Overview

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. The market constantly reshapes and redirects 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.

This *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, labor markets, regulation, taxation, 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, to foster economic growth and prosperity in the United States and around the world.

Assessing Macroeconomic Performance

Chapter 1 of the *Report* reviews the most important events for the economy in 2002. The components of aggregate demand—consumption, investment, government purchases, and net exports—are discussed in turn. Particular attention is paid to the valuation of the Nation's stock of productive assets and to the link between these asset values and demand. The chapter then discusses the near-term outlook for the economy and the outlook for productivity growth, because growth in productivity—output per worker—is the main influence on long-run growth and living standards.

The U.S. economy grew at an annual rate of 3.4 percent through the first three quarters of 2002. (The advance release for GDP in the last quarter of 2002 became available only after this *Report* went to press.) Although output rebounded after the terrorist attacks of September 2001, job growth during the recovery has remained unsatisfactory. However, the continued recovery in output over the past year, and especially the robust improvements in productivity, foreshadow a return to more vibrant job creation in the future.

The contraction of 2001, although one of the mildest on record, turned out to have started earlier and to have been more severe than data available before July 2002 had indicated. The revised data that became available at that time revealed that output had dropped moderately in each of the first three quarters of 2001 before the rebound began in late 2001 and early 2002. Output fell by a cumulative total of 0.6 percent from the peak at the end of 2000 to the trough in the third quarter of 2001, much less than in most previous recessions. The mildness of the recession—in spite of the effects of terrorist attacks, continued declines in the stock market, and concerns over corporate governance—reflects in large part the benefits derived from the flexibility of the market-driven U.S. economy.

Monetary and fiscal policy also provided support for demand in the face of these adverse developments. In 2001, faced with signs of a slowing of economic activity, the Federal Reserve reduced the target Federal funds rate 11 times during the year, for a total reduction of 4.75 percentage points, to 1.75 percent. The Federal Reserve then held the Federal funds rate steady through most of 2002, until a half-percentage-point cut on November 6 brought it down to 1.25 percent.

Recent U.S. fiscal policy has pursued the goal of promoting economic growth. Among the central components of a pro-growth fiscal policy are measures to limit the share of output commanded by the government, and measures to reduce disincentives to work, save, and invest. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA), enacted in June 2001, lowered marginal tax rates for all taxpayers. This tax cut will have important incentive effects that will lead to higher incomes and improved long-term living standards. EGTRRA also provided important support for economic activity in the short term, because of the way in which the tax rate reductions were set in place and the timing of the act's passage.

On January 7, 2003, the President proposed a plan to enhance the long-term growth of the economy while supporting the emerging recovery. The President's plan would accelerate to January 1, 2003, many features of the 2001 tax cut that are currently scheduled to be phased in over several years (including reductions in marginal income tax rates, additional marriage penalty relief, a larger child credit, and a wider 10 percent income tax bracket); it would eliminate the double taxation of corporate income by excluding dividends from individual taxable income; it would increase to

$75,000 the expensing limit for small business investment; and it would provide $3.6 billion to the States to fund Personal Reemployment Accounts for unemployed workers (described below). The package would provide near-term support to investment and improve the long-term efficiency of capital markets, while at the same time insuring against a softening of consumption by putting more money in consumers' pockets.

Relatively slow economic growth in several countries that are important U.S. trading partners contributed to a widening of the U.S. current account deficit, a broad measure of the balance of the Nation's international goods and services transactions, in 2002. The current account is equivalent to the difference between net national investment and net national saving, and therefore a large current account deficit can reflect high investment, low saving, or both. It follows that there is no one "right" level for the current account balance. Indeed, the crucial question in assessing the current account is not how large it is, but instead whether investment is growing at a rate that supports higher income and improved living standards for American households. The foreign capital inflows that are the counterpart of the current account deficit are a potentially important way in which to fund this investment.

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 this *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 Government 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.

Designing Dynamic Labor Market Policies

As noted above and in Chapter 1, employment growth during 2002 did not keep pace with the recovery in output. From December 2001 through December 2002, nonfarm payroll employment fell by 181,000, while the unemployment rate stayed between 5.5 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 this *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 the upward ratcheting effect through which movement between jobs contributes to 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 and constant flows between employment and unemployment, and a substantial number of jobs are created and destroyed each year. These large, bidirectional 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 some 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 policy to foster skill development and increase the rewards associated with work for those unemployed workers who face the most difficulty in finding new employment. Qualifying workers would receive a Personal Reemployment Account, with funds to be used for expenses such as training, child care, or relocation. These accounts 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 entitled to 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 a monetary incentive for unemployed workers to find new jobs.

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 this *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.

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. The chapter provides several examples, one of which 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. Yet although many regulatory reforms have been clear successes, others have created new problems. Examples include the experience with reform of 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 this *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.

The chapter discusses 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.

Taxing all income once, but only once, would greatly improve the efficiency with which government revenue is raised. Tax preferences represent a policy decision to exclude some income from the tax base, but this poses a tradeoff: a higher overall tax rate is then required to raise a given amount of revenue—and the higher rate in turn increases the inevitable distorting effects of taxation on the economy. Even taxing all income just once, however, would leave in place the tax code's current distortion of the decision between current consumption and future consumption (that is, saving). A tax system based on consumption rather than income would remove this distortion, but it would also require a higher average tax rate than a system based on comprehensive income, because the consumption tax would have a smaller tax base (although it would be larger than the present income tax base). The benefits of a consumption tax would have to be weighed against the disincentive effects from this higher rate.

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 accumulates human capital, and then fall as the individual retires and exits the work force. 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.

Promoting Global Growth

Chapter 6 of this *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. This involves safeguarding the rule of law, controlling corruption, and securing political freedom—all aspects of policy that are vital for developing trust in the accountability and reliability of government. 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.