have been largely saved and not spent. In the same way, it also suggests that any perceived undermining of the permanence of this tax cut would have immediate adverse repercussions in the level of consumption demand.

Consumption spending is expected to continue at solid rates in 2002, albeit a bit slower than the rapid pace in the fourth quarter. One impact, however, of the war against terrorism is the need for enhanced expenditures for defense and homeland security. The growth in these outlays represents an impetus for aggregate demand in the short run; for example, in the fourth quarter, Federal government purchases rose at roughly a 9 percent annual rate. More rapid government spending in general, however, is not a sure recipe for economic growth. Indeed, the loss of fiscal discipline represents a threat to long-run growth. The need to address the terrorist threat is very real; however, we must be vigilant against a loss of budgetary discipline and remain committed to re-prioritizing our needs and controlling the growth of government spending.

Inflation is expected to remain low and stable. As measured by the GDP price index, inflation was stable at about 2.2 percent during 2001. The Administration expects this measure of inflation to fall to 1.9 percent in 2002. The unemployment rate is now above the level that the Administration considers to be the center of the range consistent with stable inflation, and capacity utilization in the industrial sector is substantially below its historical average. Despite faster-than-trend growth of output in 2003 and 2004, some downward pressure will be maintained on the inflation rate, because the unemployment rate is projected to remain above the center of the range over that period.

Risks to the Near-Term Recovery

The Administration forecast mirrors the outlook of private sector analysts such as the Blue Chip consensus forecast. We must recognize, however, that the basic economic outlook is subject to risks.

To begin, one downside risk to the consensus outlook is a slower recovery in capital spending. In particular, some observers have emphasized the possibility of a "capital overhang" that impedes a recovery in business fixed investment. A capital overhang develops when the amount of capital in the economy exceeds the amount that businesses desire for the production of goods and services. The emergence of such an overhang complicates both business planning and policymaking. Businesses often have to alter their capital spending plans and curtail their investment spending—sometimes quite abruptly. A large overhang may also reduce the stimulative effects of tax policies designed to boost investment, possibly lengthening the recovery time during a period of sluggish economic activity, especially for the manufacturing sector.

Empirical evidence suggests that a capital overhang did develop in 2000. The overhang was modest for the economy on average, but various types of capital equipment such as servers, routers, switches, optical cabling, and large trucks were disproportionately affected. Over the past year and a half, the decline in investment spending and depreciation of the existing capital stock appear to have combined to slow capital accumulation sufficiently to eliminate the overhang.

However, estimates of the total overhang must be interpreted with caution. There is considerable uncertainty about its size, because it is difficult to estimate precisely both the capital stock that businesses desire and the capital stock they actually possess.

The remarkable slowdown in capital accumulation during 2001 and the possibility that the capital overhang has persisted longer than the data suggest some risk to the outlook This underscores the importance of the President's tax relief recommendations for economic stimulus. The partial expensing provision will encourage business investment, stimulating economic activity in the short run and laying the foundation for stronger growth in the long run. The reductions in marginal income tax rates will help spur investment by providing incentives for flow-through entities, mainly small businesses, to grow and create jobs. The President's tax relief will also help foster a smooth and more predictable transition to a period of sustainable growth.

One factor that contributed to the onset of the current recession was a sharp rise in the energy prices. Another risk to the outlook is another such rise, especially as the United States is heavily reliant on imported oil to meet its energy needs. The Administration has made a comprehensive energy policy a priority, as indicated in the President's National Energy Policy.

The House energy bill addresses many of the legislative recommendations contained in the National Energy Policy and the President has called on the Senate to act as well. H.R. 4 creates opportunities and provides incentives to foster conservation, improve energy efficiency, increase domestic energy production, and expand the use of renewable energy sources. H.R. 4 represents an important step in ensuring the Nation's future energy security.

Finally, we must acknowledge that in the current security environment our economy remains at risk. The events of September 11 had a pronounced, disruptive impact on the path of the economy. Certainly, we are hopeful that the economy will not be subjected to such adverse events in the future. The Administration worked with Congress to suggest legislation to provide a backstop against catastrophic terrorism risk and continues to support passage of measures to help the private sector build capacity to provide such insurance.

The Long-Term Economic Outlook

The economic difficulties that began in 2000 and continued into 2001 and 2002 should not blind us to the fact that the outlook for the economy remains strongly positive. The Administration projects real GDP growth to average 3.1 percent a year during the 11 years through 2012. The growth rate of the economy over the long run is determined primarily by the growth rates of its supply-side components, which include population, labor force participation, productivity growth, and the workweek.

Productivity growth in the United States accelerated during the second half of the 1990s, and economists generally believe that much of that faster productivity growth is permanent. New technology deserves much of the credit—but by no means all of it. Better, more efficient ways of doing business also contributed, and only a fraction of the many possible improvements have yet been made. Our economic challenge is, in large measure, to discover how to reap the benefits of the remainder.

The Administration expects non-farm labor productivity to grow at a 2.1 percent average pace over the projection period, the same as over the entire period since the previous business cycle peak in the third quarter of 1990. This projection is noticeably more conservative than the 2.6 percent average annual growth in actual productivity from 1995 to 2001.

The Long-Term Policy Agenda

The 1980s and 1990s witnessed a long boom (punctuated by a short recession) in which private sector technological advances and entrepreneurial innovation fueled productivity growth and increases in our standard of living. This strong productivity performance derives from advantages of our economic approach--notably, the strength of our institutions and the flexibility of our business culture. Public policy was in many ways supportive, with tax cuts in the 1980s, deregulation, and a stable anti-inflationary monetary policy leading the way. With some exceptions, policy generally promoted economic growth in the private sector.

The 2002 *Economic Report of the President* focuses on those institutions and on that culture, and proposes strategies for improving them and putting them to use, to sustain our growth and broaden our prosperity. Institutions are a key issue. Productivity growth does not arrive from the heavens. New technologies, process innovations, and other aspects of private-sector productivity gains are the result of investment, effort, testing, and implementation. In Europe, commentators from both the OECD and the European Central Bank have noted the lack of acceleration in productivity growth comparable to that witnessed in the United States. Rigidities in labor and product markets, sometimes exacerbated by regulatory impediments, are often cited as culprits.

Put differently, the important economic *outcome* – productivity growth – hinges on the structure of economic *incentives*. It is now understood that the effective use of economic incentives hinges upon the institutions in which they are embedded. The *Report* is organized around the need to build strong institutions to support a flexible economy and rapid economic growth.

As an example, one of the President's priorities is the U.S.-led effort for more open global trade. The large contribution of reduced trade barriers to growth in our standard of living has long been recognized. In 2001, the United States exported over $1 trillion in goods and services – or 10 percent of GDP.

The United States has the opportunity to reap significant gains from the future trade agreements. A recent study finds that a new World Trade Organization (WTO) round that lowers barriers to services and reduces tariffs by one-third on agricultural and industrial products would yield gains roughly equivalent to a $2,500 permanent increase in the annual income of the average family of four. An agreement on the Free Trade Area for the Americas that removes bilateral tariffs would increase GDP by about $53 billion, or about an $740 permanent increase in the annual income of a family of four.

These are important benefits for the *average* American household. Trade is sometimes portrayed as a threat to lower-income individuals. This is not the case. To take one example, in 1997 there was roughly $18 billion in tariffs, with nearly one-half on clothes and textiles. Who pays those tariffs? In a $10 trillion dollar economy, this might not seem like an important question – after all, $9 billion in clothing tariffs is a trivial fraction of overall consumption spending. The reality is that – measured as a fraction of their income – tariffs paid by the lowest -income quintile were roughly three times that of the highest-income quintile.

Trade helps our domestic productivity. Expanding global trade allows the most efficient producers to grow because selling goods in the competitive international marketplace demands higher productivity. In fact, exporting plants have up to 20 percent higher productivity non-exporting plants.

Furthermore, many domestically produced goods are shipped abroad for further processing or assembly and then returned to the United States. In 1998, for example, the United States imported $27 billion of "production sharing" goods from Mexico, and these goods may be re-imported subject to lower duties. Not duty-free. Nearly 60 percent of the value of these imports derived from U.S.-made components – roughly 16 percent of all U.S. imports from Mexico.

The benefits of free trade are substantial and investments in the institutions that support a global trading system are valuable. Indeed, an institutional commitment is a good way to overcome instances of shortsightedness. In developing countries, the advantages of international trade produce income for not only commercial consumption, but also access to better food, better health care, better education, and technologies that will help improve the environment. In a developed country, stiff import barriers on labor-intensive goods from developing countries such as clothing, leather, or agriculture not only harm consumers but reduces the income of people in developing countries as well.

A recent World Bank study identified developing countries as "globalizing" on the basis of the growth in trade related to GDP and their reduction in average tariff note. It found that, in the 1990s, the income per person in globalizing developing countries grew more than three-and-a-half times faster than it did in non-globalizing developing countries. In the six years following completion of the Uruguay Round, exports from developing nations grew by nearly $1 trillion, to a level of $2.4 trillion last year. The United States in particular has been an engine of export growth for developing nations. There has been an 82 percent increase in U.S. imports from developing countries (87 percent increase in chemical products and 72 percent increase in textiles) between 1994 and 2000.

Building on this success is important. One study indicates that new global trade negotiations would generate income gains for developing countries greater than recent flows of official assistance, and roughly comparable to total inflows of foreign direct investment. An IMF/World Bank study notes that eliminating all barriers to merchandise trade would yield static welfare gains of between $80 and $180 billion to developing countries. These numbers are well in excess of annual aid flows to these countries.

That there is tremendous value to multilateral agreements that institutionalize a commitment to free trade among countries is clear. Trade Promotion Authority (TPA) provides the President with negotiating flexibility and gives the United States additional credibility in the international community. It enhances our bargaining power in these negotiations. It also ensures that trade agreements will maintain a focus on trade, as intended by the negotiating parties. TPA sends a signal to other countries that U.S. is united in active engagement in trade negotiations that will benefit all participating countries. Obviously, Congress still has its final, rightful say on whether or not the United States signs any trade agreement.

International trade is one force behind the "creative destruction" – the continual competitive pressure to innovate, improve, and outperform competitors – that is central to our economy. Of course, for an individual worker, finding a new job in another firm or another industry may be difficult. The United States recognizes this possibility and has put programs in place to assist those who lose their jobs due to trade in finding a new position. Workers who are displaced from their jobs due to imports are given special assistance by the Federal government to smooth their transition to new jobs. For example, the Trade Adjustment Assistance (TAA) and NAFTA-Transitional Adjustment Assistance (NAFTA-TAA) programs provide those misplaced workers with training, income support, and out-of-area job search aid, and relocation allowances; these benefits are in addition to unemployment insurance, employment-related services under the Workforce Investment Act, and other programs. The Administration is committed to reauthorizing and improving the existing TAA and NAFTA-TAA programs that expired last September and were continued through FY 2002 by the action of the appropriators. The Bush Administration has worked this year to improve the TAA programs so that they more effectively ease the transition into new employment.

Another example is the President's proposed Health Insurance Tax Credit. The tax credit proposal included in President Bush's budget for 2003 is a refundable income tax credit to cover the cost of health insurance purchased by individuals under age 65. It would provide a subsidy for a percentage of the health insurance premium, up to a maximum credit of $1,000 per adult and $500 per child. A two-parent family with two children would be eligible for a maximum credit of $3,000. The maximum subsidy percentage would be 90 percent for low-income taxpayers and would phase down with income. A broad-based policy of this type anticipates the insurance needs of workers – dislocated or otherwise – and permits labor market adjustments to be less impeded by health insurance considerations.

There is great value to institutions that meet the short-run needs of displaced workers *and* move them quickly toward productive activities. The events of the past year has illustrated—in an extreme form--the shocks to which our economy is subjected. The President's vision of economic security recognizes that many events impact the economy all the time. We should think comprehensively about these policies and focus our efforts on incentives for getting workers back to work, and quickly. Resources should be devoted flexibly to basic needs, job search for reemployment, and retraining, without creating an incentive for unnecessarily long spells between jobs, because benefits extended under the wrong conditions create a "tax" when a new job is taken and those benefits are lost.

Finally, getting the most out of the economy will require an emphasis on efficiency in government as well. If government spending grows without discipline, billions of dollars will be siphoned away from private sector innovation, taxes will rise, and growth will suffer. The President's Management Agenda seeks to shift the emphasis of government toward results, not process. It aims to replace the present Federal government hierarchy with a flatter, more responsive management structure and to establish a performance-based system.

THE 2002 *ECONOMIC REPORT OF THE PRESIDENT*

The importance of using policies to set in place valuable economic institutions is not limited to displaced workers and government programs. These areas come immediately to mind in the current setting where fiscal discipline and the genuine costs of recession are apparent. However, looking toward the future, there are many areas for such improvements. The 2002 *Economic Report of the President* is devoted to the foundations of these improvements in our institutions. These institutions figure prominently both in agenda for long-term growth and in assuring that the benefits of growth are spread throughout society.

Strengthening Retirement Security

No area of American life could benefit more from enhancements to its institutional underpinnings than retirement security, and the President has made the reform of the Social Security system a central part of his economic agenda. As he has stressed, "Ownership in our society should not be an exclusive club. Independence should not be a gated community. Everyone should be part owner in the American Dream."

The *Report* examines the changing nature of retirement security and the institutional changes needed to meet this challenge. There is little dispute about the need for reform, and there is growing agreement that personal accounts within the Social Security system are an indispensable part of any reform plan. Personal accounts would enhance individual choice—the very foundation of the success of our market economy. The current Social Security system collects 12.4 percent of all covered wages and essentially constrains all working Americans to place their retirement security in a single asset—one that demographic change is rendering increasingly inadequate to support the system's obligations.

Personal accounts would permit individuals to diversify their retirement portfolios, thus increasing their retirement security. The individuals would for the first time acquire rights of ownership, wealth accumulation, and inheritance within Social Security. These advantages are widely recognized. Less well appreciated, however, is that ownership and inheritability will enhance Social Security's role in making our economic system more equitable. Some groups in our society with lower average incomes also have lower life expectancies, and as a consequence, they receive less today in Social Security retirement benefits than do other, wealthier groups. Under a system of personal accounts, the early death of a worker would no longer mean the loss to that worker's heirs of much of what he or she has paid into Social Security. Instead, those assets could be passed on to the next generation. For all these reasons, personal accounts are an important part of reforming Social Security, and thereby of strengthening retirement security for all Americans.

Although not covered in the *Economic Report of the President,* I would be remiss if I failed to mention the President's announcement last week of proposals to strengthen the security of retirement savings in 401(k) plans. These proposals would give workers more freedom to diversity their portfolios. Also, workers would have the same ability as corporate officers to trade company stocks during so-called "blackout" periods when trading is restricted.

Realizing Gains from Competition

One source of the United States' superior economic performance over the past decade has been the success of its institutions for promoting open, competitive markets. Strong incentives to compete are what drive firms to exploit new opportunities, and so achieve faster growth throughout the economy. Deregulation of several key industries during the 1970s and 1980s brought substantial benefits to consumers and to the economy as a whole, recognizing that it took time for those benefits to be realized.

The task of competition policy is to promote competition in a way that ensures the efficient allocation of resources and serves the interests of consumers. In doing so, however, competition policy must walk a fine line: Efforts to prevent anticompetitive changes in the behavior and organization of firms may inadvertently keep firms from taking steps that could lower their costs or improve their products. Such ill-advised interventions would ultimately harm consumers rather than benefit them.

The recent past has witnessed a remarkable shift in the competitive landscape. Mergers and acquisitions have reshaped and continue to reshape the organization of firms and the nature of competition itself. Our competition policy must be flexible enough to acknowledge and support the quest for efficiency that drives these changes, while remaining vigilant against changes that would harm competition. To fail in this task would be to hinder the growth of innovative firms, the adoption of new technology, and the enhancement of productivity.

The markets in which American firms compete today are increasingly global markets, and globalization motivates further changes in firms' organization. Our competition policy should acknowledge and reflect these motivations. Other countries have their own competition policies, of course, and inefficient policies in any one of them may impose costs on firms and consumers in the United States and around the world. The United States should therefore pursue the convergence of national competition policies—but should do so in a way that spreads best-practice, efficient competition policy worldwide.

Finally, competition policy must also deal with the increased importance of "dynamic competition," in which firms compete not just for increments of market share but for absolute (if temporary) market dominance, through rapid innovation. Policies should recognize that, at any given moment, high profits and substantial market share—indicators that might warrant concern about competition in some industries—may mask vigorous dynamic competition among firms in industries undergoing rapid technical change.

Promoting Health Care Quality and Access

Health care is one of the largest and most vibrant sectors of the economy. Biomedical research, both public and private, has generated stunning advances in our understanding of biology and disease and achieved major therapeutic discoveries. As a result, Americans today are living longer lives with less disability. However, the health care delivery system today is troubled, as medical expenditures are again rising rapidly. The costs of private health insurance to working Americans and the costs to taxpayers of government health programs, including Medicare and Medicaid, are increasing at rates far surpassing the growth of the economy. Managed care is under fire from patients and physicians alike. With the economic slowdown and rising costs, concerns about the growing number of uninsured are again coming to the fore.

Much of the discussion about Federal policies to address these concerns has been framed through a narrow lens that focuses on "guarantees" for access and treatment, to be achieved largely through expanding government programs that rely on regulation and price setting. Yet this approach does not ensure access to innovative care that meets the diverse needs of patients in an efficient way—evidence of which is Medicare's lack of coverage for prescription drugs and integrated disease management.

The *Report* explores the President's vision for an alternative framework, one that focuses on achieving better health care through solutions that emphasize both shared American values and sensible economics. These solutions build on existing support; they encourage flexible, innovative, and broadly available health care coverage; they emphasize the central role of the patient in making health care decisions; and they improve those decisions by creating an environment for medical practice that encourages steps to improve quality and reduce costs. This approach emphasizes patient-centered health care, with individual control and individual responsibility.

If we move toward a system of informed choice and well-crafted economic incentives, and away from rigid regulation, the health care system will improve from the resulting flexibility and competition. In this vision, incremental government support would be used to broaden access and to encourage competition in both the private and the public sectors. Support should be targeted to improving the health care of those most in need – the uninsured and those with significant health expenses. New incentives should strengthen the market by improving information about quality and cost, broadening choice, rewarding quality, and addressing costs by encouraging value purchasing by both employers and patients.

The Administration's emphasis on patient-centered health care reform focuses on three objectives. First, we must develop flexible, market-based approaches to providing health care coverage for all Americans. Second, we must support health care providers in their efforts to meet the demand for higher quality and value, in part by making better information available about providers, options, outcomes, and costs. Finally, we must provide the foundation for further innovation through strong support for biomedical research. Providing competitive choices for all Americans, and meaningful individual participation in those choices, will encourage innovation in health care delivery and coverage. Improving incentives and information, and taking steps to help patients and providers use information effectively, will help ensure continued improvements in the health of Americans in the future.

Redesigning Federalism for the 21st Century

Throughout its history, the United States has relied heavily on State and local governments to provide certain goods and services. Our federal system has been a source of greater efficiency and of innovation in government practice. History reveals several tensions as well, most vividly evidenced by Washington's all-too-frequent practice of providing funds to State and local governments without allowing flexibility in their use. This tension between flexibility and control can be resolved efficiently by specifying standards for outcomes but leaving it to State and local providers to determine how best to achieve those outcomes.

Focusing on outcome standards and flexibility to improve efficiency can also imply a role for the private sector in providing public services. The choice of where to draw the line between the public and the private sector depends on the characteristics of the services to be provided. The nature of some services makes it difficult for markets to meet the needs of the population effectively. Even then, it may be efficient to let competition among State and local governments decide what and how much shall be provided but to rely on the private sector to *produce* the service.

The *Report* describes the principles underlying the roles of differing levels of government, and of for-profit firms and not-for-profit organizations, in identifying and meeting needs for public goods and services. Specifically, allowing public and private organizations to compete in meeting preset standards can improve the efficiency of programs in education, welfare, and health insurance for needy populations.

In education, evidence supports the benefits of competition in improving quality, with public, private, and charter schools vying with each other to provide the best education most efficiently. Increased competition for students requires the right institutions so that school systems help make schools accountable for results. Similarly, the providers of safety net benefits such as welfare must be accountable to taxpayers for the quality of services they provide and the resources they use to provide them. By tying payments to these providers to results, and by allowing private nonprofit providers to compete with them on an equal footing, the market discipline that yields innovation and efficiency in the private sector can be brought to bear in the public sector as well.

Building Institutions for a Better Environment

Not so long ago, environmental protection and market-based economic growth were widely regarded as fundamentally in conflict. The past 30 years, however, have seen dramatic improvements in environmental quality go hand in hand with robust growth in GDP. Releases of many toxic substances have been reduced, and many of our natural resources are better protected. Rivers are cleaner and the air is clearer.

In many of these early environmental interventions, the anticipated benefits were clear, large, and achievable at relatively low cost. The next generation of environmental issues, however, is certain to be more challenging. Ongoing efforts to protect endangered species, maintain biodiversity, and preserve ecosystems will require carefully balancing the welfare interests of current and future generations. But those early initiatives also taught us that the costs of environmental protection can be minimized through careful policy design. Part of the challenge for environmental protection today is to identify the best institutions to address each of an array of stubborn environmental problems. Another part is to design those institutions so that they can evolve to address new problems in the future.

The *Report* describes how flexible, market-based approaches to environmental protection—using tradable permits, tradable performance standards, and similar mechanisms—allow businesses to pursue established performance goals or emission limits in the manner they find most efficient. Several case studies illustrate that such an approach can often achieve equal or greater environmental benefits at lower cost than one based on inflexible government mandates.

Supporting Global Economic Integration

The *Report* concludes by examining our institutions for international trade and finance. International flows of goods, services, capital, and people have played an increasingly important role in the world economy, raising the standard of living in the United States and around the world. These gains from international interaction stem from an improved allocation of resources. A more efficient global allocation of productive inputs such as capital and labor translates into higher global output and consumption. Today, however, signs of a slowing global economy, and threats to the freedom that is essential to a well-functioning economic system, make it more important than ever to rededicate ourselves to the free exchange of goods and services across borders.

It is therefore critical that the United States continue to lead the world in the liberalization of trade. The restoration of the President's Trade Promotion Authority will provide the Administration the flexibility and the bargaining power to promote this liberalization most effectively. By streamlining the system for approving trade agreements, TPA will allow the United States to keep pace with our trading partners in the timely adoption of trade liberalization.

The United States must also continue to encourage efforts to strengthen the international financial architecture. A stronger global financial system is needed to support the cross-border flows of capital that are vital to increasing world output. The Administration is taking the lead in the debate over principles for reform of international lending by the International Monetary Fund and the World Bank. In addition, the Administration is seeking to shift the multilateral development banks' emphasis toward grants for low-income countries: this is consistent with continued efforts to make these institutions more efficient and more focused on growth in living standards in developing countries**.** U.S. leadership in this area is essential to safeguarding and enhancing both our own economic prospects and those of the rest of the world.

CONCLUDING REMARKS

The past year has shown that we cannot be complacent about America's rate of economic growth, gains in productivity, and successes in global markets. We must be cognizant of risks that we face in the near-term, and the value of investing in institutions that raise our rate of growth in the long-term. In this way, we will be able to shoulder additional demands on our economy such as the war against terrorism.

This goal is neither narrow nor parochial. The additional resources generated by wise policies are a source of improvements with and beyond markets. To gain a sense of the importance of this issue note that Administration forecast embodies a long-run (potential) growth rate of 3.1 percent. Suppose that the long-run growth rate were to fall by a small amount, just 0.2 percent, to 2.9 percent due to the impairment of incentives to work, take risks, and accumulate capital. Over a decade real GDP would be lower by $266 billion –roughly $1,000 for every man, woman, and child in America today. Similarly, Federal receipts would be roughly $70 billion lower at the end of 10 years, and reduced by about $350 billion over 10 years.

Certainly, additional resources of this magnitude are worth the effort to improve incentives in the United States. However, they have even greater value for others in the world. Policies that remove impediments to growth are the key to prosperity for the whole world, and we can contribute to this goal by wise economic policy and farsighted institutional reform.

Thank you again, Mr. Chairman, for the opportunity to appear before you today. I am happy to answer your questions.