BUILDING A STRONG ECONOMY

The American people are building a strong economy poised for a prolonged period of solid growth that will continue to create jobs, raise wages, and lift their living standards. They are succeeding while overcoming major obstacles and by adapting readily to changing circumstances.

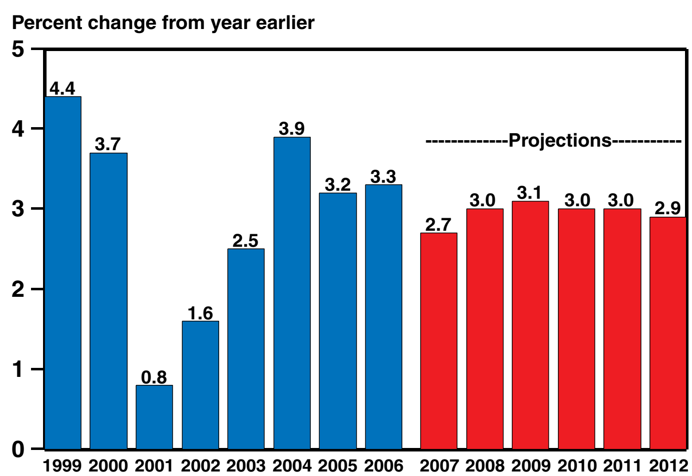
Our economy has always been and likely will always be subject to diverse shocks and disruptions. The American economy typically overcomes such influences in a relatively short period because of its inherent flexibility and vitality. This proved to be true again in 2006. Despite energy price spikes, a long-anticipated housing correction, a struggling domestic auto manufacturing sector, the current and lingering effects of a rising Federal Funds rate, the persistent uncertainties associated with the Global War on Terror, and the lingering effects of Hurricane Katrina in 2005, real Gross Domestic Product (GDP) rose 3.0 percent over the four quarters ending in September, 2006, and employment increased by 2 million jobs through the 12 months ending in December.

THE ROLE OF POLICY IN BUILDING A STRONG ECONOMY

Continuing economic strength and resilience are the product of well-designed and well-functioning economic institutions, and of sound policies such as low taxes, a strong preference for low and stable inflation, restrained regulation, open markets, and spending restraint by the Federal Government.

In 2001 the President, working with the Congress on a bipartisan basis, enacted the largest tax cut since the Reagan Administration. The tax cut doubled the Child Tax credit, cut the marriage penalty, and lowered individual income tax rates. These tax changes provided timely fiscal stimulus that combined with an aggressive monetary response by the Federal Reserve to counter the recession then underway, and were fortuitously timed to help the economy weather the effects of the September 11th terrorist attacks.

Strong Economic Growth Continues



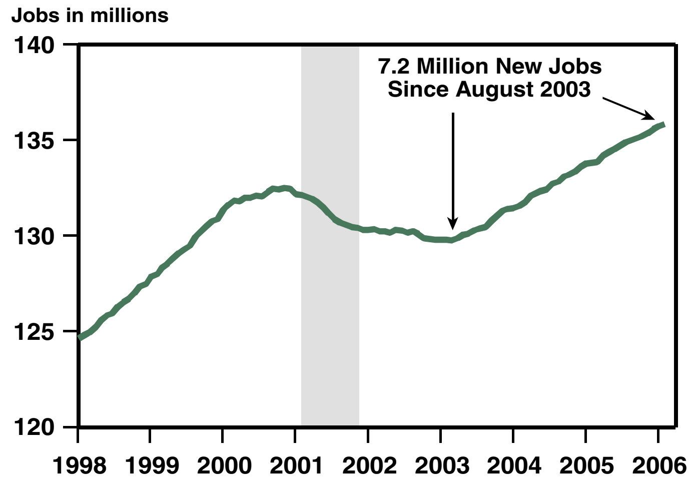
NOTE: GDP growth for 2006 is an estimate.

The 2001 tax cuts helped stabilize the economy, but it remained weak in the face of a declining stock market and corporate accounting scandals that rocked business and investor confidence. So the President pressed for additional tax relief in 2002 and again in 2003, including provisions to encourage business investment in new plant and equipment and an historic reduction in the capital gains and dividend tax rates. The combination of all these tax policies worked, and by the Fall of 2003 a robust economic expansion was underway. From August 2003 through December 2006 the U.S. economy generated over 7.2 million new jobs, including the upcoming benchmark revision.

The tax cuts will continue to strengthen growth in the years ahead by reducing the inherent biases in our Federal tax system against work, saving, investment, economic risk taking, and entrepreneurship. Along with the tax cuts, other policies of this Administration will continue to strengthen our economy. For example, the Administration has:

- Strengthened our financial markets by restoring accountability and transparency.
- Made great strides in reducing the regulatory burden, cutting the cost of new regulations by more than half while preserving protections for workers and consumers.
- Expanded export opportunities by negotiating 10 new free trade agreements with 15 countries.
- Put in place policies to restrain excessive health care inflation through market-based reforms in Medicare and through the market discipline resulting from the enactment and growing popularity of Health Savings Accounts.

Job Growth Remains Strong and Steady



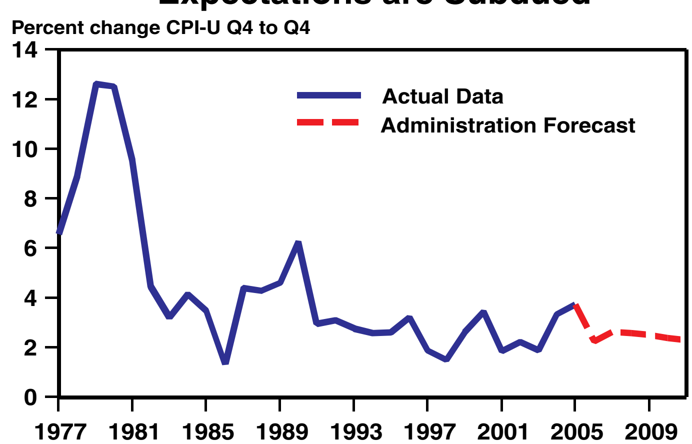
Shaded area represents recession period.

The task ahead is to sustain, improve, and build on these policies, and to address long-term national issues such as access to affordable health care, and reforms to our important, yet unsustainable, entitlement programs.

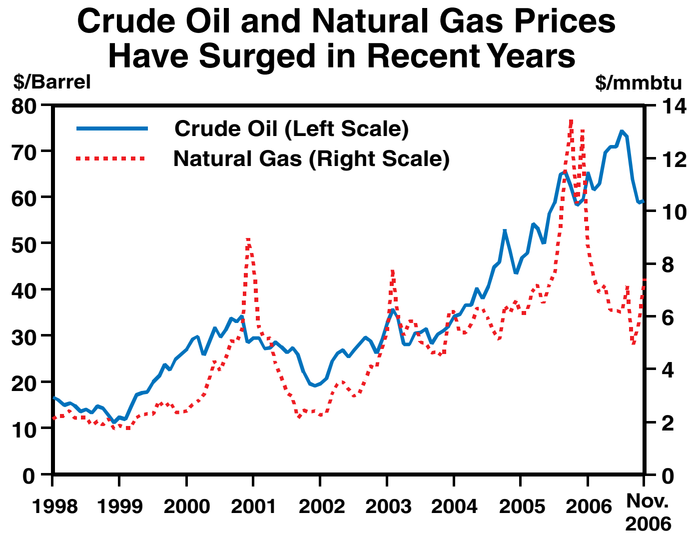
The Economy in 2006: Continued Growth and Resiliency

The economy entered 2006 with a full head of steam despite the profound and lingering effects of Hurricanes Katrina, Rita, and Wilma the previous year. In the first quarter of 2006, real GDP grew 5.6 percent at an annualized rate and the economy created over a half million new jobs. The unemployment rate stood at 4.7 percent, which is about as low as most economists believe is sustainable in the long run. Yet over the course of the year the economy would need to overcome some serious challenges if it was to continue to grow and expand employment briskly.

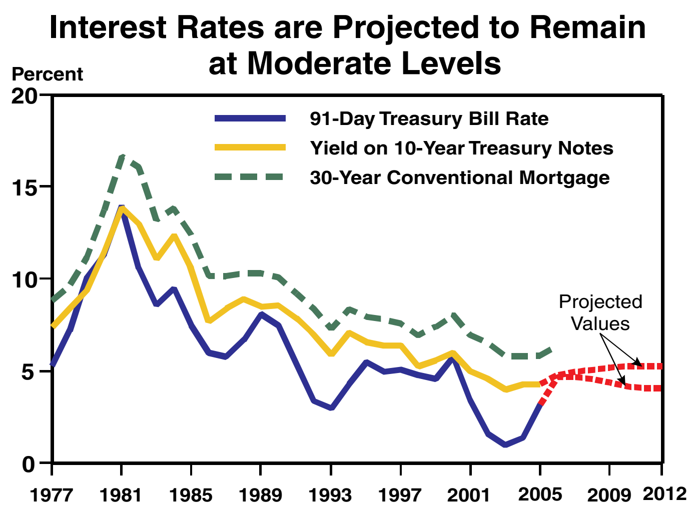
Inflation Remains Low and Inflation Expectations are Subdued



As 2006 began, the Federal Reserve was well along in moving toward a more neutral monetary policy. The Fed had steadily raised the Federal funds rate from 1 percent in mid-2004 to 4.5 percent at the start of 2006. The Fed continued to raise the funds rate until it paused at 5.25 percent in August. The evidence to date suggests the Fed responded to events successfully with a policy of aggressive monetary accommodation in 2001, and has returned to a more neutral stance while preserving a relatively low rate of inflation and subdued inflation expectations. Measured by the Consumer Price Index, prices rose about 2 percent in 2006. The Administration forecast, which is very similar to that of the Blue Chip Consensus, is for inflation to remain moderate through the forecast period.



Rising energy prices also tended to restrain economic growth in 2006 while putting upward pressure on inflation. As recently as January 2002 the price of West Texas Intermediate crude was around $20 a barrel. Four years later the price was over $65 a barrel. Natural gas prices experienced a comparable percentage increase, with a particularly remarkable, though temporary, surge in mid-2006. Crude oil prices continued to rise through the first half of the year, reaching a high of over $77 a barrel in mid-July before falling back toward $60 by the end of the year. The surge in energy prices was especially troubling for industries that are energy intensive or that produce energy-consuming products, such as the auto industry. The economy has benefited from the decline in energy prices since last summer, but energy prices remain elevated and this headwind has not yet fully abated.



Housing prices and new housing construction experienced a major boom from 2001 through 2005. Going into 2006 a correction was widely expected, and those expectations were realized: As of November housing starts were down 29 percent from their 2005 average, sales of new homes were down 16 percent, and new home prices were flat or falling in most of the country.

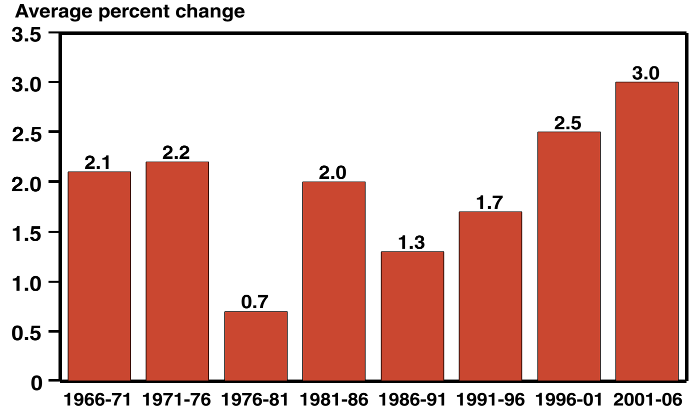
By the end of the year, however, the housing sector was showing signs of stabilizing. For example, new home sales had leveled out as had new mortgage applications, likely encouraged by the sizable drop in home mortgage rates from a peak for the year of 6.8 percent in July to around 6.15 percent by the end of the year.

Against all these headwinds the economy has continued to move forward and has continued to recover its overall balance from the 2001 recession as the expansion matures. The 2001 recession officially ended in November of that year as total output began to revive. However, increasing the level of output was only the first step as the economy recovered its balance.

Initially, America's businesses increased output using their existing facilities and their then-current workforce without adding to capacity or payrolls. This meant that labor productivity rose exceptionally rapidly at 4.1 percent in 2002, a very good sign for economic health, business profits, and subsequent real wage gains, but it also meant the economy was growing without adding jobs.

Business investment in new equipment began to accelerate shortly after the President signed the 2003 tax relief bill, and businesses began hiring again soon thereafter as economic prospects brightened. From August 2003 to the end of the year employment rose by a half million jobs, and from August of 2003 through December of 2006 employment was up by 7.2 million after revisions. In 2006 alone, employment grew by about 2 million jobs, pushing the unemployment rate down to a very low 4.5 percent. Meanwhile, real business fixed investment increased at annual rates of 5.9 percent in 2004, 6.8 percent in 2005, and over 9 percent annualized through the third quarter of 2006.

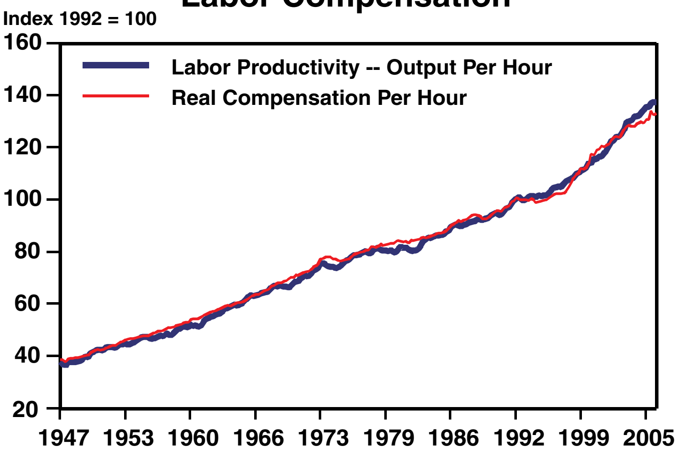
Productivity Growth has Accelerated Since the Mid-1990s



NOTE: Productivity growth for 2001-2006 is based on an estimate for 2006, fourth quarter.

Over long periods of time, growth in employee compensation adjusted for inflation tends to track improvements in labor productivity very closely, but this relationship is looser over the course of a business cycle. When output is rising and labor markets are soft, labor productivity growth tends to outrun growth in employee compensation. Once labor markets tighten sufficiently, the growth in employee compensation tends to match, and then for a period to exceed improvements in labor productivity, eventually restoring the historical relationship between compensation and productivity.

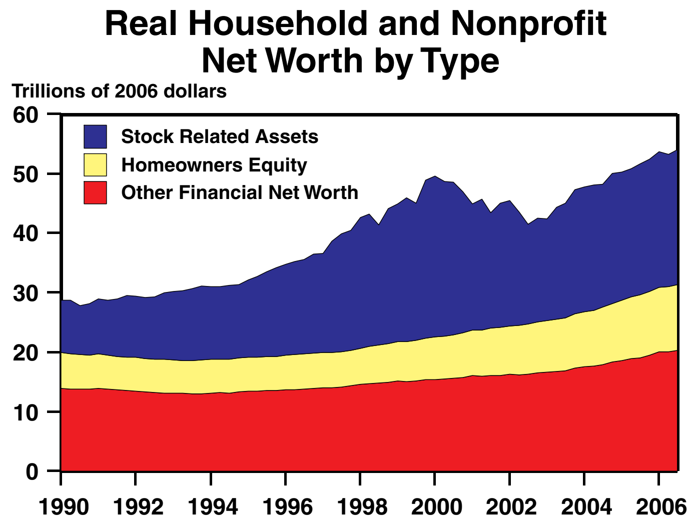
Productivity is the Driving Force Behind Labor Compensation



Source: Bureau of Labor Statistics; staff calculations. Real output and compensation measured on equivalent price index basis.

Increasing output was the first stage in the recovery; growth in employment was the second stage. The third stage in the restoration of a balanced economy is achieved when there is a strong and steady revival of real growth in wages and benefits. The signs in 2006 suggest that in this respect the economy has almost fully regained its balance: Nominal wages grew 5.1 percent in 2005 and 5.9 percent through November 2006. Total labor compensation, which includes wages and benefits, rose 5.5 percent in 2005 and 5.9 percent through November 2006. The modest, temporary surge in inflation in early to mid-2006 meant that real wage growth was somewhat subdued at the time despite the strong growth in nominal wages. However, with inflation moderating and strong growth in nominal wages, real wages were up 2.3 percent, or $1,350 for a typical family of four, over the 12 months ending in December 2006, the strongest 12-month performance since 1998 and a harbinger of strong real wage growth expected in 2007 and beyond.

In addition to strong growth in employment and income, the American people also enjoyed yet another significant increase in their real net assets in 2006. Rising real net wealth is a reflection of the increasing command over resources Americans enjoy, and an indicator of economic prospects for the future. By the third quarter of 2006, real household net worth was up 5.4 percent from the year earlier, and up almost 17 percent from the fourth quarter of 2000. Equity values have trended upward since the Summer of 2003, and as measured by the S&P 500 were up almost 14 percent in 2006. Other financial assets have risen steadily in value, and real estate wealth is up 58 percent since the President took office. The real estate sector is undergoing a correction that may reduce housing prices in some regions of the country, but even so on average housing prices were up 4.4 percent after inflation in the third quarter of 2006 compared to the year earlier.



Summing up, the Federal Reserve has held the funds rate steady at 5.25 percent since August, oil prices have retrenched and began the year well below $60 a barrel, and the housing sector has made a substantial correction. Meanwhile, long-term interest rates remain remarkably low and inflation appears to be ebbing. And, the last element of an overall balanced economy yielding a self-sustaining economic expansion is now in place: strong and steady wage growth working with steady growth in jobs justified by steady productivity growth, creating strong growth in consumer purchasing power, and preserving the competitiveness and profitability of American businesses. All in all, the economy appears well-poised to handle whatever new and unexpected disruptions 2007 may bring and to attain the growth the Administration is forecasting.

The Economy and the Budget: Reducing the Deficit

In February 2004, the President's Budget forecast a deficit for that fiscal year of 4.5 percent of GDP, or $521 billion. Even coming out of a recession and in time of war, that is a significant fiscal shortfall, and the President determined it needed to come down. And so he set a goal of cutting the deficit in half by 2009.

As countries have found across the globe and across time, significant deficit reduction is never easy. On the receipts side, governments face the choice of pursuing pro-growth policies to generate higher tax receipts, or raising taxes and sacrificing some degree of their economic growth. This Administration has chosen to pursue pro-growth policies, and they have worked. Along with steady growth in output and incomes, we have seen remarkable growth in Federal tax receipts. In 2004, tax receipts rose 5.5 percent. In 2005, tax receipts rose 14.5 percent, the largest one year growth in receipts since 1982. In 2006, tax receipts rose another 11.8 percent.

The other side of deficit reduction is restraining spending to bring it in line with receipts. Since the September 11th terrorist attacks, the President's Budgets have provided the necessary funding for prosecuting the Global War on Terror and for homeland security needs, while calling for increasing restraint in non-security discretionary spending and significant reductions in mandatory spending. The 2008 Budget continues this emphasis on fiscal discipline as non-security discretionary spending growth is held well below the rate of inflation, total discretionary spending is held to about the rate of nominal GDP growth, and the Budget proposes $96 billion in new mandatory savings over five years.

As a consequence of strong receipts growth and spending restraint, the deficit in 2006 was not the 3.2 percent of GDP, or $423 billion, predicted last February; the deficit in 2006 came in 1.9 percent of GDP, or at $248 billion, meeting the President's deficit goal three years early.

On January 2, 2007, the President set a new goal for the Nation: balancing the budget by 2012. The policies contained in this Budget represent the next steps toward meeting that goal.

The strong and steady progress toward a balanced budget would not be possible without the Administration's pro-growth economic policies. By reducing the deficit through spending restraint and growth-generated revenue increases, the Administration has shown the great strides that can be made toward fiscal discipline without raising taxes.

The pro-growth tax cuts enacted in 2001 and 2003, currently scheduled to expire at the end of 2010, should be made permanent as proposed in this Budget to ensure continued strong economic growth. The tax cuts served to energize the forces underlying our economy coming out of recession and will continue to do so, and the stronger future economic growth will help to provide the resources needed to address the very real problems we face with the unfunded liabilities in the Medicare, Medicaid, and Social Security programs discussed in the next chapter, the Nation's Fiscal Outlook.