"The Economic Outlook"

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Chairman Saxton, Vice-Chairman Bennett, Ranking Member Reed, and members of the Committee, thank you for the opportunity to testify at the Joint Economic Committee. We appreciate the long-standing relationship between the Committee and the Council of Economic Advisers.

The President's economic agenda is ambitious and addresses a number of issues that are important to maintain the strength and dynamism of the U.S. economy. Today we would first like to take a few moments to discuss the current state of the U.S. economy and the outlook moving forward. Then we will highlight two of the President's key agenda items – Social Security and tax reform. We will conclude with a summary of the 2005 *Economic Report of the President*.

The U.S. Economy

Economic growth in the United States is robust and is expected to remain strong for this year and next. Real GDP, the gross domestic product adjusted for inflation, grew 3.9 percent at an annual rate during the four quarters of 2004. Current data indicate this momentum carried into the first quarter of this year and will continue. Blue Chip consensus forecasts are currently predicting real GDP growth of 3.9 percent in the first quarter and 3.6 percent in the second quarter. Housing starts remain high. New orders for core capital goods suggest solid investment spending going forward.

The labor market continues to improve and more Americans are working than ever before. During the past 12 months, the economy has added 2.14 million jobs. The unemployment rate has dropped to 5.2 percent and remains well below the averages for the 1970s, 1980s and 1990s.

Core inflation, which excludes volatile food and energy prices, remains stable. As measured by the core consumer price index, inflation was 2.4 percent during the past 3 months and also the past 12 months—well below the 40-year average of 4.6 percent. Although the recent rise in crude oil prices is creating headwinds for the economy, we do not expect it to stand in the way of continued expansion.

The Administration forecast remains on track according to data received since the macroeconomic forecast was finalized in December of 2004. We predicted that real GDP would grow at a 3.5 percent annual rate during 2005. Now, four months later, the latest forecast from the Blue Chip consensus panel is 3.6 percent, in line with the earlier Administration projection. In December the Administration forecast that unemployment would fall to 5.2 percent by the end of 2005—a level reached in March.

This strong economic performance of the United States is particularly impressive when compared to the performance of other large, developed economies. The United States had the fastest annual rate of GDP growth of any member of the G-7 in both 2003 and 2004, and is expected to continue to have the strongest rate of economic growth in 2005. The United States is expected to grow over twice as fast as Germany, Italy, and Japan in 2005.

Strengthening Social Security

Last year's *Economic Report of the President* discussed the need to strengthen Social Security and approaches to reforming this vital program. In the intervening months a vigorous debate has begun. We welcome the debate.

By now the numbers are familiar. Population growth is declining but life expectancy continues to increase. In 1950 there were 16 workers for every one Social Security beneficiary. Today, there are just 3.3 workers for every beneficiary. When today's 20-year-olds retire, that number will have dropped to two.

Combined with Social Security's benefit structure, these demographic realities mean that in about year 2017 the program will begin paying out more in benefits than it receives in revenue. This means the Federal government will have to redeem the IOUs in the Social Security Trust Fund, forcing cuts in other programs, tax increases, or more borrowing.

These numbers have changed little in the past four years since President George W. Bush has been in office. For example, in the last Social Security Trustees Report under the Clinton Administration the program shortfall was projected to begin in 2016, compared to the current projection of 2017. In total, the program's unfunded liability is about $11 trillion in present value terms. Action is needed to deal with this problem.

To think about the problems with the Social Security system, it is useful to begin by noting that, contrary to what many workers believe, their contributions to the system in the form of taxes are not kept and used to fund their retirement. This would be known as a pre-funded system. Instead, their taxes are immediately used to pay the benefits of current retirees. The viability of this type of pay-as-you-go system is vulnerable to the changes in demographics that we are experiencing today.

Compounding this situation is a change made in 1977 where each generation of retirees receives higher real benefits than the generation before it. This stems from the indexation of the initial level of benefits to wages, which over time grow faster than prices. A person with average wages retiring at age 65 this year gets an annual benefit of about $14,000, but a similar person retiring in 2050 is scheduled to get over $20,000 in today's dollars. In other words, even after adjusting for inflation, today's 20-year old worker is promised benefits that are 40 percent higher than what his or her grandparent receives today.

The combination of large benefit increases and a growing elderly population puts the current Social Security system on an unsustainable path.

President Bush has outlined four key principles for strengthening Social Security. First, no changes should occur for current or near retirees. Social Security is secure today. It is for future generations that changes must be made. Second, there should be no increases in the payroll tax rate. The tax has already been increased 20 times since the program's creation. Third, the program must be permanently fixed. Short-term funding fixes are not acceptable. Finally, Social Security should include voluntary personal retirement accounts. The Nation's retirement system should ensure that all workers have the opportunity to build their own nest egg.

Roughly half of Americans are now investors. For example, millions of Americans have become accustomed to IRAs, 401(k)s and other defined contribution pensions. They don't have to rely on their employer to pay their pension when they retire, they can take their account from job to job, and they manage it, own it and can pass it own to their children. President Bush believes every worker – not just a middle or upper income worker – deserves the opportunity to have his or her own nest egg.

Under the President's proposal for personal retirement accounts, any worker born after 1950 would have the option of putting up to four percentage points of their 12.4 percent payroll tax into the accounts. The accounts would be phased-in over time. Contributions would be initially capped at $1,000 per year. The amount contributed to the accounts would be used to determine how much a worker's traditional Social Security benefit would be offset.

Investment options and management of the accounts would be similar to that of the Federal employee retirement program, known as the Thrift Savings Plan (TSP). Workers would be permitted to allocate their contributions among a small number of very broadly diversified index funds patterned after current TSP funds. A centralized administrative structure would be created to collect personal retirement account contributions, manage investments, maintain records, and facilitate withdrawals at retirement. The Social Security Administration's non-partisan actuaries estimate that the ongoing administrative costs for these TSP-styled accounts would be roughly 30 basis points. Private mutual funds cost roughly three times as much.

Personal retirement accounts in Social Security would not be accessible prior to retirement. Once retired, workers would not be allowed lump sum withdrawals that would result in their moving below the poverty line.

This proposal holds much promise. In addition to helping to pre-fund the system and allowing every worker the opportunity to own a nest egg, personal retirement accounts provide the possibility to earn a greater rate of return than what Social Security can actually fund for future retirees. The accounts can also help increase national savings as they reduce the likelihood that Social Security surpluses will be spent on other programs.

Other reforms to Social Security must take place in order to restore solvency to the Social Security system. In his State of the Union Address earlier this year, President Bush outlined a variety of options advocated by both Democrats and Republicans that would comply with his principles. The President is eager to work with Congress to arrive at a package of reforms that will permanently fix the system.

Taxes

This year's *Economic Report of the President* highlights the need and options for reforming our tax code. It outlines some pros and cons of various reform prototypes. The report does not make recommendations, which will be the responsibility of the tax reform advisory panel later this year.

The problems of our current tax system are well-known and well-documented. The current system is overly complex and distorts incentives for work, saving and investment. The complexity imposes high costs in terms of time and money for taxpayers to file returns and comply with all the rules.

The distortionary effects of high tax rates on work, saving and investment impose high costs of another kind: deadweight economic losses from distorted economic decisions and the resulting inefficient use of resources. These distortions cause reductions in economic welfare that exceed the amount of tax collected. These costs above and beyond the revenues collected are called the "excess burden" of the tax system.

One recent academic study estimated that for the tax system in effect before President Bush took office, the excess burden associated with increasing taxes by one dollar was about 27 cents. In other words, the total burden of collecting $1.00 in additional in taxes was $1.27, not counting compliance costs. How much better could we do if we reformed our tax system? The study estimated that adopting a reformed income tax system, or one of several alternative reforms that would eliminate the tax bias against saving and investment, could reduce this excess burden by 50 percent or more. Such reforms could also result in substantial simplification.

We should note, however, that significant progress has been made. In the last four years tax rates have been cut, the double tax on corporate income has been reduced, fairness has been improved for families, and this has been done while enhancing the overall progressivity of the tax system.

The 2001 and 2003 tax relief bills reduced marginal tax rates and created a low 10 percent rate. These lower rates improve economic incentives because taxpayers get to keep more of each additional dollar that they earn, save or invest.

The 2003 tax bill reduced the double tax on corporate income by reducing the individual income tax rates for both dividends and capital gains. Corporate income is taxed first under the corporate income tax and then a second time under the individual income tax as dividends or capital gains. Consequently, the total Federal tax rate on corporate income can be very high. For example, in 2000, the total Federal tax rate on a dollar of corporate income paid out as a dividend could be as high as 60.75 percent (calculated as the 35 percent corporate rate plus an individual tax rate of up to 39.6 percent on the 65 cents of after-tax corporate income available for dividends).

Economists are in broad agreement that this double taxation creates serious economic distortions. Indeed, historically the United States was almost alone among advanced countries in failing to provide some form of relief from double taxation of corporate income.

Proponents of the tax relief argued that it would lead to more dividends being paid by corporations. Was this prediction correct? One study found that the percentage of publicly traded firms paying dividends began to increase precisely when the new law became effective in 2003. This percentage had been declining for more than 20 years. The study found that nearly 150 firms started paying dividends after the tax cut, adding more than $1.5 billion to total quarterly dividends. Many firms already paying dividends raised their regular dividend payments, and others made special one-time dividend payments to shareholders. Overall, the response has been substantial. Another study estimated that over time, dividends will increase by 31 percent, about $111 billion in additional annual dividends at 2002 levels.

Looking more broadly, the U.S. Treasury Department has estimated that the tax relief passed in 2001 and 2003 increased real GDP by as much as 3 percent, and that without it, the unemployment rate would have been nearly one percentage point higher at the end of 2003. As many as 2 million fewer jobs would not have been available.

But there is more to be done in the tax area. As mentioned earlier, the President has appointed a bi-partisan blue ribbon panel to study tax reform and report back to the Secretary of the Treasury by July 31st of this year.

The 2005 *Economic Report of the President* discusses a number of other issues as part of the President's economic agenda. We will briefly summarize the issues below and encourage you to read the text for any issues that you find particularly interesting.

Expanding Individual Choice and Control

Property rights are the key ingredient to expanding individual choice and control. They provide the crucial link between people's effort and their reward. They are the instrument society uses to establish people's control over things. In practice, these go by many names, such as deeds, titles, permits, vouchers, allowances, or accounts. Patents and copyrights are also property rights, establishing control over inventions, books, songs, and other creative concepts. The essential idea is the same in each case: the owner of the property right controls how something valuable is used.

Using property rights to address policy problems is consistent with the principles of a free society because it assigns decision-making authority to individual decision-makers, rather than to central authorities. By giving firms, individuals, and families the authority to make decisions about the use of their own resources, property rights give control to those entities that have both the best information and the strongest incentives to use those resources efficiently.

Property rights solve the "tragedy of the commons" problem by encouraging owners to reduce the intensity of resource use. If an open access resource, such as fisheries or the air, is overused, assigning property rights to that resource will encourage its conservation. Ownership of a resource also encourages owners to invest in and improve the resource.

Property rights have important economic effects because they underpin market operation. Markets are socially beneficial because they allocate resources to their highest valued use and because they provide valuable price signals to both buyers and sellers. Without well-defined and enforced property rights, markets will work poorly or will not work at all.

Property rights analysis can illuminate similarities in policy solutions that may at first seem very different. There are numerous examples of the success of property rights in addressing policy problems, including air pollution, overfishing, and poorly performing public schools. Property rights have facilitated cleanup of the air at low cost, have allowed fish stocks to recover, and have improved the performance of schools in those areas where they have been used effectively. Property rights can be used to help address other policy issues.

The President's agenda already uses property rights to expand individual choice and control through a variety of proposals, including the recently passed Health Savings Accounts and Millennium Challenge Accounts, and his proposal for personal retirement accounts in Social Security.

Innovation and the Information Economy

The information technology sector has been a vibrant part of our economy and there is every indication that it will continue to be. The continued strength of this sector depends on fostering an environment in which innovation will flourish.

In a free market, innovators compete to lower the cost of goods, improve their quality and usefulness, and develop entirely new goods that promise quantum leaps in consumer welfare. People are motivated to invest in developing new ideas and the infrastructure to enter new markets by the prospect of earning returns on their investment. Government thus has an important role to play in defining property rights in intellectual and physical capital so that people will be spurred to invest and innovate, as well as ensuring the development of an environment in which public safety and national security are protected.

Government efforts to hasten the spread of innovative technologies should focus on lowering regulatory barriers that impede market provision. But government should avoid "picking winners" among emerging services. Doing so could entrench services that may become outdated as the marketplace evolves and hinder people from choosing the services they truly prefer. At this time, it is hard to predict the range of technologies that will emerge to deliver high-speed data services, or even what the scope of these services will be. As people vote with their dollars, the market winners that emerge will be those technologies and services that deliver customers the greatest value.

Modern International Trade

Open markets and free trade raise living standards both at home and abroad. The President's policy of opening markets around the world is based on this solid foundation. As international trade has grown in both volume and scope, however, so too have concerns that traditional ideas about trade policies no longer apply to today's trade environment.

Free trade allows countries to mutually benefit from specializing in producing goods at which they are adept and then exchanging those goods. This rationale remains the same, even with advances in technology and new types of trade.

The Administration's pursuit of trade liberalization is based upon a long history of intellectual support for free trade. Modern trade theory begins with the nineteenth century's David Ricardo. Ricardo's central insight—his elegant model of comparative advantage—is the starting point from which to explain the gains from trade. Ricardo's model of comparative advantage addressed the question of how a home country could compete with a foreign trading partner that is better at producing everything. Ricardo showed that even if a foreign country could produce each of two goods for less than the home country could (that is, the foreign country has an *absolute advantage* in the production of the goods), there could still be mutual gains from trading the two goods. The key to the argument is that it is relative costs of production (*comparative advantage*) that matter, not absolute advantage.

The best evidence indicates that the United States enjoys such a comparative advantage in services trade. The United States exports more services than it imports, and this surplus in services' trade has been growing in recent years. Moreover, U.S. services exports tend to involve relatively highly-skilled and highly-paid occupations, such as engineering, financial services, or architectural services. While services' trade may not have been envisioned in the time of Ricardo, the principle of comparative advantage still holds. Any move toward economic isolationism would thus threaten the competitive gains made by U.S. exporters while harming U.S. consumers and firms that benefit from imports.

Immigration

In recent decades the United States has experienced a surge in immigration not seen in over a century. Immigration has touched every facet of the U.S. economy and, as the President has said, America is a stronger and better Nation for it. Immigrants today come from countries around the world and work in diverse occupations ranging from construction workers and cooks to computer programmers and medical doctors.

Immigrants have settled in all parts of our Nation and have generally succeeded in finding jobs quickly, helped in large measure by the flexibility of the U.S. labor market. One indicator of this success is that foreign-born workers in the United States have a higher labor force participation rate and lower unemployment rate than foreign workers in most major immigrant-receiving countries.

While flexible institutions may speed the economic integration of the foreign-born, the distribution of the gains from immigration can be uneven. Less-skilled U.S. workers who compete most closely with low-skilled immigrants have experienced downward pressure on their earnings as a result of immigration, although most research suggests these effects are modest. Also, communities contending with a large influx of low-skilled immigrants may experience an increased tax burden as immigrant families utilize publicly provided goods such as education and health care.

U.S. immigration policy faces a complicated set of challenges, perhaps more so now than ever before. Policy should preserve America's traditional hospitality to lawful immigrants and promote their economic contributions. Yet these goals must be balanced with the Nation's many needs, including the imperative for orderly and secure borders. These challenges have only grown in a post-9/11 world. The persistence of undocumented immigration and problems with employment-based immigration suggest that the United States needs to better enforce immigration laws and do more to address the demand for immigrant workers and the need for national security. The President's proposed Temporary Worker Program and increased funding for internal enforcement recognize these problems and would implement necessary reforms.

The Global HIV/AIDS Epidemic

Societies worldwide face the challenge of curbing the acquired immunodeficiency syndrome (AIDS) epidemic. The disease has already killed over 25 million people, and currently over 40 million people are living with the human immunodeficiency virus (HIV), the virus that causes AIDS. The impact of HIV/AIDS varies across the world, both in terms of the scale of the epidemic and the ability to treat infected individuals.

Less-developed countries are particularly hard-hit on both accounts. Almost two-thirds of all people with HIV live in sub-Saharan Africa, a region that makes up only one-tenth of the world's population. At the same time, few infected individuals in the region receive adequate treatment for the disease. In addition to the devastation from the immense loss of life, the disease also has economic consequences that intensify the humanitarian crisis.

AIDS is a global problem with far-reaching consequences. While the disease's impacts on human health and mortality are widely recognized, the AIDS epidemic also has devastating economic consequences that exacerbate the humanitarian crisis.

A comprehensive and integrated approach of prevention, treatment, and care is essential to quelling the epidemic. In poor countries, treatment affordability and the lack of health care infrastructure are major concerns. Compassionate pricing policies and aid from developed nations can play an important role in expanding access to treatment.

To continue the development of better treatments and to work toward eradication of HIV/AIDS, drug companies need to maintain the highest possible quality of research. Intellectual property laws are important in ensuring appropriate incentives for innovation to create the next generation of therapies and to develop a safe and effective vaccine.

Understanding the unique challenges presented by this epidemic is essential to designing policies to prevent the spread of the disease and to treat those who are already infected. President Bush has made fighting the worldwide AIDS epidemic a priority of U.S. foreign policy, and he has taken bold action against the crisis through his Emergency Plan for AIDS Relief.

Conclusion

In conclusion, the U.S. economy is fundamentally sound and the outlook is very positive. Challenges remain, however, and the President has an ambitious agenda to address them, including proposals to improve trade, enact legal reform, improve access to health care, use our energy resources efficiently, and rationalize the regulatory system.

Mr. Chairman, we appreciate this opportunity to testify and welcome any questions. Thank you.