

**TESTIMONY OF
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“THE 2006 ECONOMIC REPORT OF THE PRESIDENT”

**AT THE JOINT ECONOMIC COMMITTEE
FEBRUARY 16, 2006**

Chairman Saxton, Vice-Chairman Bennett, Ranking Member Reed, and other members of the Joint Economic Committee, we are pleased to testify today about the 2006 *Economic Report of the President*. The *Report* reviews the state of the economy and the economic outlook, and discusses a number of economic policy issues of continuing importance. Across its 11 chapters, the *Report* highlights how economics can inform the design of better public policy and reviews Administration initiatives.

The performance of the U.S. economy continues to be strong. In 2005, the Nation’s real GDP grew 3.5 percent for the year, above the historical average. Key components of demand that accounted for growth in 2004—consumer spending, business investment in equipment and software, and exports—continued to do so in 2005. Employment increased by almost 2 million payroll jobs over the year, and the unemployment rate dropped to 4.7 percent last month, well below the averages of recent decades. Real disposable personal income increased, and real household net worth reached an all-time high. This growth comes on top of an already strong expansion, the foundation of which has been exceptionally rapid productivity growth. The Administration’s forecast, consistent with consensus private forecasts, shows the economic expansion continuing for the foreseeable future.

Increases in investment spurred by the dividends and capital gains tax relief enacted in 2003 have played an important role in the strengthening of our economy. Since the Jobs and Growth bill became law, capital investment has increased by 25 percent, contributing to sustained job growth and directly benefiting workers. It is essential that this tax relief be extended.

American productivity growth and thus competitiveness in the 21st century will rely upon American ingenuity, entrepreneurship, and labor-force talent. The President’s American Competitiveness Initiative aims to support these forces. Promoting a flexible and skilled workforce—through improved access to high-quality primary, secondary, and post-secondary education, through policies that attract the world’s best and brightest to our shores, and through investment in R&D and the continuing education and re-training of our mobile workforce—will help ensure that the United States remains a leader in this rapidly changing world economy.

But maintaining this leadership will also require a continued commitment to competition in and flexibility of U.S. product, capital, and labor markets that help transform innovations into the new products and processes in the marketplace that ultimately support rising incomes for

workers and their families. Innovation alone is not sufficient to guarantee rising prosperity. It also requires the dynamism of the marketplace for which America is uniquely positioned.

This continuing strength and competitiveness of the American economy in the global marketplace depends upon policies that open international markets to U.S. goods, and that promote growth and investment at home. The performance of the U.S. economy depends on an effective financial-services sector and on a tax system that promotes domestic growth and international competitiveness. Further opening foreign markets to U.S. goods would yield great rewards for Americans. Over the past 70 years, policymakers across political parties have consistently recognized the importance of international commerce, and have achieved major trade liberalization both here and abroad. The net payoff to America from these achievements has been substantial.

The Administration's policies will make even greater gains possible. Support of the agricultural sector can be provided in ways that are less distortionary. We must work to eliminate further barriers to trade, especially in services, and to further open markets in global, regional, and bilateral negotiations. Americans will reap the greatest benefits from this trade when intellectual property rights are well-defined and well-enforced. The Administration continues to enforce vigorously the laws that protect the rights of American intellectual-property owners.

The continued expansion of energy markets and diversification of energy sources can further increase our resilience to energy-supply disruptions. Hurricanes Katrina and Rita demonstrated that competitive markets play a central role in allocating scarce energy resources, especially during times of natural disaster or national emergency. Policies that build on economic incentives and that spur our development of alternate fuel sources can reduce U.S. vulnerability to energy disruptions and reliance on foreign oil, encourage energy efficiency, and protect the environment.

Even as living standards rise, Americans are increasingly concerned about their retirement security and health care costs. Most working-age Americans are in fact on track to have more retirement wealth than most current retirees. There are, however, a number of risks to the retirement preparations of Americans. People today are living longer and could face higher health-care costs in retirement than members of previous generations. In addition, both defined-benefit pensions and Social Security suffer from fundamental financial problems that expose not just retirees but all U.S. taxpayers to risk of substantial losses. The Administration is focused on addressing these problems and protecting the Nation's retirement security.

Rising health care costs are of concern to all Americans, young and old. All Americans deserve access to reliable, affordable, high-quality, high-value health care. Health care in the United States is second to none, but it can be better. Both public and private health care spending have grown much more rapidly than general inflation or wages, straining consumers, employers, and government budgets. The cost of finding new health insurance locks some workers into their current jobs if they or someone in their family is chronically ill. Frivolous lawsuits raise health care costs for everyone. Perverse tax and insurance incentives have led to inefficient use of health care resources.

Promoting a stronger role for consumers can help create a health care system that is more affordable, transparent, portable, and efficient. Health Savings Accounts should be strengthened by allowing people to contribute enough to them to pay for all of their out of pocket expenditures tax free. Individual purchasers should have the same tax advantages as those who get insurance from their employers. We need to ensure that patients and their doctors have the information that they need to use this control to get the health care that is best for them, and that electronic health records are widely used to reduce costs and improve the quality of medical treatment.

The *Report* provides an analytical backdrop for the President's agenda, which includes restraining government spending; making tax relief permanent; making health care more affordable and accessible; creating an economic environment that encourages innovation and entrepreneurship; continuing to open markets to American goods and services; and reducing America's dependence on foreign oil by diversifying our energy supply. These policies will help maintain the economy's momentum, foster job creation, and ensure that America remains a leader of the global economy.

We will briefly outline for you the highlights of the *Report*. Chapter 1, *The Year in Review and the Years Ahead*, reviews the economic developments of 2005 and discusses the Administration's forecast for the years ahead. The expansion of the U.S. economy continued for the fourth consecutive year in 2005, with strong growth in real GDP. Most components of demand that accounted for growth in 2004 – consumer spending, business investment in equipment and software, and exports – continued to do so in 2005. Labor markets continued to strengthen, with almost 2 million new jobs created in 2005 and a year-end unemployment rate of 4.9 percent. Productivity growth remained well above its historical average. Overall inflation rose substantially at mid-year, but came down by year-end as it reflected the movement of energy prices, while core inflation (which excludes food and energy prices) has remained in the moderate 2-percent range. The Administration's forecast, consistent with consensus private forecasts, shows the economic expansion continuing for the foreseeable future.

Chapter 2, *Skills for the U.S. Workforce*, discusses the economics of education, immigration, and job training. Promoting a flexible and skilled labor force – through improved access to high-quality primary, secondary, and post-secondary education, through policies that attract the world's best and brightest to our shores, and through investment in the continuing education and training of our mobile workforce – will ensure that the United States remains a competitive leader in this rapidly changing world economy.

Chapter 3, *Saving for Retirement*, addresses the concern that Americans have been preparing inadequately for retirement. Most working-age Americans are in fact on track to have more retirement wealth than most current retirees. There are, however, a number of risks to the retirement preparations of Americans. People today are living longer and could face higher health-care costs in retirement than members of previous generations. In addition, both defined-benefit pensions and Social Security suffer from fundamental financial problems that expose not just retirees but all U.S. taxpayers to risk of substantial losses. The Administration is focused on addressing these problems and protecting the Nation's retirement security.

Chapter 4, *Improving Incentives in Health Care Spending*, reviews the causes and consequences of health care spending growth and discusses how the President's consumer-driven proposals can improve the health care system. Growth in spending on health care has been much more rapid than general inflation, straining consumers, employers, and government budgets. Perverse tax and insurance incentives have led to inefficient levels and composition of spending on health care. Promoting a stronger role for consumers is a promising strategy for improving health care value and affordability.

Chapter 5, *The U.S. Tax System in International Perspective*, examines U.S. tax system choices in the context of other countries. These choices matter because they affect living standards and economic growth. The United States has a different tax structure from most other advanced economies, raising more of our revenue through a tax on personal income instead of consumption. While the U.S. system has been significantly improved in recent years, it could benefit greatly from additional reforms, particularly those focused on the taxation of capital income.

Chapter 6, *The U.S. Capital Account Surplus*, discusses the enormous number of trade and financial transactions the U.S. has with other countries. In 2004, the United States ran a current account deficit of \$668 billion – meaning that the United States imported more goods and services than it exported, and that foreign investors purchased more U.S. assets than U.S. investors purchased in foreign assets. The size and persistence of U.S. net capital inflows reflect a number of U.S. economic strengths, as well as some shortcomings. Greater global balance of capital flows can be promoted by higher domestic savings, better growth and investment opportunities in Europe and Japan, and greater exchange rate flexibility and financial sector reforms in Asia.

Chapter 7, *The History and Future of International Trade*, notes that while economic research and historical evidence show that the benefits of trade outweigh the costs, trade liberalization has always generated concerns in the United States and throughout the world. Over the past 70 years, policymakers across political parties have consistently recognized the importance of international commerce, and have achieved major trade liberalization both here and abroad. The net payoff to America from these achievements has been substantial. The Administration is working to eliminate further barriers to trade, especially in services, and to further open markets in global, regional, and bilateral negotiations.

Chapter 8, *The U.S. Agricultural Sector*, examines the effects of agricultural support payments and trade policy on domestic prices, the wellbeing of the agricultural sector, and of the economy overall. In 2005, the Federal government spent approximately \$20 billion on agricultural support payments, but most farmers do not benefit from these subsidies. In addition, the United States maintains barriers to the import of some commodities, and these barriers raise the domestic prices of these commodities relative to world prices. Support to agriculture can be provided in many forms that are potentially less market-distorting.

Chapter 9, *The U.S. Financial Services Sector*, explores what financial services do for an economy, how financial development relates to economic performance, and how financial services can be effectively regulated. The U.S. financial services sector improves economic

performance by addressing informational problems and facilitating innovation. An effective financial regulatory system appropriately balances the costs and benefits of public regulation.

Chapter 10, *The Role of Intellectual Property in the Economy*, notes that intellectual property rights create incentives for investment in research, development, and innovation. Well-defined and enforced intellectual property rights are an important element of the American economy and can contribute to the economic growth of all countries. The Administration continues to enforce vigorously the laws that protect the rights of American intellectual property owners.

Chapter 11, *Recent Developments in Energy*, discusses crude oil, refined petroleum products, natural gas, and electricity markets. Increased scarcity and rising prices over time will encourage conservation, increase incentives for exploration, and stimulate the development of new, energy-efficient technologies and alternative energy sources. In the near term, unexpected disruptions to energy supply and distribution networks may continue to affect consumers and businesses. Hurricanes Katrina and Rita demonstrated that competitive markets play a central role in allocating scarce energy resources, especially during times of natural disaster or national emergency. The continued expansion of energy markets through regional and global trade can further increase our resilience to energy supply disruptions. Policies that build on economic incentives can reduce U.S. vulnerability to energy disruptions, encourage energy efficiency, and protect the environment.

Thank you for this opportunity to discuss the 2006 *Economic Report of the President*. We would be happy to answer any questions you might have.