Overview

The U.S. economy retains a solid foundation, even as it faces challenges ahead. Toward the end of 2007, there were increasingly mixed economic indicators (see Chapters 1 and 2). Economic growth is expected to continue in 2008. Most market forecasts suggest a slower pace in the first half of 2008, followed by strengthened growth in the second half of the year. The inherent resilience of our economy has enabled it to absorb multiple shocks in recent years, but the President does not take this growth for granted. Recognizing the near-term risks of a broader economic slowdown, the President called on the Congress to enact an economic growth package to protect the health of our economy and encourage job creation. Much of this *Report* examines contributions of pro-growth economic policies and market-based reforms that can further strengthen our economy and allow more Americans to benefit from continued economic expansion.

The United States' commitment to fair and open trade and investment policies is an important factor in our international competitiveness and in the dynamic nature of our economy; export performance has played a notable and growing role in economic growth in recent years (see Chapter 3). Lower tax rates have also contributed to economic performance by easing the burden on labor and capital and enabling consumers to allocate resources more efficiently (see Chapter 5). There remains considerable opportunity to strengthen our economic position by enacting a short-term economic growth package, and by addressing key challenges in the housing and credit markets, rising health care costs, infrastructure financing and the need to diversify our energy portfolios (see Chapters 2, 4, 6, and 7). A mixed economic picture also underscores the need for accurate measures of economic performance. Improvements to economic statistics programs could contribute to a greater understanding of the economy for public policymakers and private decision makers (see Chapter 8).

Chapter 1: The Year in Review and the Years Ahead

Economic expansion continued for the sixth consecutive year in 2007. This economic growth came despite a weak housing sector, credit tightening, and high energy prices. Sustained growth has resulted from U.S. economic flexibility, openness and other pro-growth policies. Projections of weaker growth in the first half of 2008 and near-term risks of a broader economic slowdown, however, led the President to call on the Congress to enact a short-term economic growth package. Chapter 1 reviews the past year and discusses the Administration's forecast for the years ahead. The key points are:

- Real GDP posted solid 2.5 percent growth during the four quarters of 2007, similar to the pace of a year earlier. Compared with the preceding years of the expansion, the continued reorientation of aggregate demand resulted in more growth from exports and business fixed investment, while residential investment flipped from contributing positively to GDP growth from 2003 to 2005 to subtracting from it in 2006 and 2007.
- Labor markets were tight in the first half of 2007, but conditions slackened somewhat in the second half, with job growth slowing and the unemployment rate edging up to 4.7 percent in the third quarter and to 5.0 percent by December.
- Energy prices dominated the movement of overall inflation in the consumer price index (CPI), with large increases toward the end of the year. Core consumer inflation (which excludes food and energy inflation) moved down from 2.6 percent during the 12 months of 2006 to 2.4 percent in 2007. Food prices rose appreciably faster than core prices.
- Nominal wage gains of 3.7 percent for production workers were offset by the unexpected rise in energy prices. These nominal gains, however, exceeded measures of expected price inflation implying an expectation of real wage gains during the next several years.
- The Administration's forecast calls for the economic expansion to continue in 2008, but at a slower pace. Slower growth is anticipated for the first half of the year, and the average unemployment rate for 2008 is projected to move up from the 2007 level. In 2009 and 2010, real GDP growth is projected to grow at 3 percent, while the unemployment rate is projected to remain stable and below 5 percent.
- The contraction of the secondary market for some mortgage securities and the ensuing write-downs at major financial intermediaries are a new downside risk to this expansion. As of the end of 2007, however, these developments had not greatly affected the nonfinancial economy outside of the housing sector.

Chapter 2: Credit and Housing Markets

In the summer of 2007, the ongoing contraction in the U.S. housing market worsened and credit markets experienced a substantial disruption. Chapter 2 reviews the developments in the housing and credit markets, and describes public and private responses. The key points are:

- Rising delinquencies in subprime mortgages revealed an apparent underpricing of risk and raised concerns about which market participants were exposed to that risk, but the subprime market was not the only cause for the contraction in credit markets.
- The Federal Reserve provided liquidity and took measures to support financial stability in the financial markets in the wake of the disruptions in the credit markets.
- The Administration focused its response on housing markets and helping homeowners avoid foreclosure—in particular, subprime borrowers facing increases in the interest rate on their adjustable-rate mortgages.
- Participants in the credit and housing markets are actively addressing challenges that were revealed during the summer of 2007. Markets are generally better suited than government to adapting to changes in the economic environment; markets can respond quickly to new information, while government policy often reacts with a lag or has a delayed impact.
- Financial innovations in the mortgage and credit markets have provided a range of economic benefits, but not without some costs. Over time, markets tend to retain valuable innovations and repair or eliminate flawed innovations.
- The macroeconomic effects of the downturn in housing and the credit market disruptions may occur through several channels, including the direct effect on residential investment, the reduction of wealth on personal consumption, and tighter lending standards on business investment.

Chapter 3: The Causes and Consequences of Export Growth

One noteworthy development in recent years has been the rapid growth of U.S. exports. This growth has provided clear benefits to entrepreneurs and workers in export-oriented industries, and to the economy as a whole. Chapter 3 identifies the primary factors that have driven recent export growth and discusses several longer-term trends that have lifted exports over time. More broadly, the chapter addresses the benefits that flow from open trade and investment policies as well as some related challenges. The key points of this chapter are:

- The United States is the world's largest exporter, with $1.5 trillion in goods and services exports in 2006. The United States was the top exporter of services and the second largest exporter of goods, behind only Germany.
- In recent years, factors that have likely contributed to the growth in exports include rising foreign income, the expansion of production in the United States, and changes in exchange rates. One reflection of that growth is that exports accounted for more than a third of U.S. economic growth during 2006 and 2007.
- Over time, falling tariffs and transport and communication costs have likely lowered the cost of many U.S. goods in foreign markets, boosting demand for U.S. exports.
- Open trade and investment policies have increased access to export markets for U.S. producers. Increased investment across borders by U.S. companies facilitates exports.
- Greater export opportunities give U.S. producers incentives to innovate for a worldwide market. Increased innovation and the competition that comes from trade liberalization help raise the living standard of the average U.S. citizen.
- Nearly all economists agree that growth in the volume and value of exports and imports increases the standard of living for the average individual, but they also agree that the gains from trade are not equally distributed and that some individuals bear costs. The Administration has proposed policies to improve training and support to individuals affected by trade disruption.

Chapter 4: The Importance of Health and Health Care

The American health care system is an engine for innovation that develops and broadly disseminates advanced, life-enhancing treatments and offers a wide set of choices for consumers of health care. The health care system provides enormous benefits, but there remain substantial opportunities for improvements that would reduce costs, increase access, and improve quality, thus providing even greater health for Americans. Chapter 4 examines the economics of health and health care. The key points in this chapter are:

- Health can be improved not only through the appropriate consumption of quality health care services, but also through individual behaviors and lifestyle choices such as quitting smoking, eating more nutritious foods, and getting more exercise.
- Health care has enhanced the health of our population; greater efficiency in the health care system, however, could yield even greater health for Americans without increasing health care spending.
- Rapid growth in health care costs and access to health insurance continue to present challenges to the health care system.
- Administration policies focus on reducing cost growth, improving quality, and expanding access to health insurance through an emphasis on private sector and market-based solutions.

Chapter 5: Tax Policy

Economists and policymakers have long debated the appropriate role of the government in a market economy. The government can provide public services and transfer payments to lower-income individuals, but these benefits often come at the cost of higher taxes and lower economic output. The key points in this chapter are:

- The ratio of federal taxation in the United States to gross domestic product (GDP) has fluctuated around an average value of 18.3 percent over the past 40 years; despite the President's 2001 and 2003 tax relief, this ratio was 18.8 percent in 2007, above the 40-year average. Under current law revenues are predicted to grow faster than the economy in coming years, raising the level of taxation well above its historical average.

- Tax reductions in 2001 and 2003 have considerably lowered the tax burden on labor and capital income and reduced distortions to economic decisions. Making these tax cuts permanent can greatly improve long-term economic outcomes.
- In addition to contributing to growth, the tax cuts of 2003 also improved the efficiency of the tax structure primarily by reducing the double taxation of corporate income.
- The business tax structure in the United States still creates substantial distortions. To attract investment from abroad and compete more effectively in foreign markets, the United States must consider how best to address distortions created by the structure of business taxes, as other countries have done.

Chapter 6: The Nation's Infrastructure

Our economy depends on infrastructure that allows goods, people, information, and energy to flow throughout the nation. As our economy grows and our infrastructure faces growing demand, policy should support investments that ensure that existing capacity is used as efficiently as possible. Chapter 6 discusses some of the economic issues associated with major transportation, communication, and power transmission systems. The key points in this chapter are:

- Infrastructure typically requires large capital investments to build and maintain capacity. Once built, however, the cost of allowing an extra person to use the capacity is typically low. This often means that infrastructure cannot be provided efficiently by a competitive market and many types of infrastructure are instead provided by Government-regulated companies or, in some cases, by the Government itself.
- Demands on the U.S. infrastructure grow as the economy expands, and Government policies often determine how effectively infrastructure can accommodate that growth. Properly designed user fees can help ensure efficiency by revealing information about what infrastructure consumers value most.
- The price people pay for using infrastructure should reflect the extra cost associated with its use. This includes the cost of maintaining the infrastructure itself, as well as delays caused by increased congestion.
- The private sector plays an important role in providing infrastructure. However, lack of competition in markets for infrastructure raises concerns about market power, so that Government oversight is sometimes necessary. The Government must continually reassess the need for oversight in the face of changing market conditions.

Chapter 7: Searching for Alternative Energy Solutions

Energy is used for many purposes in our economy: electricity generation, transportation, industrial production, and direct uses by homes and businesses. Energy security and environmental concerns motivate the consideration of policies that diversify our sources of energy. Chapter 7 outlines options for changing the way we produce and consume energy in two sectors of our economy: electricity generation and transportation. The key points in this chapter are:

- The current suite of available alternative energy sources is an important part of achieving our goal, but a number of technical, regulatory, and economic hurdles must be overcome to use them fully.
- There are several promising, but currently unproven, methods of producing and delivering energy that, if successfully developed and deployed, will greatly enhance our Nation's energy portfolio.
- Appropriate and limited government action can play a useful role in helping to realize our energy security goals.

Chapter 8: Improving Economic Statistics

Statistical systems have substantial value for both public policymakers and private decision makers. Chapter 8 examines several key issues in economic statistics, including the role of Federal statistical programs in a dynamic economy, the importance of continuity in statistical series, and ways to improve the value of existing statistical data.

The key points are:

- Robust statistical systems produce products that are important to understanding the changing state of the economy and to formulating sound policy. But statistical systems, like physical infrastructures, become obsolete or depreciate with time if they are not maintained.
- Statistical measures must keep up with the changing nature of the economy to be relevant and useful. For example, it is important that these measures reflect new and growing industries (such as high-technology industries or services) and intangible capital (such as research and development).
- Disruptions in a statistical series render it much less useful to policymakers and other data users. Thus, continuity in statistical series is an important goal.

- More effective statistical use can be made of existing data. In particular, amending relevant legislation to enable full implementation of the Confidential Information Protection and Statistical Efficiency Act (CIPSEA) could greatly improve the quality of Federal statistics.