

**TESTIMONY
OF
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CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS
AND
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MEMBER, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE
JOINT ECONOMIC COMMITTEE, U.S. CONGRESS
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3:30 p.m.**

Chairman Bennett, Vice Chairman Saxton, Ranking Member Stark, and members of the committee, it is a pleasure to appear before you 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 2002 brought new challenges for the U.S. economy and for America's economic policy. Efforts to strengthen homeland security and prosecute the war against terrorism placed new demands on the economy. The recovery from the 2000-01 economic slowdown continued, but with an unsatisfactory pace of job creation. These developments make it all the more important to undertake policies that promote growth, both in the United States and in the global economy.

Reliance on markets is key to enhancing growth. Thanks to the flexibility of markets, consumers, businesses, workers, and investors can continuously adapt to changing economic circumstances. Markets constantly reshape and redirect economic activity and economic output in response to changes in producers' supplies and costs and in consumers' incomes, demands, and the prices they face. In turn, the market itself evolves, as new information, new technologies, altered supplies, and other changes in the economic and physical environments pose new problems and open up new opportunities. Put simply, markets are dynamic.

The *Report* emphasizes the importance of dynamic markets in the U.S. economy and the need to design public policies so as to preserve and build on this dynamism. In particular, it discusses recent developments and policies in the areas of corporate governance, regulation, taxation, labor markets, and international economic development. It describes the lessons that have been learned from recognizing the dynamic flexibility of the U.S. economy, and how the President's policy initiatives are putting those lessons into practice.

A fundamental theme in this year's *Report* is the need to craft short-run economic policy with a long-term perspective. An example is the President's Jobs and Growth Package, which is designed to assist the recovery of 2002 in gaining momentum in 2003. A key feature of this package is ending the double taxation of corporate income. In the short run, the positive effect of this policy on equity-financed equipment investment would be equivalent to an immediate investment tax credit of 4 to 7 percent, according to CEA calculations. Higher investment will raise job creation and insure continued economic growth in the next few years. In the long run, the additional investment encouraged by the proposal would raise the nation's stock of productive capital, which in turn would increase the productivity and wages of the nation's workforce. Another important component of the President's plan is the acceleration of marginal tax rate reductions that have already been approved by Congress. In the short-run, these reductions will support consumption by bringing forward permanent tax relief. In the long run, marginal rate cuts reduce disincentives to risk-taking and entrepreneurship and thereby help the economy grow. The package also includes two other important components: an expansion of expensing allowances for small businesses and an innovative program, "Personal Reemployment Accounts," which will give workers money to fund job search or job training expenses, as well as a cash incentive to find work quickly.

In my testimony, we will first discuss the economy's performance in 2002 and discuss both the short-term and long-term outlooks. We will then discuss specific areas in which the Administration's approach to economic policy promises to foster economic growth and prosperity in the United States and around the world.

ASSESSING MACROECONOMIC PERFORMANCE

The U.S. economy solidified its forward progress in 2002, with the fourth quarter of the year marking the fifth consecutive quarter of economic growth. (GDP data from the fourth quarter of 2002 were not available as the *Report* went to press, but will be referenced in this testimony.) This progress followed a contraction in 2001 that was deeper and longer than initial data suggested, but still mild by historical standards. Real gross domestic product (GDP) declined by 0.6 percent during the first three quarters of 2001, about one-fourth the average percentage decline over the previous seven recessions. Growth resumed in the fourth quarter of 2001—despite the terrorist attacks in September—and real GDP rose 2.8 percent over the four quarters of 2002. Although economic activity weakened in the fourth quarter relative to the other three quarters of the year, ongoing improvement in productivity growth, together with lean inventories, foreshadows a return to more normal levels of production and job growth in the quarters ahead.

The economic recovery of 2002 resulted from a constellation of factors, including the resiliency of the economy after the terrorist attacks and the lagged effects of stimulative monetary and fiscal policy in 2001. Although the Federal Reserve lowered the Federal funds rate only once in 2002—by half a percentage point on November 6—the 475-basis-point reduction over the course of 2001 continued to stimulate the economy throughout the year. (A basis point is 0.01 percentage point.) Monetary stimulus was complemented by fiscal stimulus, in the form of the tax rate reductions included in the Economic Growth and Taxpayer Relief Reconciliation Act of 2001 (EGTRRA) and the investment incentives in the Job Creation and Worker Assistance Act (JCWAA) of 2002. In the long run, EGTRRA's reductions in marginal tax rates will raise potential output by increasing labor supply and encouraging the entrepreneurial activities that are the building blocks of economic growth. In the short run, the tax cuts also buoyed disposable income and helped maintain consumption. Robust consumption, in turn, was a crucial locus of strength in the overall economy, contributing an average of 1.8 percentage points to real GDP growth during the four quarters of the year. Additionally, the tax incentives in JCWAA, which the President signed in March, provided needed support to investment at a time when stability in this component of final demand was especially important.

In 2002, discussions of both economic activity and economic policy paid particular attention to the valuation of the economy's stock of productive assets. One of the more favorable developments for many Americans in 2002 was the continued appreciation of their most important investment: their home. Housing prices rose 6.2 percent from the third quarter of 2001 to the third quarter of 2002, following an 8.7 percent increase in the same period a year earlier. As discussed below, housing values were buoyed not only by low mortgage interest rates, which reached levels not seen in more than a generation, but also by rising demand, continuing strength in purchases of second homes, and ongoing improvements in mortgage finance. Strength in housing values contributed to robust increases in residential investment, providing another important impetus to final demand in 2002.

In the aggregate, however, the appreciation in housing wealth was overshadowed by continued losses in the stock market. Like those for all of the world's major equity exchanges, U.S. stock indexes lost ground in 2002, continuing a general slide that began in the spring of 2000. From the market's high point in the first quarter of 2000 to the fourth quarter of 2002, stockholders lost nearly \$7 trillion in equity wealth. These losses continued to weigh heavily on economic growth and job creation in 2002, by reducing the wealth of consumers and raising the cost of equity capital for investing firms. The precise reasons for the bear market of 2000-02 are subject to debate, but the market's three-year decline was probably influenced by two general factors – a decline in expected profit growth and an increase in the premium that investors required to hold risky assets. These factors continued to play important roles in the first three quarters of 2002 as the stock market continued its decline. Specifically, corporate accounting scandals called into question the reported profits of some firms, while risk premiums (as measured by the difference, or spread, between the yields of corporate bonds and those of U.S. Treasuries) rose to near-record levels. Although some observers attributed most of the market's decline to the corporate scandals, it is worth noting that equity prices fell around the world, even in countries with different accounting systems and governance institutions. In any event, asset markets played important roles in the determination of the components of GDP in 2002, which we will now discuss in turn.

Consumption. Consumption continued to be the locomotive for the recovery in 2002. Expenditure on consumer durables was especially strong, in large part because of motor vehicle sales that were sparked by aggressive financing offers. Additional strength in consumption

stemmed from robust increases in incomes, as low inflation, tax relief, and steady nominal income growth kept real disposable incomes high. Another positive determinant of consumption growth in 2002 was the strength of the housing market, which was supported by low mortgage rates as well as continued growth in housing demand. Housing wealth is more widely distributed among American families than stock market wealth, and housing equity continued to rise in 2002. A common way for this equity to support consumption is through borrowing against home equity; the outstanding value of revolving home equity loans at commercial banks rose from \$155.5 billion in December 2001 to \$212.4 billion in December 2002. Another way for homeowners to tap the equity in their homes is by refinancing their outstanding mortgages. Many refinancers chose to remove equity from their homes by taking out a new mortgage with a larger principal than the amount outstanding on the original mortgage. These “cash-out” refinancings boomed in 2002 as a result of the continued appreciation in housing prices and declining long-term interest rates. All in all, the positive effects on consumption stemming from higher incomes, higher housing wealth and lower interest rates helped to counter any negative influences on consumption than resulted from declining stock market wealth.

Nonresidential investment. The stock market was a depressing influence on business investment in 2002, as lower equity values make it more difficult to finance investment projects (Chart 1). Business investment was one of the weakest components of demand in 2002, declining by 1.9 percent over the four quarters of the year. The decline was heavily influenced by a precipitous decline in investment in structures, which fell 15.7 percent over the course of the year. The other, larger component of business fixed investment, equipment and software, was also weak, rising only 3.0 percent. In light of the rapid increase in investment in the late 1990s, many observers wondered whether the economy suffered from a capital overhang, built up by excessive investment in the years immediately before the 2001 recession. As discussed in last year’s *Report*, this possibility is hard to verify, because it requires an estimate of the “correct” amount of capital relative to the economy’s output, a figure that is hard to know with certainty. Yet, as the 2002 *Report* also noted, some empirical evidence had emerged in 2001 indicating that a modest overhang had developed the previous year for some capital goods, notably servers, routers, switches, optical cabling, and large trucks. Evidence that a widespread overhang continues to hinder overall investment outside of a few particular industries, however, is harder to find.

Residential investment. In contrast to the softness in nonresidential investment, residential investment grew briskly in 2002, sparked by the lowest mortgage interest rates in more than a generation. After hitting a recent peak of 8.64 percent in May 2000, interest rates for conventional, fixed-rate 30-year loans fell to 5.93 percent by the end of December 2002, their lowest level since 1965. Low mortgage rates contributed to the 6.8 percent increase in single-family housing starts over their already high level of 2001, while boosting sales of new homes to record levels at the end of the year. The strength of housing construction during the past 3 years stands in contrast to past business cycles, when housing starts were not nearly as robust.

Net exports. Although the output of the U.S. economy remained below potential in 2002, its growth rate still outpaced those of many other industrialized countries. Slow growth among many of the United States' major trading partners, in turn, contributed to slow growth in U.S. exports compared with that of imports. Exports rose 5.0 percent during the four quarters of 2002, while imports grew 9.2 percent. This discrepancy between the rates of growth in exports and imports led to an increase in the U.S. trade deficit, so that net exports exerted a drag on GDP growth in three of the four quarters of the year. (Net exports were essentially unchanged in the third quarter.)

Government purchases. The war on terrorism continued to exert upward pressure on federal government purchases in 2002. In late March, the President requested that the Congress provide an additional appropriation of \$27.1 billion, primarily to fund this effort. More than half of this amount was allocated to activities of the Department of Defense and various intelligence agencies. Most of the rest was needed for homeland security (mainly for the new Transportation Security Administration) and for the emergency response and recovery efforts in New York City. Although most of this spending was required for one-time outlays only, it nevertheless contributed to the 7.3 percent increase in real federal government purchases in 2002. State and local government purchases rose at a more moderate 1.7 percent during the same period.

The Near-Term Outlook

The Administration expects that aggregate economic activity will gather strength during 2003, with real GDP growing 3.4 percent during the four quarters of the year. The unemployment rate, which was 5.9 percent in the fourth quarter of 2002, is projected to edge

down about 0.3 percentage point by the fourth quarter of 2003. Although growth in equipment and software investment was low, several factors suggest a rebound in 2003. To begin with, any capital overhang that might have arisen during the late-1990s investment boom has been reduced, because the level of investment fell in 2001; expectations of future GDP growth have stabilized after falling during 2001; and the replacement cycle is approaching for the short-lived capital goods put in place during the investment boom of 1999 and 2000. At the same time, the financial foundations for investment remain positive: real short-term interest rates are low, and prices of computers are falling more rapidly than they did in 2000. (Computer investment accounted for a third of all nonresidential investment growth from 1995 to 2000.) Less bright is the outlook for nonresidential structures, which still appears weak even after two years of decline. Even so, structures investment is projected to stabilize around the second half of 2003, as the maturing recovery generates higher occupancy rates for office buildings and greater demand for commercial properties. The recent passage of legislation for terrorism risk insurance may unblock some planned investments in structures that were held up because of lack of insurance. Real exports, which turned up in 2002, are projected to improve further during 2003. Although real imports and exports are expected to grow at similar rates during the four quarters of 2003, the United States imports more than it exports, and therefore the dollar value of imports is expected to increase more than the dollar value of exports. As a result, net exports are likely to deteriorate further during 2003. Consumption should remain robust in 2003. The negative influence of the stock market decline on household wealth, and thus on consumption, should wane as this decline recedes into history. Consumption growth will also be supported by fiscal stimulus and the lagged effects of recent interest rate cuts. Finally, low interest rates will continue to support the purchase of consumer durables, just as they did for much of 2002.

Long-Term Outlook

The Administration forecasts real annual GDP growth to average 3.4 percent during the first four years of the projection. As this is somewhat above the expected rate of increase in productive capacity, the unemployment rate is projected to decline as a consequence. In 2007 and 2008, real GDP growth is projected to continue at its long-run potential rate of 3.1 percent. The growth rate of the economy over the long run is determined by the growth rates of its

supply-side components, which include population, labor force participation, the workweek, and productivity.

The Administration expects nonfarm labor productivity to grow at a 2.1 percent annual average pace over the forecast period, virtually the same as that recorded from the business cycle peak in 1990 through the fourth quarter of 2002. This projection is notably more conservative than the nearly 2¾ percent average rate actually recorded since 1995. In addition to productivity, growth of the labor force is projected to contribute 1.0 percentage point a year to growth of potential output on average through 2008. Taken together, potential real GDP is projected to grow at about a 3.1 percent annual pace, slightly above the average pace since 1973.

THE 2003 *ECONOMIC REPORT OF THE PRESIDENT*

The central goal of the Administration's economic policies is the promotion of economic growth. The remaining chapters of the *Report* illustrate ways in which pro-growth economic policies can improve economic performance at home and abroad by striking the right balance between the encouragement and regulation of firms, by promoting flexibility and dynamism in labor markets, and by reducing tax-based disincentives to economic activity.

Improving Corporate Governance

Corporate governance is the system of checks and balances that serves to align the decisions of corporate managers with the desire of shareholders to maximize the value of their investments. It is a largely private-sector activity built on the bedrock of the nation's legal infrastructure. Good corporate governance can substantially reduce the costs to investors of delegating decisions to managers, as must inevitably occur when corporations obtain external financing. Good governance also contributes to the ability of U.S. corporations to maintain dispersed ownership and to the existence of well-developed financial markets. It enables corporations to compete more effectively in financial and product markets that have become increasingly global. The economy then benefits through more effective use of the available factors of production, including managerial talent, external capital, and natural and human resources. Importantly, strong corporate governance improves the attractiveness of corporate investments to households and other investors by more closely aligning managers' actions with investors' interests, and by making information about the corporation and the quality and

diligence of its management more transparent to outsiders. Chapter 2 of the *Report* examines the evolution of institutions for corporate governance in the United States. Last year was marked by important reforms in U.S. corporate governance, including new laws, government regulations, and private-sector initiatives. The reforms were in part a response to the failure of some managers and accountants to provide accurate information about corporate financial and operating performance—events that drew attention to possible weaknesses in the current system of governance.

In calling for reform in March of last year, the President articulated a plan based on three core principles of good corporate governance—accuracy and accessibility of information, accountability of management, and independence of external auditors. The plan recognizes both the complexity of modern corporate governance systems and their inherent flexibility. Its call for a careful reexamination of private governance customs and legal rules was followed by a series of private and public sector initiatives. These include stepped-up enforcement efforts by state and federal authorities, facilitated by the President’s creation of a Corporate Fraud Task Force in July to focus on conduct by managers and accountants that has been a source of concern. The President also signed the Sarbanes-Oxley Act in July, which the Securities and Exchange Commission is now implementing through a series of new regulations.

Under the Sarbanes-Oxley Act, a new regulatory body is being created to strengthen the incentives of auditors to meet their legal obligation to serve the interests of shareholders and other investors. The Securities and Exchange Commission must issue new disclosure regulations, including rules designed to make it easier for investors to gauge the incentives and performance of corporate managers. State governments are also instituting changes; state law is fundamental to the governance structures of corporations. Private-sector organizations were among the first to respond to the President’s call for reform. Self-regulatory organizations such as those that operate the nation’s stock exchanges contribute in important ways to the quality of U.S. corporate governance. Along with individual investor organizations, corporate officials, and others, these organizations have taken steps to strengthen U.S. corporate governance.

Even in the midst of these reforms, it is important to remember that change is not new to U.S. corporate governance. The U.S. system of corporate governance is designed to be flexible.

This flexibility indeed accounts for its capacity to support economic growth over the decades, and for its strong global reputation. The chapter highlights the three main components of the U.S. corporate governance system: external governance mechanisms, internal corporate governance, and laws and regulations. External and internal corporate governance mechanisms serve to align managers' interests with those of shareholders and can adapt to changing market conditions. The surety provided by the U.S. legal system in upholding the contracts that investors enter into when they supply capital to corporations contributes to the flexibility of the corporate governance system. This framework, which relies on both the flexibility of private institutions and the integrity of public institutions, remains in place throughout the present reforms and provides a model for other economies to follow.

Developing Regulation for a Dynamic Economy

Competitive, efficient, and equitable markets are the cornerstone of a flexible and dynamic economy. Regulation of economic activity is an essential element of a market economy, but regulation can hinder economic growth and well-being just as it can advance them. Well-formulated regulation can lead to improved market outcomes, but regulation that is ill-conceived or that is not cost-effective can have unintended consequences that actually make matters worse. Chapter 4 of the *Report* illustrates how both the government and the private sector play critical roles in ensuring a flexible economic environment that promotes growth and prosperity by allowing economic resources to be redeployed as opportunities evolve. The chapter provides a framework for the evaluation of regulatory policies, focusing on federal regulation and how it can foster or hinder economic dynamism.

Regulation stems from a number of needs. Some demands for regulation reflect a desire to improve the efficiency of markets rendered imperfect by spillover effects, informational problems, or lack of competition. By compensating for or correcting these market imperfections, such regulation may enhance growth. Other demands for regulation, in contrast, reflect a desire to change market outcomes, for reasons that may be compassionate or selfish, far-sighted or opportunistic. Regulatory policy must identify and deny those demands for regulation that seek only economic rents for a privileged few, and instead be based on sound science and economics, along with a careful evaluation of the social needs behind the desire for regulation. The chapter

suggests some guidelines for evaluating both new regulations and proposed regulatory reforms that will help reduce the costs of regulation and achieve the best possible outcomes. When regulation is necessary, it should be flexible and market based, and the burden of each regulation should be justified by the benefits it confers. An important Administration initiative is the revision of the Office of Management and Budget's Guidelines for the Conduct of Regulatory Analysis and the Format of Accounting Statements. Conducted jointly by the Council of Economic Advisers and the Office of Management and Budget, this initiative stresses the principles of sound regulatory policy based on economic analysis. The revised guidelines have recently been published and sent to agencies and external experts for peer review.

Part of a complete understanding of the consequences of regulation is recognizing that the impact and efficacy of specific regulations can change over time with changes in technology, economic conditions, and scientific knowledge. An excellent example is the President's Clear Skies Initiative. Aimed at reducing power plant emissions of atmospheric pollutants, this program was designed in light of scientific evidence linking impairments of human health to exposure to certain polluting chemicals. Importantly, however, Clear Skies has also been crafted in such a way that economic incentives provide the mechanism for reduction of these pollutants at least cost to the economy.

Regulatory review and reform offer an important means for policymakers to control the buildup of regulatory costs and limit the economic harm of outdated regulations. Although many regulatory changes have been clear successes, others have created problems. Examples include the experience with the savings and loan industry in the 1980s and the more recent experience with electricity markets in California. To avoid in the future the kinds of unsatisfactory outcomes that resulted from these episodes, regulatory reform should be guided by the same basic principles as the development of new regulations.

Analyzing Tax Policy

An efficient tax system adequately finances government activities, while imposing as few distortions as possible on household and business decisions. A tax system with high marginal tax rates or a complicated structure impedes work effort and saving and hinders the risk taking and entrepreneurship that are the foundations of growth. Tax rates that are unequal across activities

encourage tax avoidance and lead to potentially wasteful efforts at regulation, reporting, and monitoring to control it. Tax deductions, exclusions, and credits are often undertaken with the aim of targeting resources to worthwhile social goals, but they can create considerable complexity for taxpayers. They can also impose high effective tax rates in the range of income over which the tax benefits are gradually withdrawn, in some cases discouraging additional work effort among the very people the preferences were intended to help. The combined result of all of these imperfections can be a tax system that imposes significant compliance costs and wastes resources by misallocating them to nonproductive activities.

Chapter 5 of the *Report* considers how tax policy changes could improve economic growth and real incomes for all Americans. Such changes involve difficult questions of how best to balance the sometimes competing objectives of simplicity, fairness, and faster long-term growth. The chapter considers some approaches that economists have identified to achieve the gains of higher incomes and efficiency within the framework of the existing tax system. Even relatively modest changes can lead to important improvements in economic incentives and efficiency. In particular, the opportunity exists to reduce significant differentials in tax rates across different activities and to lower the tax on the return to capital in ways that improve incentives. Small improvements in this regard can have large long-run effects, because saving and investment decisions made now will affect capital accumulation, technological change, and innovation for years to come.

An excellent example is the President's proposal to abolish the double tax on corporate income. The current taxation of corporate income is an important example of how the current tax code falls short of the goal of taxing income only once. Taxing corporate income twice, once at the corporate and again at the individual level, reduces the after-tax reward to investing. It distorts corporate financing decisions, diminishes capital formation, and results in too little capital being allocated to the corporate sector. As a result, the capital stock grows more slowly than it could otherwise, lowering the productivity of workers and thus the growth of their real wages. The President's plan to eliminate this double taxation will boost long-term efficiency and support increased investment that will promote higher near-term growth and job creation.

The chapter also discusses ways in which the dynamism of the U.S. economy affects the evaluation of tax policies. For example, the effect of the tax system on an individual taxpayer is not well represented by a one-year, static snapshot of his or her income. Rather, its impact

changes significantly over time as the taxpayer proceeds through the stages of life and his or her earnings rise and fall. Earnings typically rise through the working years, as the individual gains experience and human capital, then fall as the individual retires and exits the work force. (Chart 2 shows the progression of marginal tax rates for a hypothetical couple.) One's tax bill is also affected by, among other things, changes in employment, marriage and divorce, having and raising children, giving to charity, starting up a business, and buying and selling assets. The ebbs and flows of the business cycle also have an impact. In evaluating the distribution of the tax burden and how changes in the tax code affect that distribution, it is therefore important to consider the full range of individuals' lifetime experiences. For example, a college student is likely to have little income today but will benefit from tax relief upon entering the labor force. Conversely, a working couple nearing retirement who currently pay the top marginal income tax rate would benefit today from a reduction in that rate, but they might benefit less in the future once they have retired and their income is lower. In short, because everyone's tax situation changes over time for a variety of reasons, proper analysis of the distribution of taxation must consider not just who will benefit from tax relief today but who will benefit in the future as well.

Designing Dynamic Labor Market Policies

As noted above, employment growth during 2002 did not keep pace with the recovery in output. From December 2001 through December 2002, nonfarm payroll employment fell by 229,000, while the unemployment rate stayed between 5.6 and 6.0 percent. These statistics may give the impression of a static labor market. Yet dynamism remains the predominant characteristic of the labor market in the United States: in 2002 millions of workers found new jobs, started new businesses, and raised their earnings. Chapter 3 of the *Report* documents some important dimensions of these labor market dynamics and discusses their implications for employment and productivity growth and for the design of policy.

The mobility of workers—across jobs, up the opportunity ladder, and even in and out of employment—is one important dimension of a dynamic labor market and one of the great strengths of the U.S. labor market. American workers change jobs frequently, particularly during the first decade of their working lives, in part because doing so allows them to gain new experience and skills and, importantly, to increase their earnings—most earnings growth for younger workers comes about through job changes. For these new entrants, however,

employment itself is the key aspect of this dynamic, because tenure on a job provides returns in terms of skill development and on-the-job training. This improvement in skills, in turn, makes possible increased earnings. Although staying on the ladder of upward mobility means maintaining an attachment to the labor market, it does not necessarily mean staying put in any one job. In a well-functioning labor market, there are large flows between employment and unemployment, and a substantial number of jobs are created and destroyed each year.

These large flows are further evidence of the flexibility of the U.S. economy, as expanding firms and industries take on more workers while those in decline contract their labor forces. Research shows that frequent job changes for the young are, in an important sense, the means through which individuals are matched to the jobs that will provide them with the best opportunities.

Government policies are more effective when they recognize and foster labor market mobility. Policies can support this mobility—and earnings growth—by encouraging skill development and education. Another important policy goal is to meet the desire of individuals for social insurance against the adverse consequences of short-term macroeconomic fluctuations and personal misfortune. Policymakers face difficult tradeoffs in designing social insurance, however, because the provision of insurance can itself distort behavior, making individuals less likely to enter employment or to exert full effort toward finding a job. As an example, for decades the Aid to Families with Dependent Children program provided insurance against destitution, but it also created a financial incentive for recipients to stay out of the work force. Welfare reform and the Earned Income Tax Credit are examples of policies that have supported individuals in time of need while also giving them incentives to enter the labor market and find jobs.

The Administration has proposed a new program to help unemployed workers find jobs quickly. Qualifying workers would receive a Personal Reemployment Account of up to \$3,000 each, with funds to be used for expenses such as training, child care, or relocation. These accounts, which are in addition to unemployment compensation, would be targeted to those unemployed workers who are deemed most likely to exhaust their unemployment benefits before finding a new job. Those who find a new job within 13 weeks would be able to receive a cash payment of the remaining funds in the account as a “reemployment bonus.” Personal Reemployment Accounts thus would provide not only support for training and skill

development, but also potential additional transition assistance. One advantage of these accounts compared to traditional unemployment insurance is that traditional insurance encourages workers to wait until their insurance runs out before finding a new job (Chart 3).

Promoting Global Growth

Chapter 6 of the *Report* examines how countries throughout the world can promote economic growth and thereby enhance the well-being of their people. In recent years many countries, especially in the developing world, have experienced robust growth, which has led to reduced poverty, lower infant mortality, improved health outcomes, and longer life expectancy. Many others, however, have been far less successful at promoting growth and have not seen similar improvements in social indicators. The central theme of the chapter is that all countries can experience faster growth by creating an economic environment in which market signals lead to better economic performance. Three principles guide these growth-oriented policy reforms. The first is economic freedom, in which encouraging competition and entrepreneurship leads to stronger growth. Economic freedom involves, among other things, a stable domestic macroeconomic environment with low inflation, appropriate government regulation, encouragement of entrepreneurial initiative, and openness to the global economy. The second pro-growth principle is governing justly—safeguarding the rule of law, controlling corruption, and securing political freedom. Indeed, the relationship between the strength of the rule of law in a country and its per-capita income is striking (Chart 4). The third principle is investing in people. These investments include those that promote the health and education of the population, making workers more productive. No one of these principles is enough to guarantee strong growth; rather, all three are mutually reinforcing aspects of a pro-growth agenda. The specific policy measures that will implement these pro-growth principles similarly involve a number of elements: responsible fiscal and monetary policies, an appropriate size and role of government, domestic flexibility and internal competition, openness to the global economy, a healthy and educated population, and sound institutions. Countries that pursue a broad range of policies consistent with these principles perform better than those that do not. During the 1980s and 1990s, for example, those countries that were more open to the international economy grew much faster on average than those that were more closed.

The President has inaugurated three important policy initiatives designed to stimulate economic performance in countries around the world: trade liberalization initiatives negotiated pursuant to Trade Promotion Authority, which will promote countries' openness to international trade and investment; the Millennium Challenge Account, which will provide direct financial assistance to developing countries adopting pro-growth policies; and reform of the multilateral development banks, which will encourage private sector involvement in results-oriented development programs undertaken by the World Bank and the regional development banks. Through these and other policies, the United States will help countries address the challenge of improving their economic growth. Ultimately, however, creating a pro-growth environment is up to each country's own people and government. The initiatives of the United States will help in important ways, especially by reinforcing pro-growth decisions by governments and individuals. They are not, however, substitutes for the adoption of good policies in developing countries themselves, which are ultimately the key to success. The pro-growth agenda embodied in these three policy initiatives will enhance growth and prosperity both at home and abroad. This is the most direct way to improve standards of living and thus the lives of people around the world.

CONCLUSION

The United States is recovering from both an economic downturn and the aftershocks of the terrorist attacks of September 2001. Government policies have aided this recovery in important ways, with support from both fiscal and monetary initiatives. Perhaps most important in ensuring recovery, however, has been the underlying flexibility and dynamism of the U.S. economy. In the midst of the downturn, workers continued to find new opportunities, savers continued to reallocate their funds in search of greater returns, and firms continued to regroup and to invest in future growth. The economic policies of the Administration will likewise continue to support this quest for growth, both here at home and around the world.

Thank you, Mr. Chairman. We look forward to your questions.

Chart 1: Equity Prices and Business Investment

Percent change year over year

Percent change year over year

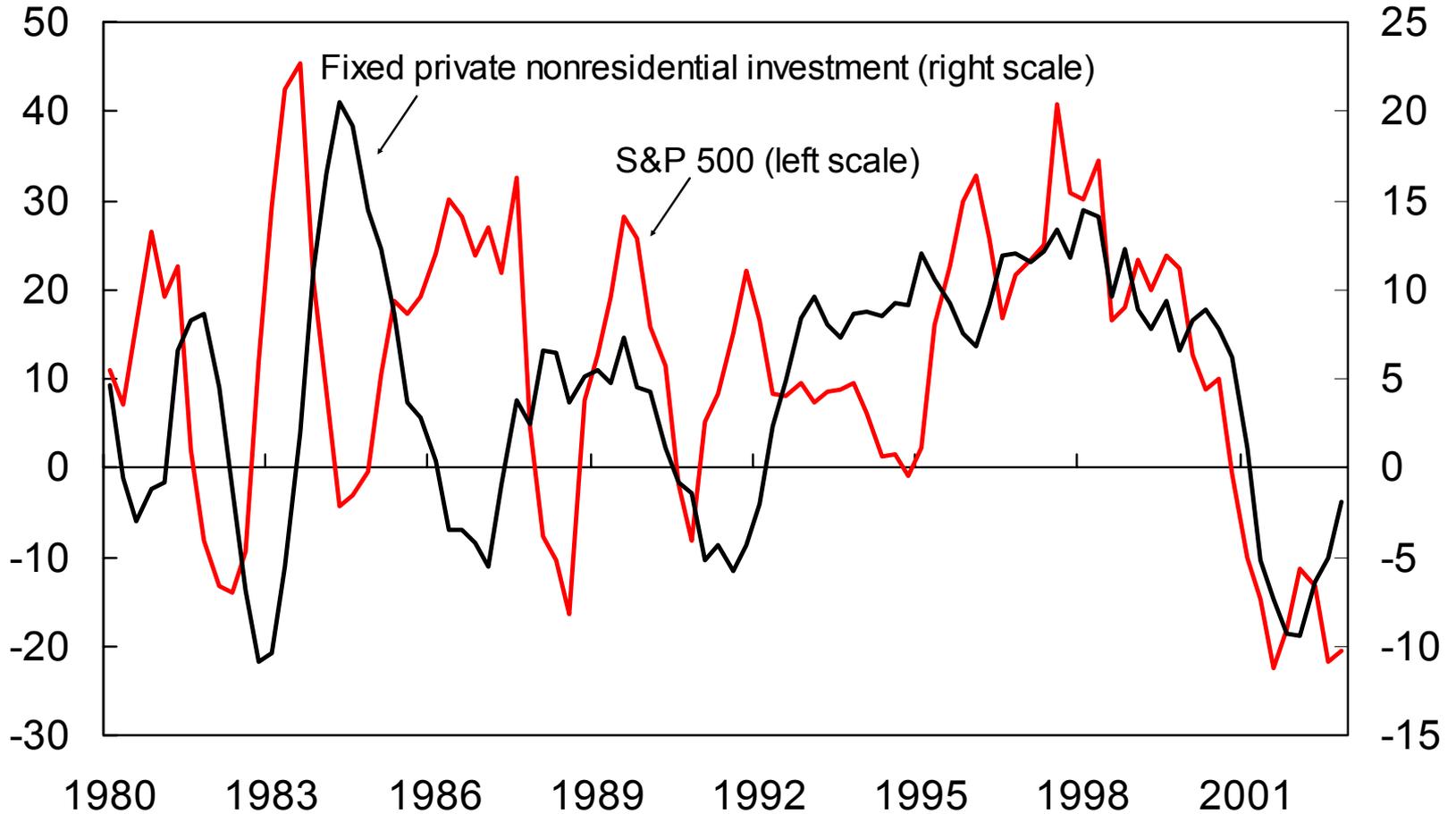
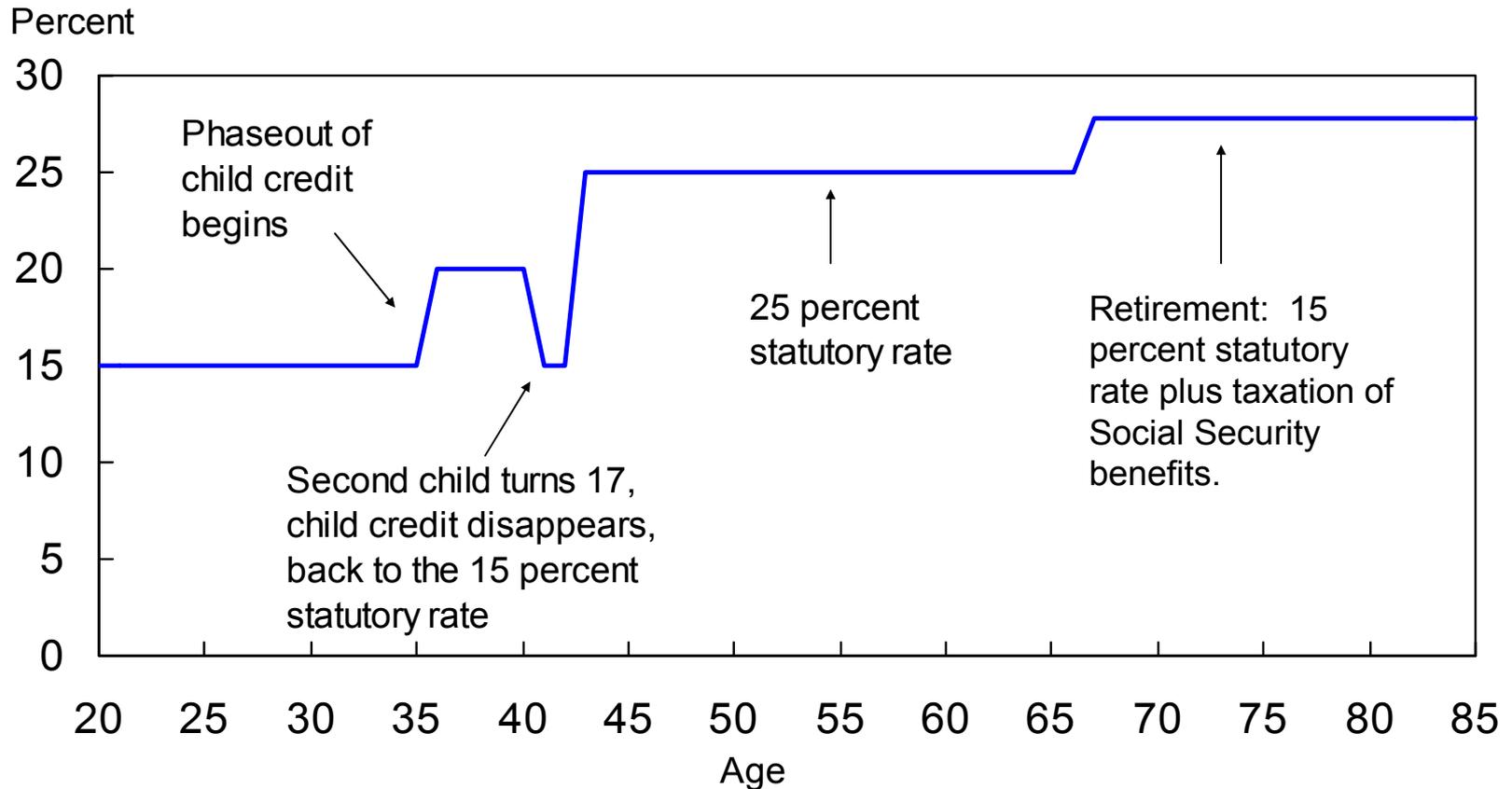


Chart 2: Effective Marginal Tax Rates by Age for Hypothetical Couple*



*Calculations are for joint-filer, two-earner family with moderate lifetime income and assume taxpayers not subject to the alternative minimum tax.

Chart 3: Fraction of Unemployed Workers Finding Work by Number of Weeks Unemployed

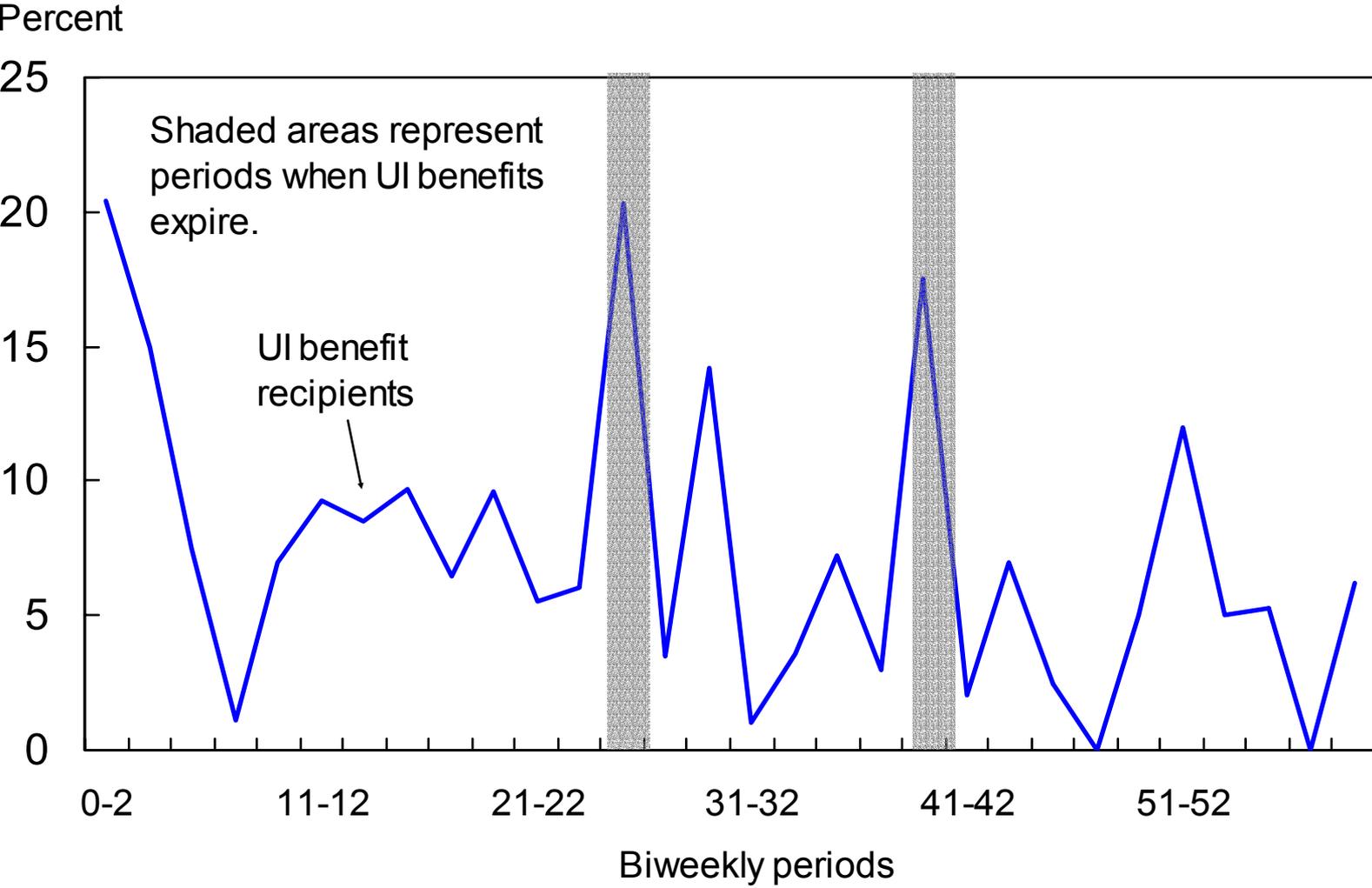
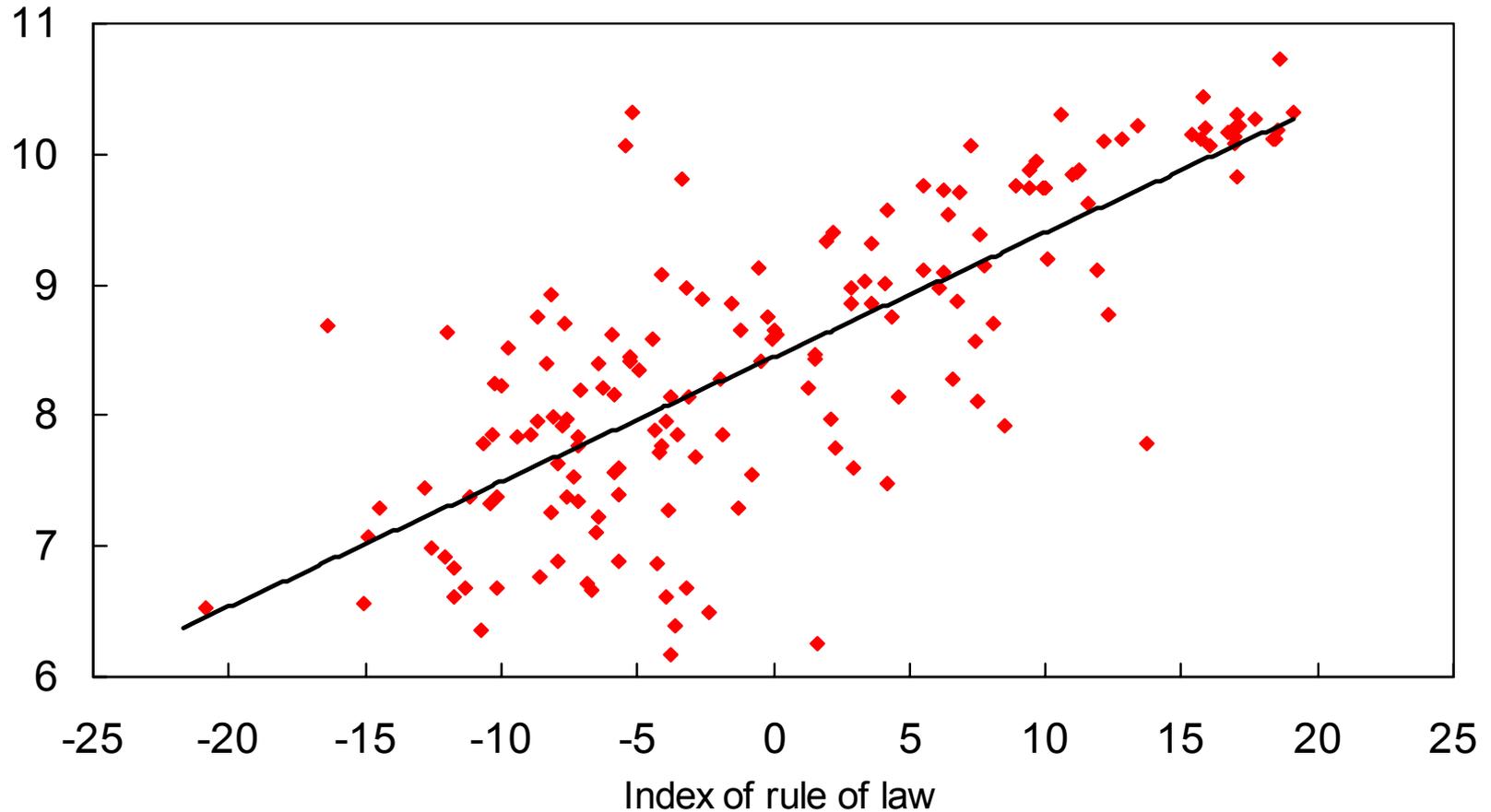


Chart 4: Rule of Law and Income per Capita*

Log of real income per capita



*Income adjusted for purchasing power parity.