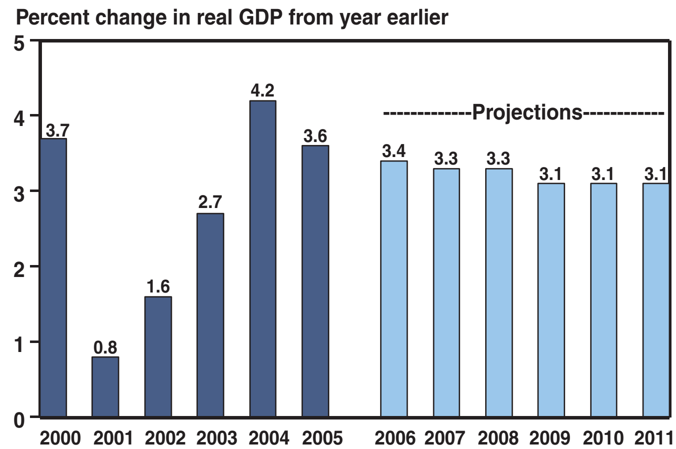
EXPANDING ECONOMIC OPPORTUNITY

The resilience and strength of the economy is producing ever-greater opportunity and prosperity for Americans. In 2005, the economy overcame major shocks, including hurricanes that devastated the Gulf region, a jump in energy prices, inflation fears, and continued economic weakness among many of our major trading partners. Yet in the third quarter, when those effects were most pronounced, the economy grew at a 4.1 percent annual rate, with low core inflation. Over the past year, inflation-adjusted Gross Domestic Product (GDP) is estimated to have grown at a strong 3.6 percent rate. Through the third quarter of 2005 the economy had grown at a 3 percent annual rate or higher for 10 straight quarters. Since the recession of 2001, total output and income have grown almost 14 percent.

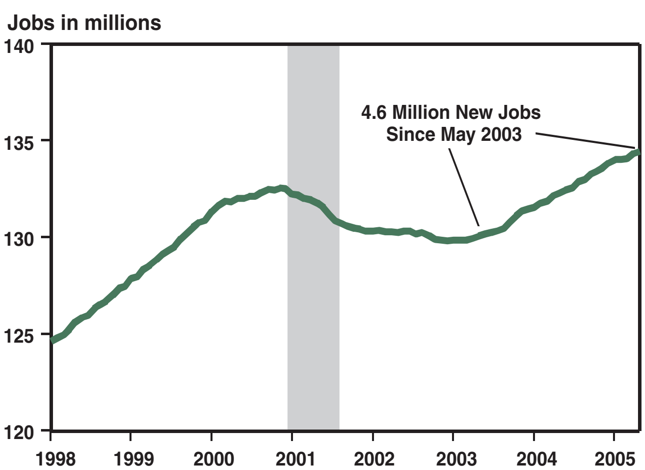
Strong Economic Growth Continues



NOTE: GDP growth for 2005 is an estimate.

We are also seeing the sustained job growth expected from a strong economy. Employment is up by 4.6 million jobs since May of 2003. The unemployment rate, which peaked at 6.3 percent in June of 2003, fell to 4.9 percent by the end of 2005, a level consistent with strong growth and low inflation. This unemployment rate is lower than the average unemployment rates of the 1970s, 1980s, and 1990s, and it is significantly lower than the unemployment rates of many of our major trading partners.

Strong Job Growth Has Resumed



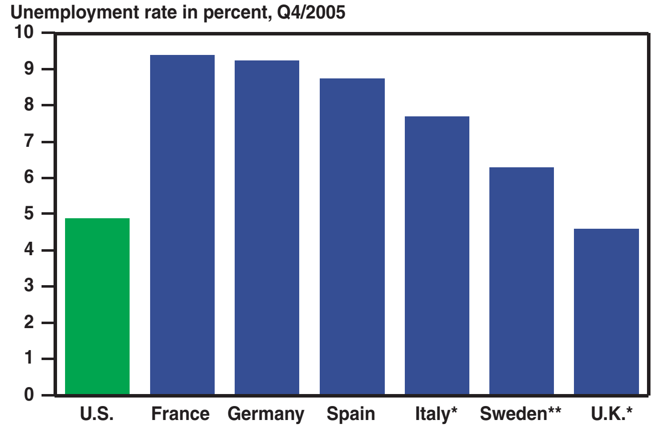
Shaded area represents recession period.

Energy prices rose sharply over the past year, yet core inflation in 2005 remained subdued at 2.2 percent, a low rate by historical standards. Similarly, long-term interest rates remained low, with the 10-year Treasury bond ending the year at just under 4.4 percent, nearly unchanged from the 4.2 percent at which it started the year, and despite steady increases in a key short-term interest rate by the Federal Reserve.

The manufacturing sector, which took the brunt of the 2001 recession, is recovering steadily, with manufacturing industrial production up 12 percent over the past two and a half years. The housing sector continued its best sustained performance in more than a quarter century, with housing starts hitting 2.1 million units in 2005 while the home ownership rate continued near its record level of 69 percent set in 2004.

American families have benefited directly from the growth in the economy. In addition to the strong job growth, they have seen real after-tax income per person increase by 7 percent since the President took office. And as of the third quarter of 2005, household wealth had reached $51 trillion, up 10.9 percent over the previous four quarters.

Unemployment Rate is Much Lower in the United States than in Europe



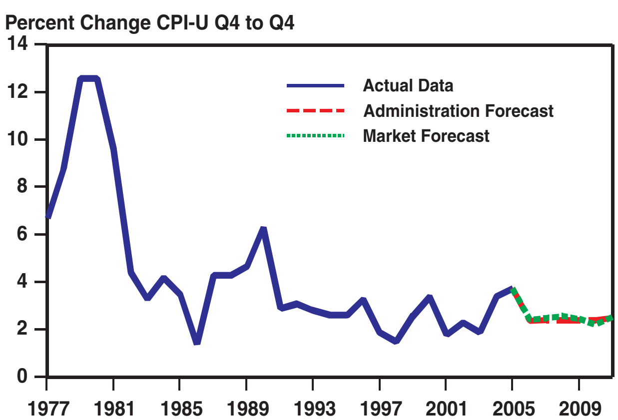
*Q2/2005, **Q1/2005

The strength of our economy has produced rapid increases in the level of Federal receipts, thereby helping to reduce the budget deficit. From a trough of $1.8 trillion in 2003, receipts rose to $2.2 trillion in 2005—a 20.8-percent increase in just two years. From 2004 to 2005, receipts grew 14.5 percent, or more than twice as fast as the economy itself. The Budget forecasts receipts to grow another $132 billion from 2005 to 2006, an increase of 6.1 percent.

ECONOMIC GROWTH AHEAD

The Administration anticipates continued healthy economic growth, with real GDP growth at 3.6 percent in 2005, and 3.4 percent for 2006. These rates are in line with the consensus views of private-sector forecasters. Low inflation, low interest rates, resumed strong job growth, and strong growth in business investment support this optimistic outlook.

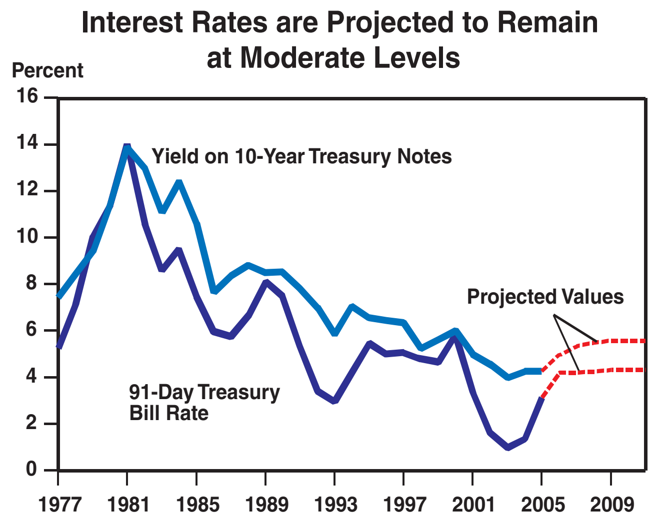
Inflation Remains Low and Inflation Expectations Are Subdued



Rates are derived from Treasury's Inflation-Indexed Securities.

Future economic growth is predicated on the continuation of pro-growth policies that have played an important role in returning our economy to health from a stock market collapse, the recession of 2001, the terrorist attacks of September of that year, the War on Terror, corporate scandals, surging energy prices, and most recently, Hurricanes Katrina and Rita. Chief among the Administration's pro-growth economic policies has been tax relief. In response to the major challenges of the Administration's first term, individual income tax rates were reduced, the child credit was doubled, the marriage penalty was reduced, the death tax was put on a path to full repeal, and tax rates on dividends and capital gains were cut. Everyone who pays income taxes received tax relief.

The tax relief has been instrumental in restoring economic growth, yet it will expire in coming years unless the Congress acts. The reductions in the dividend and capital gains tax rates are set to expire at the end of 2008, and the reductions in the income tax rates, the doubling of the child tax credit, the reduction in the marriage penalty, and the repeal of the death tax all expire at the end of 2010. Allowing the tax relief to expire would result in large tax increases for millions of American families and businesses. The President has called on the Congress to make the tax cuts permanent to help ensure a strong economy in the future.



The President has proposed many complementary policies to support the economy's continued growth in the years ahead. He has an aggressive agenda for opening foreign markets to U.S. goods and services, through bilateral and regional trade agreements and through the worldwide negotiations of the Doha Round. By opening markets at home and abroad, U.S. businesses have greater access to foreign markets to sell their products and services while American consumers and businesses have a wider selection of lower-priced goods and services from which to choose. This Administration has successfully pursued legislation approving and implementing free trade agreements with Jordan, Chile, Singapore, Australia, Morocco, Bahrain, and CAFTA-DR (Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua), and has recently completed agreements with Oman and Peru.

In addition, the President is addressing major impediments to job creation and economic growth. The Administration has cut the cost of new regulations by 70 percent and will continue to work to contain these costs. The President has proposed tort reform to reduce the costs of runaway lawsuits. He has highlighted the need to reform the Federal income tax system to make it simpler, fairer, and more pro-growth. The Administration has proposed reforms to our private pension system to ensure that workers will receive in retirement the pensions they were promised while working, and to protect taxpayers from being called on in the future to bail out the Federal pension insurance system.

The Administration has also taken steps to confront the challenge of rising health care costs. These costs are a threat to family budgets because they reduce the amount of income available for other purposes; they are a threat to the Federal budget because they drive up the cost of Medicare, Medicaid, and other health programs; and they are a threat to our economy's ability to create jobs in the future because they put upward pressure on labor costs. An important step in restraining health care inflation was the enactment of Health Savings Accounts (HSAs) as part of the Medicare Modernization Act. An HSA allows a worker to set aside on a tax-free basis funds to pay out-of-pocket expenses as long as the worker has purchased a high-deductible health insurance policy. The combination of HSAs and high-deductible health insurance policies gives workers greater control over how they spend their health care dollars. This combination will also instill a stronger element of cost consciousness among health care purchasers, thereby working to slow the rise in health care inflation for all Americans. One million Americans have already set up HSAs according to estimates, with an additional two million accounts projected to be set up in 2006.

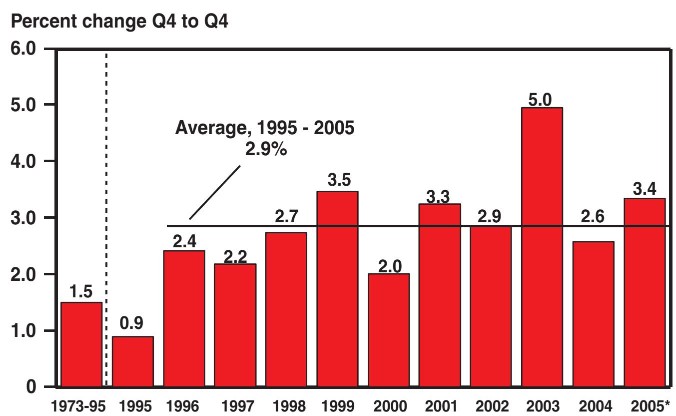
The Budget proposes to make HSAs even more attractive. Under the Administration's plan, workers who purchase health insurance on the individual market would be able to purchase a high-deductible health insurance policy and make qualified HSA contributions free of income tax and effectively free of payroll tax through an income tax credit. Under this policy, every worker in the country with an HSA would receive comparable tax treatment to those who today receive traditional employer-provided health insurance.

The President is putting forward a number of other proposals to help individuals and families obtain the health insurance coverage they need. One such proposal would make it easier for workers with an HSA and a high-deductible insurance policy to keep their policy if they move from job to job or State to State. The Administration is addressing the lack of transparency in price and quality information for health care consumers: Medicare will soon be posting its provider payment rates on the Internet, thereby facilitating market comparisons. The Administration will be working with business and insurance leaders to encourage them to improve price and quality transparency for more medical products and services. Combined with the Administration's proposal for Association Health Plans that will further expand the options available for purchasing health insurance, the Administration's policies will reduce the number of uninsured, make health care more affordable and more accessible, and help contain the health care price pressures that threaten future job creation.

PRODUCTIVITY: THE KEY TO FUTURE GROWTH

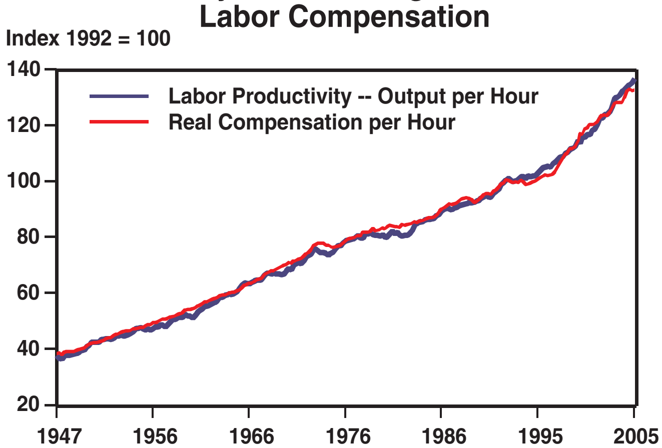
Each of the policies mentioned above is aimed at promoting long-term economic growth through both job growth and by raising worker productivity. Labor productivity growth rates have varied over long periods. From the mid-1970s to the mid-1990s, worker productivity rose at only 1.5 percent a year on average. In the mid-1990s, average productivity growth accelerated to around 2.5 percent per year. Since 2001 the rate of productivity growth has accelerated again to 3.4 percent per year. The Administration is seeking through its many economic policy initiatives to build on this productivity growth and ensure its continuation.

Productivity Growth has Continued at a Strong Pace Since the Mid-1990s



*Q4 to Q3

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.

Strong productivity growth is important to the country's future economic strength for two reasons. First, productivity growth reflects the net efficiency gains of all the developments underway in the private economy. Productivity growth, along with job growth, over time also reflects the net effects of government policies on the economy. In short, productivity growth measures how well our Nation allocates its resources—people, capital, and natural resources—to their best possible uses.

Second, productivity growth ultimately determines the rate of growth in labor compensation—wages and benefits—in America. Strong job growth is important to the economic well-being of individuals and families, as are rising wages and benefits. Setting aside the transitory effects from business cycles, in free and flexible labor markets workers' total compensation tends to rise with increases in output attributable to the more efficient use of their labor.

Federal policies should help businesses to create jobs, and they should promote growth in labor compensation over time by supporting each of the four basic sources of labor productivity growth—capital investment, technological innovation, education and training, and enhancing basic efficiency.

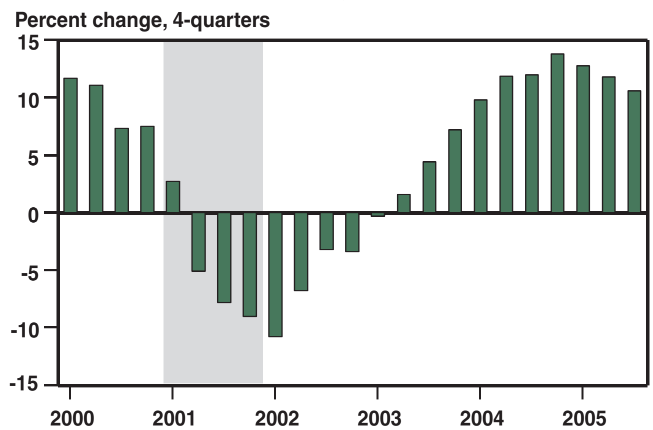
Capital Investment

First, the most basic source of increased productivity growth is increased capital available per worker. A crew raking leaves will tend to be more efficient using two rakes rather than one. A busy retailer will move more customers through its checkout line if it has three registers rather than just two. Making more equipment available to workers allows them to be more productive. As workers become more productive, business profits and labor compensation rates increase. More business investment today means faster growth in labor productivity and labor compensation tomorrow.

Government policies have a pronounced effect on the willingness of businesses to invest in productive capital. One sure way to discourage such investment is by adding to the uncertainties businesses face. While uncertainty is inherent in business decisions, government policies can add to the uncertainty with inconsistent or unwise laws and regulatory policies, poor spending discipline, or anti-business rhetoric and legislation. By raising the uncertainty about making an investment, government actions make the investment less likely.

In contrast, Government policies can encourage business investment by reducing the taxes levied on the return to that investment. The 2001 tax bill did just that by reducing individual income tax rates significantly. Small business owners are generally subject to individual income tax rates, and so the lower tax rates immediately reduced the tax disincentive facing small businesses considering hiring new workers or making new investments. The President and the Congress have enacted numerous additional tax cut provisions specifically aimed at raising business investment and boosting worker productivity at America's small businesses.

Business Equipment and Software Spending Has Rebounded

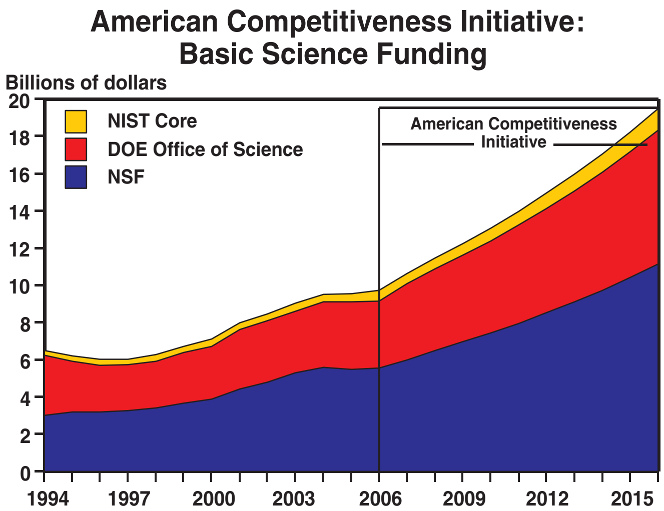


Shaded area is recession period.

Lower individual income tax rates and lower dividend and capital gains tax rates have significantly improved the investment incentives of America's businesses. Businesses have responded, and business investment in new equipment has been especially robust over the past two and a half years, indicating strong confidence in the future of our economy and also signaling future labor productivity growth and therefore future growth in labor compensation. Making these tax cuts permanent as the President has proposed would preserve the incentives for investment and would eliminate a source of uncertainty about the future.

Technological Innovation

A second source of productivity growth is the development and application of new technologies. Just as a leaf blower substituting for a rake can generate a significant increase in the productivity of a lawn crew, raising the quality of capital investment also contributes to worker productivity gains. While major technological achievements are well-recognized, the incentives and extensive infrastructure leavening this process are less well-known.



Private industry is responsible for much of the innovation that occurs in the United States, yet the Federal Government also plays an important role. To strengthen this role, the President has proposed an American Competitiveness Initiative (ACI) that includes making the Research and Experimentation (R&E) tax credit permanent, increasing Federal research and development spending, and increased funding for math and science education.

The R&E tax credit encourages businesses to increase their level of spending on new technology. Unfortunately, the credit has never been made a permanent feature of our tax code, and has been extended periodically on a temporary basis. In addition, certain features of the credit itself may limit its effectiveness. The President has called on the Congress to make the R&E tax credit permanent, and the Administration intends to work with the Congress to modernize the credit to make it more effective in raising the level of private research and development.

The Federal Government also makes significant investments in science and technology. The President's 2007 Budget requests $137 billion for Federal research and development. This level of spending would represent an increase of 50 percent since 2001. In addition, the ACI increases funding over the long term for strategic investments in research and development in the physical sciences that are likely to have broad effects on innovation and science and will further promote economic growth and competitiveness. Specifically, the ACI calls for a doubling over 10 years of funding on basic research conducted through the National Science Foundation, the Department of Energy's Office of Science, and the Department of Commerce's National Institute of Standards and Technology.

Education and Training

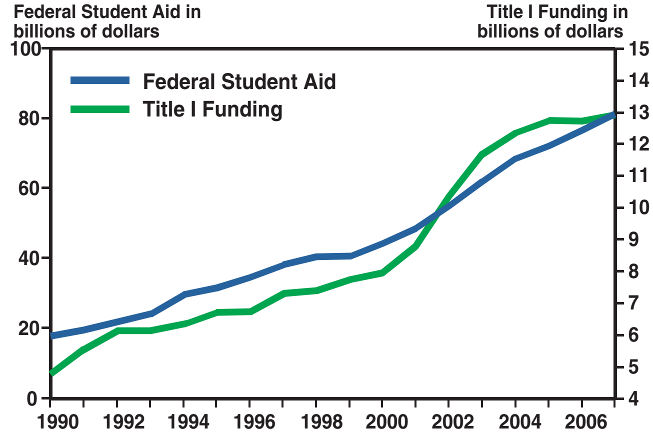
Labor productivity growth also results from investments in human capital that improve the quality of the labor force. Many factors influence the quality of the American labor force, but over the long run education is crucial. A recent study found that about one third of the productivity growth in America from 1950 to 1993 was due to increased education levels.

The tools necessary to compete in the global marketplace are sure to become more technically sophisticated. As Americans find themselves increasingly competing with workers around the globe, the competitiveness of U.S. workers and businesses will depend in large part on the ability of the workers themselves to innovate, recognize and recommend improvements, and seek new efficiencies. Only a well-educated workforce will be able to participate in this competitive process in a meaningful way.

President Bush has made improving results in our education system a centerpiece of his Administration. While Federal funding for education has increased significantly, the real measure of success is the educational achievement of America's children. The President's signature No Child Left Behind Act of 2001 launched a historic commitment to hold schools accountable for improving educational outcomes for all children—regardless of race, income, or special needs. This commitment is starting to pay off: test scores for minority students especially are on the rise, in particular in the early grades.

The 2007 Budget seeks to extend the gains in achievement in the early grades to the high school level through a secondary school reform agenda of implementing proven interventions and supporting more rigorous courses. As part of the American Competitiveness Initiative, the Administration proposes $380 million in new funding for math and science education programs at the Department of Education. This funding will enhance our understanding of how students learn, applying that knowledge to train highly qualified teachers, promote new math and science opportunities in schools, develop effective curricular materials, and improve student learning.

Federal Education Investments: Title I and Student Aid



Source: Department of Education.

To make a college degree more affordable, the President has provided the largest increase in Pell grant funding in the history of the program and has increased by one million the number of students receiving this assistance. The 2007 Budget continues to ensure that all students have an opportunity to pursue higher education by making more than $80 billion in student aid available to approximately 10 million post-secondary students. This includes the new Academic Competitiveness Program included in the legislation adopted by both houses of the Congress that will help target $3.7 billion over the next five years to low-income students who excel in math and science.

To help Americans continue to receive the job training they need for high-growth industries, the Administration created Community-Based Job Training Grants. Under this program, in 2005 the Federal Government awarded $125 million in grants to local technical and community colleges that work with employers to train workers for jobs in growing industries. The Administration is proposing additional reforms to Federal job training programs to make them more effective in preparing workers for the high-tech economy of the 21st Century.

Enhancing Efficiency

The fourth source of productivity growth results from actions that ensure the most efficient allocation of resources across the economy. In a microeconomic sense, such productivity gains can be achieved, for example, by reordering steps in the production process to maximize product quality, use of time, or work effort. A series of small improvements, or a small improvement spread widely, will often yield large results. Government's direct role in producing these kinds of improvements is limited. Yet Government policies can have an important impact on how individuals and businesses make decisions about the use of their resources—both time and money.

For example, monetary policies can contribute to low and stable inflation so that businesses and individuals can accurately interpret and react to the price signals they receive. Better decisions based on more accurate information lead to higher productivity.

Conversely, Government can impede the pursuit of efficiency through its regulation of commerce. Excessive regulations and intrusive legislation may restrict the ability of workers and businesses to adapt to changing circumstances. In other developed countries, rigid labor laws have greatly weakened the incentives for workers to find new jobs and for businesses to hire workers. By contrast, labor markets in the United States are relatively flexible, and employers can alter their labor plans as conditions dictate. This flexibility also means workers can adapt to changing circumstances for their own benefit whether by changing jobs, entering new industries, acquiring new skills, or simply moving to where demand for their labor is stronger. A recent report found that the United States had by far the highest rate of internal mobility of any of the 17 advanced countries studied. Such internal mobility has helped the U.S. workforce become more productive and more competitive, and has helped increase Americans' standard of living.

Many of the Administration's economic policies contribute to growing worker productivity rates. Low tax rates on both income and investment returns have helped drive a recovery in the environment for business investment, from which so much future productivity growth is derived. A policy of free and fair trade and opening up foreign markets gives U.S. businesses an incentive to shift resources to the production of their most exportable products. In general, any policy that allows workers, families, and businesses to keep more of what they earn and to make decisions about the best possible use of their resources will result in higher levels of productivity.

CONCLUSION

The President's policies are delivering a strong, sustained economic expansion, increasing employment, raising productivity, and increasing Americans' standard of living. Building a strong economy is one half of the formula for a sound fiscal policy of steady deficit reduction; as we have seen, a strong economy will generate robust growth in revenues to the Treasury. The second half of the formula is a commitment to effective spending restraint as advanced again in this Budget. When the Federal Government carefully focuses on its priorities, and limits the resources it takes from the private sector, the result is both deficit reduction and a strong, more productive economy.