Economic Update, Achievements, and Objectives for the Future

A White Paper by the Council of Economic Advisers
August 9, 2005

Executive Summary

The U.S. economy is in the midst of a strong and sustainable economic expansion. The labor market continues to improve, inflation is low, and rapid productivity growth supports future economic growth and improvements in living standards.

- Real GDP has grown at a 3.6 percent rate over the past four quarters, 4.1 percent at an annual rate during the past eight quarters.

- So far in 2005, the economy has added 1.3 million payroll jobs (an average of 191,000 per month), and the unemployment rate has fallen to 5.0 percent. Since May 2003 the economy has created nearly 4 million net new payroll jobs.

- Inflation is well-contained. Core inflation, which excludes volatile food and energy prices, was 2 percent over the past 12 months, according to the consumer price index.

The recent strong economic performance is remarkable, given the severe shocks that buffeted the economy between 2000 and 2003. Policy actions taken by President Bush and Congress, including multiple rounds of tax relief and other measures, helped to get the economy back on track (see Figure 1 and Appendix A).

With the economic recovery well under way, the Administration has increased its focus on long-term economic issues. Recent policy successes include the passage of a comprehensive energy bill to strengthen energy security; CAFTA-DR to open new markets and level the playing field for American workers; a new budget to limit spending; class-action lawsuit reforms; and updates to our bankruptcy laws.

Further policy priorities include making tax relief permanent and reforming the federal tax system to make it simpler, fairer, and more pro-growth; limiting government spending to reduce the budget deficit; increasing personal saving; strengthening Social Security; reduce the drag of junk lawsuits on our economy; and pursuing a more consumer-driven approach to health care that helps lower costs for all Americans.

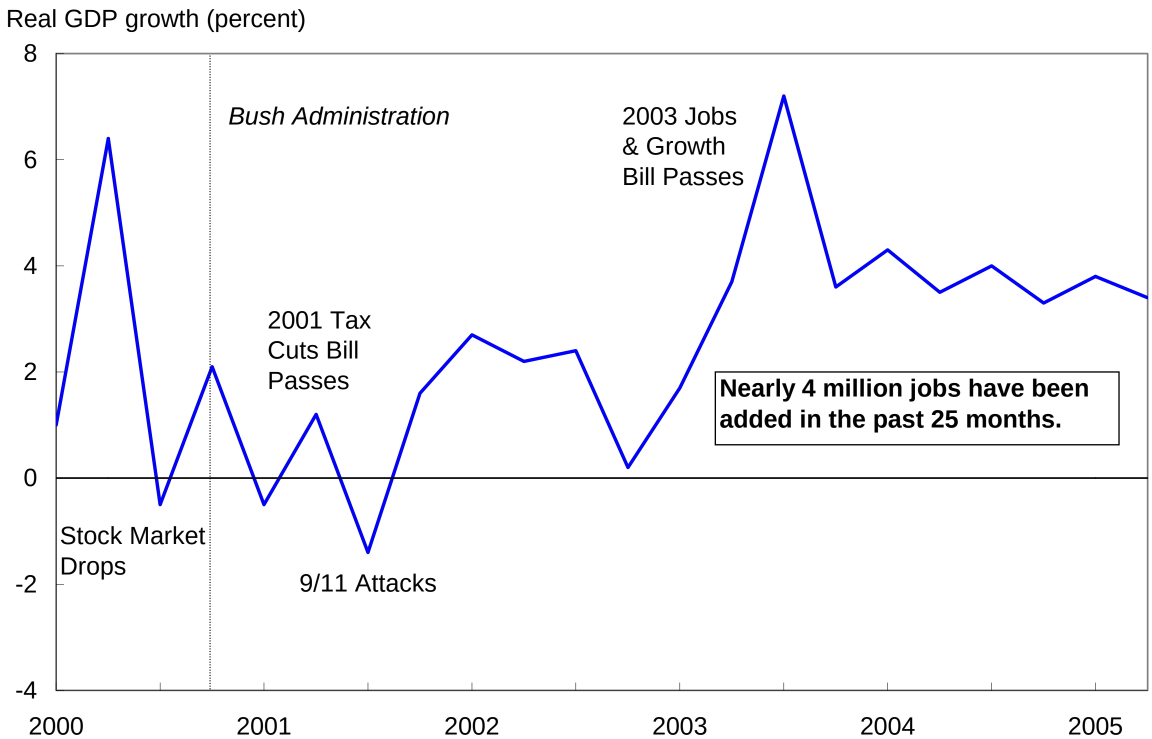
To help keep the U.S. internationally competitive, the President has proposed policies to develop a more productive labor force. These include his efforts to improve education and job training, and immigration reform to match willing workers with willing employers. Finally, the President will continue to open markets through bilateral and multi-lateral free-trade agreements that provide economic opportunities and benefits for American producers, investors, and consumers.

Taken together, the President's economic policies lay the foundation for long-term economic growth and increased economic security for American families.

Economic Policy: A Retrospective

Business confidence was hit hard by economic shocks during 2000-2003. In 2000 the stock market bubble burst; from its peak in early 2000 until 2002, the S&P 500 equity index dropped almost 50 percent. As stock prices declined and the economy weakened, businesses became exceptionally cautious about expanding their operations and hiring new workers. Economic growth turned negative in the third quarter of 2000, and by 2001 it became clear that the economy was in a recession. The terrorist attacks of September 11, 2001 and the consequent geopolitical uncertainty further eroded confidence. A series of corporate governance scandals in 2002 proved a further setback to the economy. In March 2003 the Federal Reserve, citing "unusually large uncertainties," declared itself unable even to assess the balance of risks between slower economic growth and higher inflation.

Figure 1: Recent Timeline of the U.S. Economy



Source: Bureau of Economic Analysis

The Bush Administration took action on many fronts (see Appendix A). In June 2001, President Bush signed the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), the Administration's first round of tax relief. The Act focused on reducing individual income tax rates for all taxpayers, adding to disposable income and improving incentives to work and save. It also helped families by reducing the marriage penalty on working couples, doubling the child tax credit to $1,000, and repealing the estate tax. In the wake of the terrorist attacks and continuing softness in the economy, the Congress passed the Job Creation and Worker Assistance Act (JCWAA), which the President signed into law in March 2002. This bill provided increased incentives for businesses to build plants and buy equipment, provided relief for struggling companies, and temporarily extended the period of unemployment benefits. Finally, in early 2003, with economic growth and job creation still lagging, the President proposed and Congress passed the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), which the President signed into law in May. JGTRRA further increased the tax incentives for business investment, targeted relief for small businesses, and reduced the cost of capital by lowering tax rates on dividends and capital gains. Altogether, the President's program of tax relief provided much-needed and remarkably well-timed stimulus to a struggling economy.

The Administration's response was not confined to tax policy. After 9/11, the Administration took steps to increase the nation's security and restore confidence, such as creating the Department of Homeland Security. Congress and the Administration provided reconstruction funds for cities hit by terrorism and temporary relief for certain industries, such as airlines. In November 2002 the President signed the Terrorism Risk Insurance Act to provide a temporary backstop for terrorism risk insurance and to allow the insurance industry time to develop the financial and analytic capacity needed to adapt to these new risks. Following the discovery of corporate scandals that began in the 1990s, the Administration worked with Congress to improve corporate governance and restore confidence by passing the Sarbanes Oxley Act of 2002.

Administration policies also looked to the future. The Administration recognizes the need to put the economy on a solid, long-term footing. Important legislative accomplishments included the No Child Left Behind Act of 2001, which will help to ensure that our workforce is better educated and able to meet the ever-changing demands of the global economy. The Medicare Modernization Act of 2003 created a prescription drug benefit for seniors and established Health Savings Accounts, which to put individuals in charge of their health care and make providing health insurance more affordable for small businesses and other companies. To stimulate international trade and to open new markets, the President obtained Trade Promotion Authority and completed trade agreements with 12 countries.

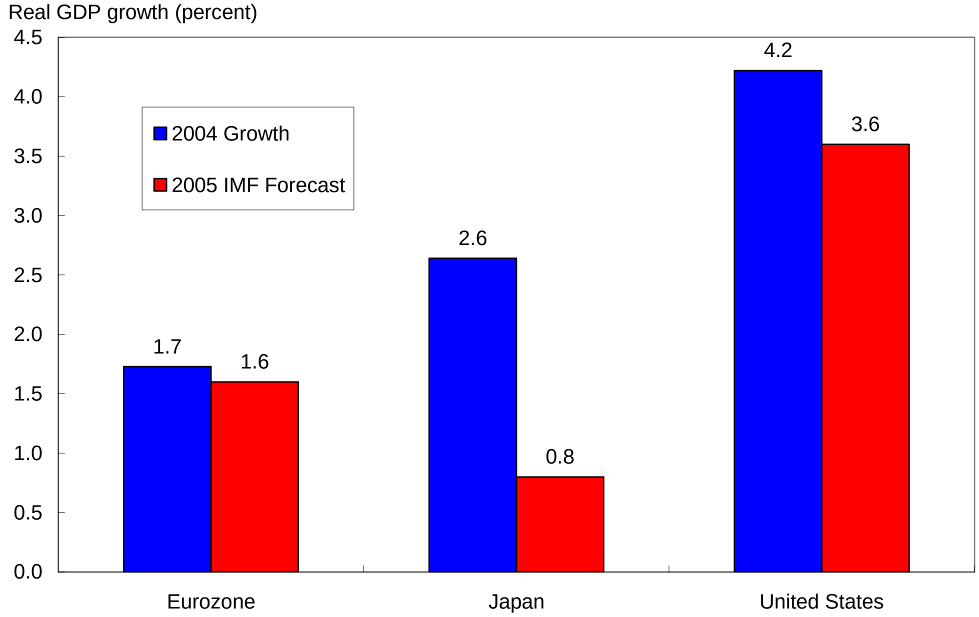
The Federal Reserve responded as well. The Federal Reserve's Open Market Committee lowered short-term interest rates 13 times during 2001-2003. Businesses took advantage of lower interest rates to increase investment and to restructure their balance sheets. Consumer spending was likewise supported by a low cost of borrowing and the opportunity to refinance mortgages or extract home equity.

Following these actions, renewed economic growth and job creation took hold. The economy accelerated in 2003, with real GDP growth topping 7.2 percent at an annual rate in the third quarter of 2003. The return of business confidence has been apparent both in terms of capital investment and hiring. Business fixed investment has rebounded over 21 percent since its trough in the first quarter of 2003, and the economy has added nearly 4 million net new payroll jobs since the labor market bottomed out in May 2003.

Current State of the Economy

The U.S. economy is now in the midst of a strong and sustainable economic expansion. Real GDP has grown at a 3.6 percent annual rate over the past four quarters, and a 4.1 percent annual rate during the past eight quarters. The Blue Chip consensus of forecasters expects solid growth in 2005 and 2006. The U.S. economy is growing faster and adding more jobs than any other major industrialized country (see Figure 2).

Figure 2: The U.S. is Growing Faster Than Other Major Industrialized Economies



Source: Bureau of Economic Analysis/Eurostat/Cabinet Office and IMF World Economic Outlook

The labor market and job creation have improved markedly. In 2004 the economy added almost 2.2 million net new payroll jobs, and new jobs have been created at the rate of 191,000 per month so far in 2005. The number of jobs is now at an all-time high. The unemployment rate has fallen to 5.0 percent, below the average of the 1970s, 1980s, and 1990s. Initial unemployment claims have fallen to low levels consistent with sustained job growth.

After-tax incomes and household wealth are on the rise. Real disposable income has risen by 2.9 percent in the past 12 months and 12.7 percent since December 2000. Tax relief is responsible for half of the increase in real per capita income since 2000. Real household wealth is currently $49 trillion, or 5.4 times disposable income, above the long-run average ratio of 4.8. Increased wealth reflects primarily gains in the values of homes and equities rather than personal saving, which remains low.

Consumer spending continues to grow. Real personal consumption is up 4.4 percent in the past 12 months. Sales of consumer durables are up 8.6 percent in the past 12 months.

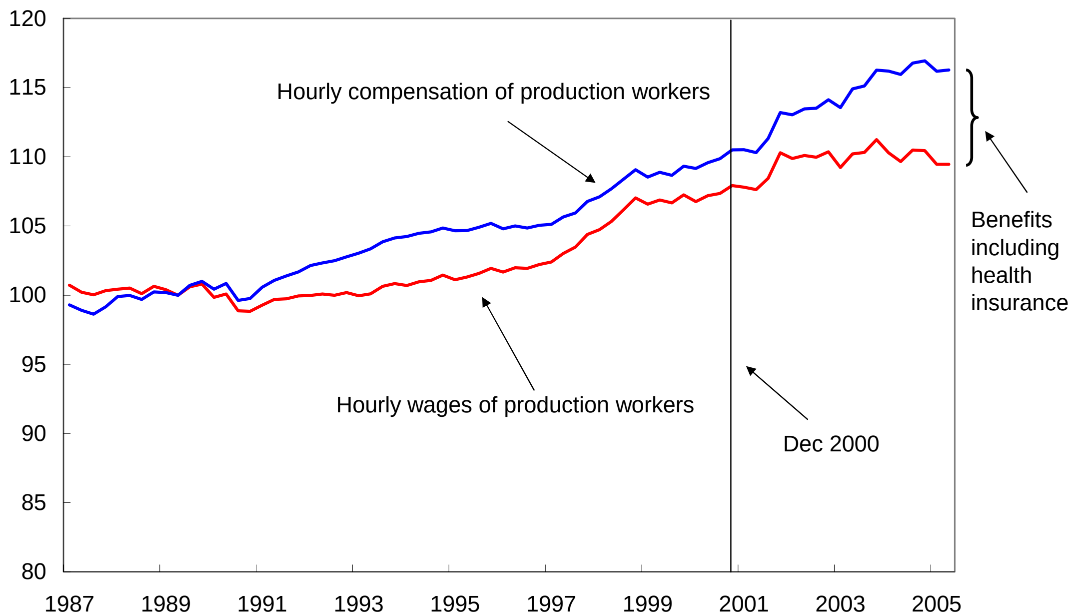
Overall inflation is tame. Core inflation, which excludes volatile food and energy prices, remains well-contained. As measured by the core consumer price index, inflation over the past 12 months was 2 percent. Expected inflation over the next ten years, as inferred from inflation-indexed Treasury bonds, is 2.3 percent per year.

Energy prices remain elevated, reflecting a tight balance between rapidly growing world demands for oil and other energy resources and limited supplies. Higher energy prices hurt family and small business budgets, raise production costs, and hamper economic growth.

Costs of medical care continue to rise more quickly than other prices. Higher costs of medical care and health insurance, though paid in part by employers, are in the longer term borne mostly by workers. For some workers, the increase in benefits has caused wage growth to lag total compensation, reducing gains in take-home pay (see Figure 3).

Figure 3: Because of Rising Benefits, Wages Lag Total Compensation

Real hourly wages and hourly compensation for production workers (Index 1989=100)



Source: Bureau of Labor Statistics, Employment Cost Index
Note: Benefit costs are the difference between compensation and wages.

Productivity growth remains remarkably high. Over the past four quarters (ending in 2005:Q2), productivity in the nonfarm business sector grew at a 2.3 percent annual rate. Over the past four years, productivity grew at a 3.6 percent annual rate. These rates are above historic norms. Productivity growth leads to increased wages, profits, and standards of living.

Investment in equipment and software is expanding rapidly. Real investment in equipment and software rose 11.8 percent in the past four quarters and 25.1 percent in the past eight quarters. Investment in nonresidential structures, which grew 1.8 percent in the past four quarters, has not fully recovered from the overbuilding of the late 1990s.

The housing sector is healthy. The national homeownership rate was at 68.6 percent in the second quarter of 2005, near the all-time high set last year. The minority homeownership rate set a new quarterly record in the first quarter of 2005, at 51.6 percent. Housing starts have recently set new records. Despite rising home prices, affordability of housing remains good, in large part because of low mortgage interest rates. While speculative behavior appears to be surfacing in some local markets, strong economic fundamentals are contributing importantly to the housing boom. These fundamentals include low mortgage rates, rising employment and incomes, a growing population, and limited supply of homes or land in some areas.

Strong economic growth and the resulting increase in tax revenues have significantly reduced estimates of the budget deficit for 2005 and subsequent years. The U.S. federal budget deficit for fiscal year 2005 was revised down in the mid-session review by $94 billion, to $333 billion, or 2.7 percent of GDP. This puts the federal government ahead of schedule to meet the President's target of cutting the deficit in half by 2009. State and local governments have also seen increased revenues this year.

The current account deficit remains large, reflecting both strengths and weaknesses of the economy. The U.S. current account deficit was about 5.7 percent of GDP in 2004, implying an imbalance of trade and the continuing accumulation of U.S. stocks and bonds by foreign investors. The causes of the current account deficit include strong U.S. economic growth (implying increased imports), the attractiveness of the U.S. as a destination for foreign capital flows, low U.S. national saving, and insufficient growth and spending abroad. In addition to increased saving in the United States and faster economic growth in our trading partners, smooth adjustment of these global imbalances will require flexible, market-based exchange rates. Although the current account deficit is expected to decline only slowly, real export growth of 12.6 percent in the second quarter is encouraging.

Recent Policy Achievements

Comprehensive energy legislation will enhance the long-run energy security of the United States. The bill includes measures to promote conservation and energy efficiency, to help develop new technologies for clean, safe, and efficient use of coal and nuclear power, to increase the domestic production of conventional fuels, to support the development of alternative and renewable energy resources, and to modernize the electricity grid. Over a period of time these measures will reduce U.S. dependence on imported energy, improve the environment, and provide the sources of energy needed to power a growing economy. The Administration has also announced an agreement with a number of countries, including China and India, to cooperate in developing energy technologies that will be efficient and good for the environment.

The Dominican Republic-Central America-U.S. Free Trade Agreement (CAFTA-DR) will help to create jobs and opportunities for Americans by further reducing trade barriers and leveling the playing field. CAFTA-DR immediately eliminates tariffs on nearly 80 percent of U.S. goods sold to Central America countries and the Dominican Republic. It also helps to strengthen fledgling democracies to our south and support economic prosperity and opportunity in our region.

The highway bill will help modernize our roads and bridges. After tough negotiations the Congress passed a bill that is fiscally responsible and does not raise gasoline taxes. Updating our infrastructure reduces transportation costs, improves safety, reduces congestion, increases productivity, and supports growth in output and employment.

New litigation reform will help to reduce costs and uncertainty. The President earlier this year signed into law class-action reform, which will make our legal system fairer, more effective, and less prone to abuse by eliminating "court-shopping" and ensuring that those who are injured receive appropriate compensation. The President also recently signed a bankruptcy reform measure will reduce abuse of the bankruptcy process and lower the cost of credit to consumers by ensuring that those who are able to pay some part of their debts do so, while protecting those who are unable to pay.

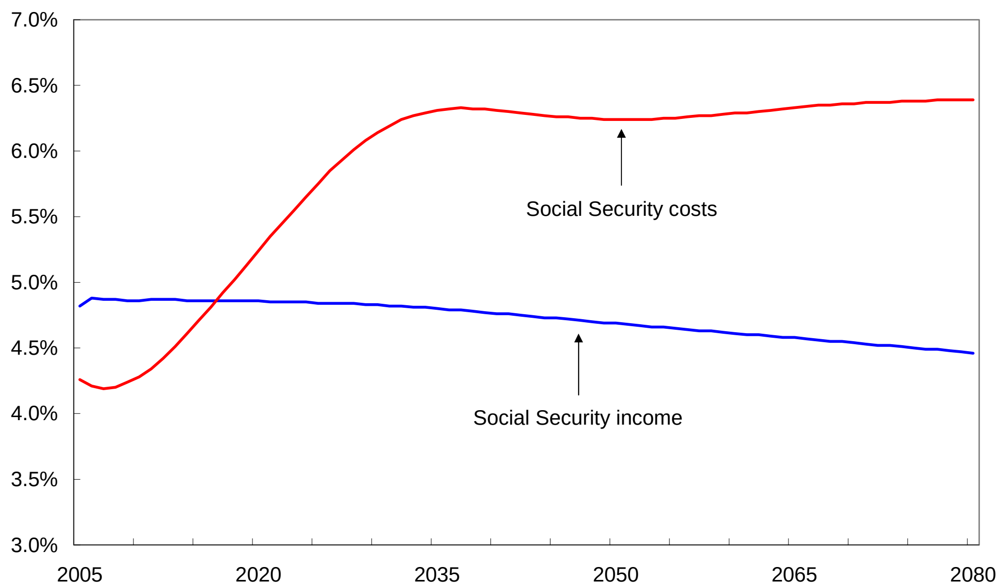
Policy Objectives for the Future

Keep taxes low, and reform the tax code so that it is simpler, fairer, and more pro-growth. President Bush continues to work with Congress to make his tax relief permanent. The President also recognizes the need for a federal tax code that is simpler, fairer, and more supportive of economic efficiency and growth than the current code. To meet this need, he appointed a bipartisan panel of experts that will present several alternative recommendations for tax reform on September 30 of this year.

Control spending and cut the budget deficit in half by 2009. This year the President's budget proposes to cut non-security discretionary spending by 1 percent from last year's level, the first budget to propose a cut in this category since the Reagan Administration. These savings are achieved by eliminating or substantially reducing scores of duplicative programs and providing only limited increases to others.

For the longer term, budget discipline will require bringing entitlement spending under control. President Bush proposed reforms to mandatory programs like Medicaid, and this year, for the first time since 1997, Congress plans to use its expedited procedures to reduce mandatory spending growth. To achieve fiscal balance in the longer run, the financial problems of major entitlement programs such as Social Security must be addressed (see Figure 4). The President has proposed reforms to Social Security to make the system sustainable, permanently solvent and fairer for younger workers.

Figure 4: Social Security's Annual Costs Will Exceed Its Income Starting in 2017
Annual Social Security income and outlays as a share of GDP (percent)



Source: Social Security Administration

Strengthen the three major components of retirement security: Social Security, pensions, and personal saving. As already noted, President Bush has made the reform of the Social Security system a priority. His approach combines progressive indexing with voluntary personal accounts to help make Social Security permanently solvent and give all workers, including low-income workers, the opportunity to build a nest egg for retirement.

The President has proposed a comprehensive reform of the rules governing defined benefit pension plans to make sure that companies will keep their promises to workers. Central to the proposed reform are improved funding rules which will ensure that corporations actually put aside the funds needed to make good on their pension promises. Other key elements of the proposal include an increase in the premiums employers pay to the Pension Benefit Guaranty Corporation (to reflect actual risks and costs), new disclosure requirements, and restrictions on the ability of firms with under-funded plans to make new promises to workers.

The President proposes to increase personal saving by creating tax-favored vehicles for saving, in some cases combining several existing types of accounts. A simple system might include one type of account for individual retirement saving, one for employer-sponsored retirement saving, and one for lifetime saving for future education costs, home purchase, or other expenses. The President's budgets have included proposals for Retirement Savings Accounts (RSAs), Employer Retirement Savings Accounts (ERSAs), and Lifetime Savings Accounts (LSAs).

Address rising health care costs and access to care. To promote health security, to increase ownership, and to strengthen family finances, the President has proposed a comprehensive, consumer-driven approach to health care. Rising costs of health care and health insurance are creating financial burdens for families and employers and increasing the number of uninsured, and the lack of health insurance portability raises the financial costs of job loss or job change.

An important step in that direction was taken with the creation of Health Saving Accounts (HSAs). HSAs allow individuals or families to pay for health care with before-tax funds, so long as their health insurance policy includes a sufficiently high deductible ($1000 for an individual, $2000 for a family) and catastrophic coverage (a limit on out-of-pocket expenditures). Insurance policies with these features give people the incentive to shop wisely for health care while at the same time protecting them against large financial losses. Moreover, these policies tend to be less costly than other types of plans. By empowering consumers to make their own health-care choices, HSAs together with high-deductible policies harness the power of market forces to reduce the prices and increase the quality of health care services. HSAs are also portable, which allows a worker who loses or changes his or her job to retain the funds in the account.

To increase the number of insured and to enhance insurance portability, the President has also proposed to provide financial assistance to individuals or families who purchase high-deductible health plans and hold HSAs. For low-income individuals and families, a health insurance tax credit includes an option that would allocate a portion of the credit to support the purchase of insurance, with any remaining funds deposited in an HSA for the payment of medical expenses. The President proposes to allow those who purchase a high-deductible health plan in conjunction with a HSA to deduct the premium from their taxable income, even if they do not itemize deductions. To provide further assistance to those seeking to obtain health insurance, the

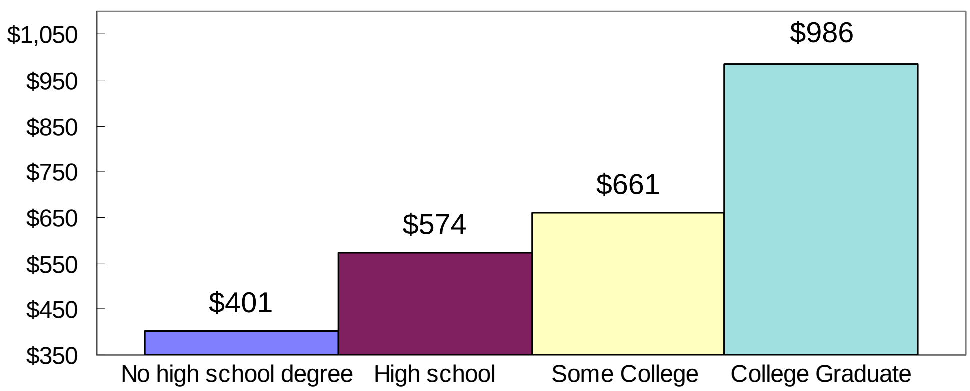
President has proposed the creation of state purchasing pools and Association Health Plans for workers in small businesses.

The President is also working to strengthen Medicare and Medicaid. The MMA created the Medicare Advantage program to offer more choices and better benefits to Medicare beneficiaries through competition among private health insurance plans. Beginning January 1, 2006, a subsidized Medicare drug benefit will be available for beneficiaries. Both programs are currently being implemented. With respect to Medicaid, which provides medical services to low-income Americans, the President's budget includes a proposal to increase the flexibility with which states administer the program. The 2006 budget also proposes Cover the Kids, a national outreach campaign to enroll as many Medicaid and State Children's Health Insurance Program-eligible children as possible.

Improve education and job training to increase competitiveness in the global economy. Because education and job training raise incomes and allow workers to adapt more effectively to a changing economic environment, the Administration will continue to work for improvements in education and training. Figure 5 shows the important effect of educational attainment on real weekly earnings.

Figure 5: Education is Key Factor for Worker Earnings

Real weekly earnings by education ($2004 per week)



Source: Current Population Survey (CPS), Bureau of Labor Statistics

Following up on the early success of the No Child Left Behind Act of 2001, the President has proposed to continue to challenge the public schools, including high schools, to demonstrate quantifiable progress in teaching both basic and more advanced skills. For example, the President has proposed a new High School Initiative to improve the quality of secondary school education and ensure that every student graduates from high school prepared to enter college or the workforce with the skills to succeed. All schools must also be held responsible for raising the achievement of often underserved groups, such as the poor and ethnic minorities. Supporting school choice programs, perhaps initially on a pilot or experimental basis, will give parents and students the option to leave failing schools while creating an incentive for those schools to improve.

Federal funds for job training, about $15 billion in 2005, are now disbursed through more than 40 federal programs, each with separate rules and reporting requirements. As described in the President's Job Training Reform Proposal, consolidation of these funds into a smaller number of streams, together with increased flexibility and greater accountability for governors to manage these funds, would lead to better outcomes. The important role that vocational schools, technical colleges, and community colleges can play in retraining workers should be recognized, as was done by the recent approval by Congress of $250 million in job training grants for community and technical colleges to train workers for high-growth industries. To make assistance to the unemployed more effective, the President has proposed the creation of Personal Reemployment Accounts, which would provide unemployed workers a fixed sum of money to use for retraining, job searches, child care, or other services that might help the worker find a new job. Personal Reemployment Accounts exemplify the idea that empowering individuals, rather than working through bureaucracies, can often be the most effective means for achieving public policy goals.

Reform our immigration laws. Workforce development should be combined with an economically beneficial immigration policy that admits both high and low skilled workers as needed to promote economic growth. The President has called for a comprehensive, integrated approach to reform our current immigration system. This would strengthen border security to ensure legal entry, build a robust interior enforcement program to ensure compliance with the law, and fill an economic need for willing workers through a temporary worker program.

Reduce trade barriers. Open and fair trade through free-trade agreements provides economic opportunities for American workers, producers, investors, and consumers. Open trade is also important for developing nations seeking economic growth and development. Following the successful passage of CAFTA-DR, the President plans to continue to seek the expansion of trade bilaterally, regionally and globally, especially through negotiations under the ongoing Doha Round.

Continue efforts to reduce costs of frivolous lawsuits. The Administration continues to pursue litigation reforms, among them plans to streamline the processing of asbestos claims and to limit medical liability, ensuring in each case that victims are appropriately compensated without incurring excessive administrative and legal costs that waste resources and hamper economic growth.

Provide for environmentally safe oil exploration. The Administration is working with Congress as part of its budget reconciliation process to allow for environmentally responsible energy exploration in a small part of the Arctic National Wildlife Refuge. Efforts to increase domestic energy production help to create jobs and reduce U.S. reliance on foreign sources of energy.

Conclusion

Taken together, the President's economic policies lay the foundation for long-term economic growth and increased economic security for American families.

Appendix A

Major Legislation Relevant to the Economy Signed by President Bush

Date Signed	Legislation
June 7, 2001	**Economic Growth and Tax Relief Reconciliation Act** reduced individual income taxes for all taxpayers.
Fall 2001	**Post-9/11 legislation** provided reconstruction funds and temporary relief for certain industries, such as airlines.
January 8, 2002	**No Child Left Behind Act** reformed federal K-12 education programs.
March 9, 2002	**Job Creation and Worker Assistance Act** included tax incentives to stimulate business investment and a temporary extension of unemployment benefits.
July 30, 2002	**The Sarbanes-Oxley Act** enhanced corporate accounting and reporting standards.
August 6, 2002	**Trade Promotion Authority** gave the President the necessary authority to negotiate agreements reducing barriers to trade.
November 26, 2002	**Terrorism Risk Insurance Act** put in place a temporary program of government-provided reinsurance for terrorism risk, to give the insurance industry time to develop the capacity to deal with these risks.
May 6, 2003	**US-Singapore Free Trade Agreement** reduced trade barriers between the US and Singapore. Additional free trade agreements include agreements with Chile (June 6, 2003), Australia (May 18, 2004), Morocco (June 15, 2004), Bahrain (September 14, 2004).
May 28, 2003	**Jobs and Growth Act** accelerated tax relief for individuals and reduced taxes on saving and investment.
December 8, 2003	**Medicare Modernization Act** created Health Savings Accounts, encouraged greater competition in Medicare, and established a prescription drug benefit for seniors.
October 4, 2004	**Working Families Tax Relief Act** extended expiring tax cuts.
October 22, 2004	**American Jobs Creation Act** took measures needed to end European tariffs on U.S. manufactured goods and established tax incentives to support U.S. manufacturing.
February 18, 2005	**Class-action reform bill** streamlined the process of class-action suits to combat abuses while ensuring that people who are harmed receive appropriate compensation.
April 20, 2005	**Bankruptcy reform bill** strengthened the system to reduce borrowing costs and improve access to credit.

August 2, 2005	**CAFTA-DR** cut trade barriers with Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic.
August 8, 2005	**Comprehensive energy bill** will promote energy security.
To be signed August 10, 2005	**Surface transportation bill** will fund construction of highways and other transportation projects.