Overview

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. These uses of our economic growth contribute to achieving the President's vision of "prosperity with a purpose."

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 that 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. After several quarters of increasingly weak growth, the terrorist attacks of September 11 tipped the economy into recession, the first in 10 years.

The economic difficulties that began in 2000 and continued through 2001 should not blind us to the fact that the outlook for the economy remains strongly positive. What matters most for long-term growth is improvements in productivity. 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 United States is unique among industrial economies in having experienced this recent boom in productivity growth. In principle, nothing prevents businesses in all of the world's industrial and industrializing economies from adopting the same technologies available here. Yet only the United States has enjoyed an increase in sustained productivity growth since 1995. This stronger productivity performance therefore likely derives from uniquely American advantages: notably, the strength of our institutions and the flexibility of our business culture. Accordingly, this *Report* 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.

The *Report* begins, in Chapter 1, by reviewing the important economic events of 2001. The chapter goes on to present the economic outlook for the United States and to sketch an agenda for the institutions needed to speed the Nation's growth and enhance its economic security.

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."

Chapter 2 of this *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 that sizable share of our wealth in a single entity—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. They 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 benefit less today from Social Security 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.

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—however, it took time for all of those benefits to be realized, and this counsels patience in evaluating more recent deregulation initiatives in, for example, electricity markets.

The task of competition policy—as detailed in Chapter 3 of this *Report*—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 efforts to restrain 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. But other countries have their own competition policies, 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 harmonization 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—need not preclude 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.

Chapter 4 of this *Report* explores 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 benefit from the resulting flexibility and competition. In this vision, 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 centers 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. And 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. As discussed in Chapter 5 of this *Report*, 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 rely on the private sector to *produce* the service, but to let State and local governments decide what and how much shall be provided.

Chapter 5 of this *Report* discusses 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, the chapter shows how 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. When the right institutions are in place, school systems can be held accountable for results. Similarly, the providers of safety net benefits—such as welfare and Medicaid—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 tradeoffs between 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.

Chapter 6 of this *Report* describes how flexible, market-based approaches to environmental protection—using tradable permits, tradable performance standards, and similar mechanisms for a fixed overall standard—allow businesses to pursue established performance goals or emission limits in the manner they find most efficient. The chapter documents, through several case studies, that such an approach can often achieve equal or greater environmental benefits at lower cost than one based on inflexible government mandates. The chapter concludes by illustrating how—and how not—to apply this experience with flexible mechanisms to the long-term challenge of global climate change.

Supporting Global Economic Integration

The final chapter of this *Report* examines 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 part and parcel of a well-functioning economic system, make it more important than ever to rededicate ourselves to the free exchange of goods, services, and capital 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 (TPA) 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.

Conclusion

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. Nor can we afford to be parochial. We seek growth and prosperity for the whole world, and we will achieve it by wise economic policy and farsighted institutional reform.