"The Economic Outlook"

N. Gregory Mankiw
Chairman of the Council of Economic Advisers

Testimony before the House Budget Committee
Washington, D.C.

February 3, 2004

Chairman Nussle, Ranking Member Spratt, and members of the Committee, thank you for the opportunity to testify on the Administration's economic forecast as it relates to the President's Budget for fiscal year 2005.

As you know, the forecast is a key input into the Budget process. The Council of Economic Advisers initiates a macroeconomic forecast twice a year, in the fall for the Budget and the spring for the Mid-Session Review. The forecast itself is a joint product of the Council, the Office of Management and Budget, and the Treasury—the Administration's economic "troika." The chief economists and staffs from the three agencies work closely together, and then I review the forecast carefully, together with the Secretary of the Treasury and the Director of the Office of Management and Budget.

In developing the forecast, the Administration consciously adopts conservative economic assumptions that are close to the consensus of private-sector forecasters. This approach provides a prudent and cautious basis for the budget projections.

The outlook for 2004 and beyond reflects the key role of the Administration's policies in supporting the recovery and boosting job creation. The Administration's policies are designed to enhance U.S. economic growth, not just maintain it.

2003: An Economic Turning Point

The U.S. economy made notable progress in 2003. The recovery was still tenuous going into the year. On the one hand, it was still struggling against powerful contractionary forces—the capital overhang, revelations about corporate scandals, and uncertainty about future economic and geopolitical conditions. On the other hand, it had the benefits of the stimulus from expansionary monetary policy and the Administration's 2001 tax cut and 2002 stimulus package. Over the course of 2003, the contractionary forces dissipated and the expansionary forces were augmented by the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), which the President signed into law in May.

The economy now appears to have moved into a full-fledged recovery. The economy has gained momentum over the past year, with annualized real GDP growth increasing from 2½ percent during the first half of 2003 to 6.1 percent during the second half—the strongest GDP growth for any half-year period in nearly 20 years. GDP growth in 2003 was supported by robust gains in consumption, residential investment, and defense spending. Inventory investment declined over the first three quarters of last year but turned positive in the fourth quarter. Growth in business equipment and software investment and in exports picked up noticeably in the second half of the year. The labor market began to rebound in the final five months of 2003. Core consumer inflation declined to its lowest level in decades.

GDP Growth, Productivity, and Unemployment

The Administration forecasts that the economic recovery will strengthen further this year, with real GDP growth running well above its historical average of 3.3 percent since 1960 and the unemployment rate continuing to decline. The Administration expects real GDP to increase 4.0 percent during the four quarters of 2004. This projection is close to that in the latest Blue Chip consensus economic forecast (as of January 10, 2004). This compares with GDP growth of 4.3 percent during the four quarters of 2003 and 2.8 percent during the four quarters of 2002. Measured on a calendar year-over-year basis, the Administration projects GDP growth of 4.4 percent in 2004, compared with 3.1 percent in 2003 and 2.2 percent in 2002.

In 2004, the composition of GDP growth is expected to shift away from household and government spending and toward business fixed investment and net exports. Evidence of emerging momentum in investment accumulated over the course of 2003: businesses began to hire, build inventories, and increase shipments of nondefense capital goods. In addition, expected faster growth among U.S. trading partners and the decline in the exchange value of the dollar make U.S. exporters well-positioned for expansion.

Much stimulus remains in the pipeline in the form of refunds on 2003 tax liabilities this spring and the ongoing effects of the current low interest rates. The reduction in the tax withholding schedule included in the 2003 fiscal package (JGTRRA) only began in July 2003, and households are still adjusting to these lower tax rates. Moreover, tax refunds in the first half of 2004 are expected to be higher than usual: the tax cuts were retroactive to January 2003, but last year's withholding changes generally did not capture tax savings on income earned in the first half of the year. In addition, because of the 2002 and 2003 tax cuts, businesses will be able to cut their tax liabilities by expensing 50 percent of their equipment investment (rather than depreciating the new capital) through the end of 2004. The lower tax rates, higher tax refunds, and investment expensing included in the Jobs and Growth Tax Relief Reconciliation Act are expected to reduce tax collections by $146 billion in 2004, up from $49 billion in 2003.

The U.S. economy continues to display supply-side characteristics favorable to long-term growth. Advances in productivity have been remarkable, and inflation remains low and stable. We estimate the growth of the economy's potential GDP to be 3.1 percent per year.

During each of the next four years, real GDP is expected to grow faster than its potential rate as the economy continues to recover. The Administration forecasts that real GDP growth will average 3.7 percent at an annual rate during the four years from 2003 to 2007—again in line with the consensus of private-sector forecasters. Because this pace is somewhat above the assumed rate of increase in productive capacity, the unemployment rate is projected to decline over this period. In 2008 and 2009, real GDP growth is projected to continue at its long-run potential rate of 3.1 percent, and the unemployment rate is projected to stabilize at 5.1 percent.

The growth rate of the economy over longer time horizons is determined by its supply-side components, which include population, labor force participation, productivity, and the workweek. The Administration expects nonfarm labor productivity to grow at a 2.1 percent average annual pace over the forecast period, virtually the same as that recorded during the 43 years since the business-cycle peak in 1960. The projection is notably more conservative than the 4.4 percent average annual rate of productivity growth since the output peak in the fourth quarter of 2000. After such an extraordinary surge, a period of more typical productivity growth is likely as firms shed their hesitancy to hire. In addition, the slower pace of productivity assumed in the forecast reflects the Administration's view that in the absence of a good explanation for the recent acceleration, it is prudent to base the productivity forecast on longer-term averages.

In addition to productivity, growth of the labor force is projected to contribute 1.0 percentage point per year to growth of potential output on average through 2009. Labor force growth results from growth in the working-age population and changes in the labor force participation rate. The Bureau of the Census projects that the working-age population will grow at an average annual rate of 1.1 percent through 2009—roughly the same pace as during the years between 1990 and 2003. The last year in which the labor force participation rate increased was 1997, so the long-term trend of rising participation appears to have come to an end. Since then, the participation rate has fallen at an average 0.2 percent annual pace—although some of the decline in 2001 and 2002 probably resulted from the recession-induced decline in job prospects. In 2003, the baby-boom cohort was 39 to 57 years old, and over the next several years the boomers will be moving into older age brackets with lower participation rates. As a result, the labor force participation rate is projected to edge down an average of 0.1 percent per year through 2009. The decline may be greater, however, after 2008, which is the year that the first baby boomers (those born in 1946) reach the Social Security early-retirement age of 62.

In sum, potential real GDP is projected to grow at a 3.1 percent annual pace, slightly above the average 3.0 percent rate of real GDP growth since 1973 and slightly below the 3.3 percent average since 1960. Actual real GDP growth during the six-year forecast period is projected to be slightly higher, at 3.4 percent, because the civilian employment rate makes a transitory and small (0.2 percentage point) contribution to growth through 2007 as the unemployment rate falls. This contribution then ends as the unemployment rate stabilizes at 5.1 percent.

Consumer Spending

Consumer spending is expected to moderate this year after rising briskly in the second half of 2003. Real personal consumption expenditures increased at an average annual pace of 3.0 percent during the first half of 2003 and then accelerated to an annual rate of 4.7 percent in the second half of the year.

Wages and salaries increased moderately in the second half of 2003, bolstered by the emerging recovery in the labor market. Moreover, the personal tax cuts included in the 2003 fiscal package (JGTRRA) meant that U.S. households were able to keep substantially more of their earnings. The reduction in withholding and the advance rebates of the child tax credit added $37 billion to disposable income (not at an annual rate) in the second half of the year.

Other factors also likely contributed to the strengthening of consumer spending over the course of 2003. The robust performance of equity markets and solid gains in home prices bolstered wealth. Household wealth (net financial resources plus the value of nonfinancial assets such as cars and homes) increased $2¼ trillion during the first three quarters of 2003, and it probably rose substantially further in the fourth quarter given the solid increase in broad indexes of stock prices in the last few months of the year. Consumer sentiment was depressed early in the year by the prospect of war with Iraq. Sentiment jumped in April and May following the successful resolution of major combat operations and then was little changed until November, when it picked up noticeably. By the end of the year, household sentiment was somewhat higher than it had been at the end of 2002 and much higher than it was just prior to the war with Iraq.

During 2003 as a whole, consumption grew somewhat faster than household after-tax income. Personal saving as a fraction of disposable personal income averaged 2.3 percent in 2002 and was slightly lower, at 2.0 percent, in 2003.

The likely behavior of personal saving in coming years is a key factor in the consumption outlook. In particular, the relative flatness of the personal saving rate over the past couple of years appears to be the result of offsetting forces. On the one hand, capital losses associated with the decline in the stock market from March 2000 to March 2003 probably tempered consumption (with some lag) and, in turn, caused the personal saving rate to increase. On the other hand, personal saving was likely depressed by the boost to consumption from low interest rates (both directly through the availability of low-interest-rate loans on durable goods and indirectly through the funds made available by cash-out mortgage refinancings). As interest rates and incomes rise over the course of the next several years, the transitory forces boosting consumption growth should dissipate, and as a result, real consumption is expected to grow more slowly than real GDP.

An increase in corporate contributions for defined-benefit pension plans may boost the saving rate in the near term from what it might be otherwise. The Pension Benefit Guarantee Corporation (PBGC) has estimated that corporate contributions to defined-benefit plans will increase sharply above 2003 levels. Indeed, rapid increases have already begun, according to separate data included in the Employment Cost Index. The contributions raise personal income (as it is measured in the National Income and Product Accounts), but because these funds are not placed in the hands of employees until retirement, they may have smaller effects on current-year consumption. As a result, they may increase the personal saving rate.

Residential Investment

Real residential investment is expected to slow somewhat in 2004 after a remarkably robust performance in 2003. During the four quarters of 2003, real residential investment grew at an average annual rate of more than 10 percent. Housing starts moved above the already high 2002 level to an average of 1.8 million units in 2003, the largest number of starts since 1978. In addition, sales of both new and existing single-family homes rose to record levels.

Some of the strength in housing demand reflected the same gains in after-tax income and wealth that bolstered real consumer spending. The low levels of mortgage interest rates were another important driving force. The interest rate on new fixed-rate 30-year mortgages slipped from an average of 6½ percent in 2002 to an average of 5¾ percent in 2003. This level is the lowest in the 32 years for which comparable data are available. Indeed, according to data from the Michigan Survey Research Center, consumers' assessments of home-buying conditions remained very positive in 2003, largely because of low mortgage interest rates. As a result of the very favorable conditions in the housing sector, the U.S. home-ownership rate climbed to 68.2 percent in the third quarter of 2003—equal to its highest level on record.

Business Fixed Investment

Business investment in equipment and software picked up sharply in the second half of 2003 and the strength is expected to persist in 2004. However, business investment in structures is forecast to gain only slightly over the year.

Real business fixed investment—firms' outlays on equipment, software, and structures—posted a gain of 6.4 percent during the four quarters of 2003 after declines of 10.2 percent during the four quarters of 2001 and 2.8 percent during the four quarters of 2002. The acceleration during the year was noteworthy, with real investment rising at an annual rate of 9.8 percent in the second half compared with 3.1 percent in the first half of the year. The improvement from 2002 to 2003, as well as the pickup over the course of 2003, largely reflected a strengthening in real purchases of equipment and software.

Within the equipment and software category, the largest increases occurred for certain high-tech items. Real outlays for computers increased nearly 40 percent during the year, and real investment in software continued its solid upward trend, rising 12½ percent. Outlays for transportation equipment were held down by further large declines in purchases of aircraft during the year. Finally, real spending on equipment outside of the high-tech and transportation categories posted a solid gain over the course of 2003.

The increased momentum in business purchases of capital goods in 2003 likely reflects the impact of several factors. First, with capital overhangs probably behind them, firms were poised to take advantage of further declines in prices of high-tech goods stemming from continued technological advances. Second, striking gains in productivity and falling unit labor costs bolstered corporate profits. Third, the cost of capital was held down by a number of factors, including falling prices for high-tech capital goods, but also by low interest rates, rising stock prices, and the investment incentives introduced in the Job Creation and Worker Assistance Act of 2002 (JCWAA) and expanded in the 2003 fiscal package (JGTRRA).

The Administration expects the recovery in real business investment in equipment to strengthen further this year, reflecting the acceleration in output, continued low interest rates, and the investment incentives provided by the 2002 and 2003 tax cuts. Fixed investment in equipment tends to be related to the pace of growth in output (along with the cost of capital), and so the pickup in real GDP growth from 2.8 percent during the four quarters of 2002 to 4.3 percent during the four quarters of 2003 is projected to lead to an increase in investment during 2004.

Growth in equipment investment in 2004 should be further boosted as firms pull forward spending in anticipation of the expiration of the period when businesses are able to expense (rather than depreciate) 50 percent of the value of their equipment investment. The flip side of some investment being pulled forward into 2004 is that investment may grow more slowly in 2005. Even so, the pace of equipment investment in 2005 is projected to be strong.

Despite the emerging recovery in spending on equipment and software, business demand for structures remained soft in 2003. High overcapacity seems to have offset the impetus imparted by low interest rates and higher cash flow. In the office sector, vacancy rates rose substantially for the third consecutive year. Vacancy rates moved still higher in the industrial sector and now stand at extremely elevated levels. The good news is that the substantial declines in total spending on structures seem to have abated. Indeed, real investment in nonresidential structures dipped only about 1.3 percent over the four quarters of 2003, in contrast with a plunge of more than 25 percent during the preceding two years. Strength in oil and gas drilling and an increase in construction of general merchandise stores during the year have offset continued softness in some other sectors.

The forces that shape the outlook for business structures—the growth of output and the cost of capital—are much the same as for business equipment. However, they operate with a longer lag because of the time it takes to plan and build these structures. Investment in business structures is projected to post a small gain during 2004.

Business Inventories

Inventory investment is projected to make a noticeable positive contribution to GDP growth through the first half of 2004 and then stay at a level that keeps stocks in line with rising sales throughout 2004 and 2005. This would continue a turnaround in stockbuilding that appears to have begun in September 2003 and was evidenced by the positive contribution of 0.6 percent by inventory investment to fourth-quarter GDP growth. Businesses began 2003 with lean inventories following a massive liquidation in 2001 and little restocking during 2002. Inventory investment was substantially negative over the first three quarters of 2003, as increases in production lagged those in final demand. The reasons for this slow response of production are unclear. Firms may have been surprised by the strength of final demand, or they may simply have been waiting for compelling evidence that a sustainable recovery was under way. The net decline in inventories during the first three quarters of 2003 left stocks in their leanest position relative to final sales of goods and structures in at least 50 years. This lean position resulted, at least in part, from efficiencies generated by just-in-time inventory-management techniques.

Government Purchases

Real federal government spending is expected to fall in the 2005 and 2006 fiscal years, and remain fairly flat thereafter. The defense supplemental appropriations for FY 2004, signed in November 2003, allows for some further near-term growth in federal government purchases. Real Federal spending (consumption expenditures and gross investment) climbed 5¾ percent during the four quarters of 2003. The gain was led by a rise of 7¾ percent in real defense spending largely related to military operations in Iraq. Real nondefense spending rose about 2½ percent. This increase was less than one-third as large as the gain during the four quarters of 2002, when outlays were stepped up considerably for homeland security.

Tax receipts of states and localities decelerated during the economic slowdown, while fiscal positions deteriorated as well from rising health care costs and increased demand for security-related spending. With many of these governments subject to balanced-budget rules, they have taken a variety of measures to address their fiscal imbalances, including drawing on accumulated reserves (so-called "rainy day funds"), raising taxes, and restraining spending. Real expenditures of state and local governments were little changed during the four quarters of 2003, in contrast with an average annual gain of around 3 percent over the preceding five years. With state and local governments still under pressure, their real expenditures are projected to increase slowly during the coming year. Eventually, their fiscal situations should be improved by increases in tax revenue resulting from the strengthening of the economy.

Exports and Imports

Prospects for exports over the next two years look promising for the first time since the global slowdown began in 2000. Growth among the non-U.S. OECD countries is projected by the OECD Secretariat to rise to 2.6 percent during the four quarters of 2004, up from a pace of 1.6 percent during 2003. Growth is expected to rise further to 2.8 percent in 2005. The expected growth in foreign markets should support growth in U.S. exports. In addition, the effect will likely be augmented by a rise in the U.S. market share of world exports owing to the effects of the 23 percent decline in the value of the dollar against major currencies from its peak in early 2002 through the end of 2003. The effect of the recent dollar decline on exports will likely take a couple of years to be fully felt.

Real imports are projected to increase along with domestic output, but the growth of real imports is likely to be slowed by the recent decline in the dollar's value relative to other currencies. On balance, real imports are projected to grow at about the same pace as GDP, on average, during the next two years. Nominal imports will increase faster than real imports because import prices will rise in reaction to the recent dollar decline. The current account deficit, which rose to about 5 percent of GDP in the first three quarters of 2003, is projected to edge up in 2004 and decline thereafter.

Overall, real net exports are expected to make a small positive contribution to real GDP growth during the next year and are likely to make a larger contribution thereafter. Over the next six years, the returns to foreign owners of U.S. capital are likely to grow faster than the returns to U.S. owners of foreign capital, a legacy of a long period of strong foreign investment in the United States during the past decade. As a result, real gross national product (GNP), which includes these net foreign returns to capital, is expected to grow slower than real gross domestic product (GDP).

The Labor Market

Boosted by strong demand and income growth, the labor market in 2004 and beyond is expected to build upon the favorable developments in the last five months of 2003. Nonfarm payroll employment fell an average of 50,000 workers per month in the first seven months of 2003, before increasing 35,000 in August, 99,000 in September, and an average of 48,000 per month in the fourth quarter. The strengthening was experienced in most sectors. Job gains in professional and business services stepped up appreciably from the modest upward pace seen earlier in the year. Construction employment began to expand in the second quarter after two years of modest job losses, and the quarterly averages of employment in the wholesale trade, transportation, and utilities industries turned up at the end of the year. The manufacturing sector continued to shed jobs through year-end, though the pace of decline slowed, and the factory workweek climbed more than 0.5 hour, on balance, in the final five months of 2003.

The unemployment rate increased in the first half of 2003, reaching a peak of 6.3 percent in June, before falling during the second half of the year. In the fourth quarter, the unemployment rate averaged 5.9 percent, the same as it had been a year earlier. Because the labor force is constantly expanding, employment must be growing moderately just to keep the unemployment rate steady. For example, if the labor force is growing at the same rate as the population (about 1 percent per year), employment would have to rise 110,000 a month just to keep the unemployment rate stable, and larger job gains would be necessary (and are expected) to induce a downward trend in the unemployment rate.

Looking ahead, temporary-help services employment—a leading indicator for the labor market—suggests substantial further employment growth in the future. Average growth in temporary-help services employment over a six-month period has a striking positive correlation with growth in overall employment over the subsequent six months. Statistical analysis suggests that an increase of one job in temporary-help services corresponds to a subsequent rise of seven jobs in overall employment. Employment in temporary-help services has expanded 194,000 since last April, suggesting robust growth in overall employment this year. The unemployment rate is projected to fall to 5.5 percent by the fourth quarter of 2004—well below its average of 6.3 percent since 1970.

Inflation

Core CPI inflation is expected to continue at a low level in 2004, and overall inflation is expected to be even lower as energy prices retreat further. Overall CPI inflation is projected to fall to 1.4 percent during the four quarters of 2004—close to the past year's pace of core inflation. With the unemployment rate expected to average 5.6 percent for the year as a whole (above the estimated 5.1 percent midpoint of the range of unemployment rates consistent with stable inflation) the level of slack—although less than in 2003—is still projected to hold down inflation during 2004. Also keeping inflation in check is the recent rapid pace of—and solid near-term prospects for—productivity growth. Offsetting this effect is the somewhat higher pace of import-price inflation (resulting from the recent dollar decline) and the quicker pace of GDP growth. Over the next five years, CPI inflation is expected to edge up, eventually flattening out at 2.5 percent, a level that is identical to the consensus private-sector forecast.

The path of inflation as measured by the GDP price index is similar, but a bit lower throughout the projection period. Inflation as measured by the GDP price index is projected to fall to 1.2 percent during the four quarters of 2004, the same as the 1.2 percent pace of the core GDP price index during the four quarters of 2003. GDP price inflation is projected to increase slowly thereafter—roughly parallel to the rise in CPI inflation.

The wedge between the CPI and the GDP measures of inflation has important implications for the Federal budget and budget projections. A larger wedge reduces the Federal budget surplus because cost-of-living adjustments for Social Security and other indexed programs rise with the CPI, whereas Federal revenue tends to increase with the GDP price index. For a given level of nominal income, increases in the CPI also cut Federal revenue because they raise income tax brackets and affect other inflation-indexed features of the tax code. Of the two indexes, the CPI tends to increase faster in part because it measures the price of a fixed market basket. In contrast, the GDP price index increases less rapidly than the CPI because it reflects the choices of households and businesses to shift their purchases away from items with increasing relative prices and toward items with decreasing relative prices. In addition, the GDP price index includes investment goods, such as computers, whose relative prices have been falling rapidly. Computers, in particular, receive a much larger weight in the GDP price index (0.8 percent) than in the CPI (0.2 percent).

During the eight years ended in 2002, the wedge between inflation in the CPI-U-RS (a version of the CPI designed to be consistent with current methods) and the rate of change in the GDP price index averaged 0.5 percentage point per year. With the core CPI and the core GDP price index both increasing at about a 1¼ percent pace during the past year, inertia suggests that the near-term wedge will be only about 0.2 percentage point in 2004. The wedge is expected to widen eventually to its recent mean of 0.5 percent by 2009.

Financial Markets

Stock prices skidded early in the year, but rallied in March and have been on a solid uptrend since then. During the 12 months of 2003, the Wilshire 5000 index—a broad measure of stock prices—rose 29 percent. An increase of this magnitude has not been seen in any year since 1997. High-tech stocks did even better; for example, the Nasdaq index, which is heavily weighted toward high-tech industry, rose 50 percent during 2003. Nearly two-thirds of the rise in broad measures of stock prices occurred after the President signed the 2003 tax cut (JGTRRA) in late May; the Act reduced marginal tax rates on dividends and capital gains and thus likely contributed to the robust performance of stock prices.

Following a large decline in 2001, and a smaller one in 2002, the interest rate on 91-day Treasury bills fell an additional 29 basis points in 2003 and ended the year at 0.9 percent. These reductions reflected the Federal Reserve’s efforts to stimulate the economy, leaving real short-term rates (that is, nominal rates less expected inflation) slightly negative. Following market-based expectations of interest rates (derived from rates on Eurodollar futures), the Administration does not expect real rates this low to persist once the recovery becomes firmly established, and nominal Treasury bill rates are projected to increase gradually. Long-term interest rates fell sharply last spring and then rebounded in the summer. For the year as a whole, long-term Treasury rates were about unchanged, but corporate interest rates dropped a bit as the spread over Treasury rates narrowed. The Administration projects that the yield on 10-year Treasury notes, which averaged 4.3 percent in December 2003, will edge up gradually next year, consistent with the path of short-term Treasury rates.

The gradual increase in the interest rate on 91-day Treasury bills is projected to continue through 2009. The rate is expected to reach 4.4 percent by 2009, at which date the real interest rate on 91-day Treasury bills will be close to its historical average. The projected path of the interest rate on 10-year Treasury notes is consistent with that on short-term Treasury rates. By

2008, this yield is projected to be 5.8 percent, 3.3 percentage points above expected CPI inflation—a typical real rate by historical standards. By 2009, the projected term premium (the difference between the 10-year interest rate and the 91-day rate) of 1.4 percentage points is in line with its historical average.

The Composition of Income

A primary purpose of the Administration's economic forecast is to estimate future government revenue, which requires a projection of the components of taxable income. The Administration's income-side projection is based on the historical stability of the long-run labor and capital shares of gross domestic income (equal to GDP less a statistical discrepancy). During the first three quarters of 2003, the labor share of gross domestic income (GDI) was on the low side of its historical average. From this jump-off point, it is projected to rise to its long-run average and then remain at this level over the forecast period. (The income share projections are consistent with data available through December 2, 2003. They exclude any effects of the later comprehensive revision to the National Income and Product Accounts.) The labor share consists of wages and salaries, which are taxable, employer contributions for employee pension and insurance funds (that is, fringe benefits), which are not taxable, and employer contributions for government social insurance. The Administration forecasts that the wage and salary share of compensation will decline while employer contributions for employee pension and insurance funds grow faster than wages. This pattern has generally been in evidence since 1960 except for a few years in the late 1990s. During the next five years, the fastest growing components of employer contributions for employee pension and insurance funds are expected to be employer-paid health insurance and contributions for defined-benefit pension plans.

The capital share (the complement of the labor share) of GDI is expected to fall before leveling off at its historical average. Within the capital share, a near-term decline in depreciation (an echo of the decline in short-lived investment during 2001 and 2002) helps boost corporate economic profits, which in the third quarter of 2003 were noticeably above their post-1973 average of about 8 percent of GDI. The share of corporate economic profits in GDI is projected to be bolstered in 2004 by the strong recent productivity growth together with stable gains in hourly compensation, and an expected decline in depreciation.

From 2005 forward, the profit share is expected to slowly decline back to its historical average of about 8 percent. The projected pattern of book profits (known in the national income accounts as "profits before tax") reflects the 30 percent expensing provisions of the Job Creation and Worker Assistance Act of 2002 and the 50 percent expensing provisions of the Jobs and Growth Tax Relief Reconciliation Act of 2003. These expensing provisions reduce taxable profits from the third quarter of 2001 through the fourth quarter of 2004. The expiration of the expensing provisions increases book profits thereafter, however, because those investment goods expensed during the three-year expensing window will have less remaining value to depreciate thereafter. The share of other taxable income (the sum of rent, dividends, proprietors' income, and personal interest income) is projected to fall, mainly because of the delayed effects of past declines in long-term interest rates, which reduce personal interest income during the projection period.

Conclusion: The Importance of Spending Restraint

Let me conclude with a few remarks on the relationship between the budget deficit and the economy. It is true that, according to most economic models, large, persistent deficits act as a drag on the economy. It is true as well that, according to most models, higher tax rates alter incentives in a way that also acts as a drag on the economy. In my view, concerns about the deficit should *not* be resolved with higher tax rates. Doing so would merely replace one drag on growth with another. Rather, the solution to long-run deficits is continued pro-growth tax policy and spending restraint. The President's tax cuts were designed to encourage work, saving, and investment—the building blocks of growth—and he has presented a Budget with significant spending restraint. These proposals will ensure that the current economic recovery continues and position the U.S. economy for further strong growth in the years ahead.

Thank you for the opportunity to testify. I look forward to your questions.