"The Economic Report of the President"

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Chairman Bennett, Ranking Member Stark, and members of the Committee, thank you for the opportunity to discuss the release of the *Economic Report of the President* and the current challenges facing economic policy. The *Economic Report* released today covers a wide range of issues, including recent business cycle developments, tax policy, the health system, regulation, and the role of the United States in the world economy.

The U.S. economy made notable progress in 2003, propelled forward by pro-growth policies that led to a marked strengthening of activity in the second half of the year and put the United States on a path for higher sustained output growth in the years to come.

The recovery was still tenuous coming into 2003, as continued fallout from powerful contractionary forces—the capital overhang, corporate scandals, and uncertainty about future economic and geopolitical conditions—was offset by stimulus from expansionary monetary policy and the Administration's 2001 tax cut and 2002 fiscal package. The contractionary forces dissipated over the course of 2003, and the expansionary forces were augmented by the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) that was signed into law at the end of May.

The economy appears to have moved into a full-fledged recovery, with real gross domestic product (GDP) expanding 4.3 percent over the four quarters of 2003, significantly above the average growth rate since 1960 of 3.3 percent. This growth was particular strong in the second half of the year, after the passage of the Jobs and Growth tax relief bill. The last two quarters of 2003 showed the most rapid growth of any half-year period in nearly 20 years. The labor market is also starting to improve. Payroll employment reached a trough in August, and the economy has since created 366,000 jobs. The unemployment rate has fallen from a peak of 6.3 percent to 5.6 percent.

This *Report* discusses this turning of the macroeconomic tide, along with a number of other economic policy issues of continuing importance. The 14 chapters of this *Report* cover five broad topics: macroeconomic policy, fiscal policy, regulation, reforms of the health care and tort systems, and issues in international trade and finance. In all of these areas, the *Report* highlights how economics can inform the design of public policy and discusses Administration policies.

The Administration's pro-growth tax policy, in concert with the dynamism of the U.S. free-market economy, has laid the groundwork for sustainable rapid growth in the years ahead. Well-timed fiscal stimulus combined with expansionary monetary policy to offset and eventually reverse the contractionary forces impacting the economy. But there is still much to be done. The tax cuts must be made permanent to have their full beneficial impact on the economy. A stronger economy will also result from progress on the other aspects of the Administration's economic agenda, including making health care more affordable; reducing the burden of lawsuits on the economy; ensuring an affordable and reliable energy supply; streamlining regulations; and opening markets to international trade. These initiatives are discussed in this *Economic Report of the President*.

MACROECONOMIC POLICY

Chapter 1, *Lessons from the Recent Business Cycle*, discusses the distinctive features of the recent recession and subsequent recovery, and draws five key lessons for the future. The recent business cycle was unusual in that it was characterized by especially weak business investment but robust consumption and housing investment. This makes clear the first lesson, that structural imbalances such as the "capital overhang" that developed in the late 1990s can take some time to resolve. A number of events contributed to a climate of uncertainty in 2003, including the terrorist attacks of September 11, 2001, corporate governance and accounting scandals, and geopolitical tensions surrounding the war with Iraq. The second lesson from the recent business cycle is that the effects of the uncertainty from these events on household and business confidence can have important effects on asset prices, household spending, and investment. Resolution of some of the uncertainties appears to have contributed to the resurgence of growth.

Monetary and fiscal policies played a critical role in moving the economy back toward potential. Third lesson is that aggressive monetary policy can help make a recession shorter and milder. The fourth lesson is that tax cuts can likewise boost economic activity. Tax cuts raise after-tax income, while at the same time promoting long-term growth by enhancing incentives to work, save, and invest. Tax relief enacted in 2001 and 2002 helped lessen the severity of the recession, while the 2003 tax cut appears to have propelled the economy forward into a strong recovery. Job creation has lagged behind, even as demand has surged. Thus, the fifth lesson of the recent recession is that strong productivity growth, as was experienced in 2003, means that much faster economic growth is needed to raise employment. This productivity growth, however, is not to be lamented, since it ultimately leads to higher standards of living for both workers and business owners.

Chapter 2, *The Manufacturing Sector*, examines recent developments and long-term trends in manufacturing and considers policy responses. Manufacturing was affected by the

economic slowdown earlier, longer, and harder than other sectors of the economy and manufacturing employment losses have only recently begun to abate. The severity of the recent slowdown in manufacturing was largely due to prolonged weakness in business investment and exports, both of which are heavily tied to manufacturing.

Over the past several decades, the manufacturing sector has experienced substantial output growth, even while manufacturing employment has declined as a share of total employment. The manufacturing employment decline over the past half-century primarily reflects striking gains in productivity and increasing consumer demand for services compared to manufactured goods. International trade has played a relatively small role by comparison. Consumers and businesses generally benefit from the lower prices made possible by increased manufacturing productivity, and strong productivity growth has led to real compensation growth for workers. While the shift of jobs from manufacturing to services has caused dislocation, it has not resulted, on balance, in a shift from "good jobs" to "bad jobs." The best policy response to recent developments in manufacturing is to focus on stimulating the overall economy and easing restrictions that impede manufacturing growth. This Administration has actively pursued such measures.

Chapter 3, *The Year in Review and the Years Ahead*, reviews macroeconomic developments in 2003 and discusses the Administration forecast for 2004 through 2009. Real GDP growth picked up appreciably in 2003, with growth in consumer spending, residential investment, and, particularly, business equipment and software investment increasing noticeably in the second half of the year. The labor market began to rebound in the latter part of 2003. Inflation remained well in check, with core consumer inflation declining by the end of the year to its lowest level in decades. The improvement in the economy over the course of the year stemmed largely from faster growth in household consumption, extraordinary gains in residential investment, and a sharp acceleration of investment in equipment and software by businesses. Payroll employment bottomed out in August and rose 254,000 over the remainder of the year and a further 112,000 in January. Financial markets responded favorably to the strengthening of the economy, with the total value of the stock market rising more than $3 trillion, or 31 percent, over the course of 2003.

The Administration expects the economic recovery to strengthen further in 2004, with real GDP growth running well above its historical average and the unemployment rate falling. Boosted by pro-growth policies and expansionary monetary policy, and on the foundation of the underlying strength of the free-market society in the United States, the economy is expected to continue on a path of strong, sustainable growth.

FISCAL POLICY

Chapter 4, *Tax Incidence: Who Bears the Tax Burden?*, discusses the analysis of how the burden of a tax is distributed among taxpayers. This question is important to policy makers, who want to know whether the distribution of the tax burden (between rich and poor, capital and labor, consumers and producers, and so on) meets their criteria for fairness. The key result is that the economic incidence of a tax may have little to do with the legal specification of its

incidence. Rather, it depends on the actions of market participants in response to the imposition of the tax.

Distributional tables showing the tax burdens borne by different income groups are an important application of incidence analysis. When used properly, distributional tables can contribute to informed decision making on the part of citizens and policy makers. Unfortunately, mainstream economic analysis suggests that these tables do not always accurately describe who bears the burden of certain taxes. This problem does not arise from bias or lack of economic knowledge on the part of the economists who prepare these tables. Instead, it reflects resource and data limitations, uncertainty about some of the economic effects of taxes, and variations in the time frame considered by the analyses. Nevertheless, the shortcomings of distributional tables can lead to misperceptions of the impact of tax changes.

An important implication of the economic analysis of incidence is that, in the long run, a large part of the burden of capital taxes is likely to be shifted to workers through a reduction in wages. Analyses that fail to recognize this shift can be misleading, suggesting that lower income groups bear an unrealistically small share of the burden of such taxes and an unrealistically small share of the gain when capital income taxes are lowered.

Chapter 5, *Dynamic Revenue and Budget Estimation*, examines how taxes affect the behavior of firms, workers, and investors and discusses the implications for the estimated effects of a tax change on revenue. Changes in taxes and spending generally alter incentives for work, investment, and other productive activity—a higher tax on an activity tends to discourage that activity. Revenue estimation is called *dynamic* if it incorporates the behavioral responses to tax changes and *static* if it does not incorporate these behavioral responses.

To make informed decisions about a policy change, policy makers should be aware of all aspects of its budgetary implications. Currently, official revenue estimates of proposed tax changes incorporate the revenue effects of many microeconomic behavioral responses. However, these estimates are not fully dynamic because they exclude the effects of macroeconomic behavioral responses. Several obstacles have prevented macroeconomic behavioral responses from being incorporated in such estimates. This chapter discusses the ongoing efforts to provide a greater role for fully dynamic revenue and budget estimation in the analysis of major tax and spending proposals. At least in the near term, it may not be practical for macroeconomic effects to be incorporated in official estimates. But estimates of these effects should be provided as supplementary information for major tax and spending proposals. Dynamic estimation of policy changes should distinguish aggregate demand effects from aggregate supply effects, include long-run effects, apply to spending as well as tax changes, reflect the differing effects of various policy changes, account for the need to finance policy changes, and use a variety of models.

Reform of entitlement programs remains the most pressing fiscal policy issue confronting the Nation. Chapter 6, *Restoring Solvency to Social Security*, examines the largest entitlement program. Social Security is a *pay-as-you-go* system in which payroll taxes on the wages of current workers finance the benefits being paid to current retirees. While the program is running a small surplus at present, deficits are projected to appear in 15 years; by 2080, the Social

Security deficit is projected to exceed 2.3 percent of GDP. These deficits are driven by two demographic shifts that have been underway for several decades: people are having fewer children and are living longer. The President has called for new initiatives to modernize Social Security to contain costs, expand choice, and make the program secure and financially viable for future generations of Americans.

This chapter assesses the need to strengthen Social Security in light of its long-term financial outlook. The most straightforward way to characterize the financial imbalance in entitlement programs such as Social Security is by considering their long-term annual deficits. Even after the baby-boom generation's effect is no longer felt, Social Security is projected to incur annual deficits greater than 50 percent of payroll tax revenues. These deficits are so large that they require a meaningful change to Social Security in future years. Reform should include moderation of the growth of benefits that are unfunded and would otherwise require higher taxes in the future. However, the benefits promised to those in or near retirement should be maintained in full. A new system of personal retirement accounts should be established to help pay future benefits. The economic rationale for undertaking this reform in an era of budget deficits is as compelling as it was in an era of budget surpluses.

REGULATION

Chapter 7, *Government Regulation in a Free-Market Society*, discusses the role of the free market in providing for prosperity in the United States and considers situations in which government interventions such as regulations would be beneficial. An important reason for Americans' high standard of living is that they rely primarily on markets to allocate resources. The government enables the system to work by enforcing property rights and contracts. Typically, free markets allocate resources to their highest-valued uses, avoid waste, prevent shortages, and foster innovation. By providing a legal foundation for transactions, the government makes the market system reliable: it gives people certainty about what they can trade and keep, and it allows people to establish terms of trade that will be honored by both sellers and buyers. The absence of any one of these elements—competition, enforceable property rights, or an ability to form mutually advantageous contracts—can result in inefficiency and lower living standards. In some cases, government intervention in a market, for example through regulation, can create gains for society by remedying shortcomings in the market's operation. Poorly designed or unnecessary regulations, however, can actually create new problems or make society worse off by damaging the elements of the market system that do work.

Chapter 8, *Regulating Energy Markets,* discusses economic issues relevant to several energy markets, including natural gas, gasoline, electricity, and crude oil. While energy markets generally function well, some parts of the energy industry have characteristics associated with market failures. These could stem from the large fixed costs required to construct distribution networks for electricity and natural gas that give rise to *market power* in the form of a natural monopoly. Alternatively, the market may not function well in the presence of *negative externalities,* such as when energy producers and consumers do not fully take into account the fact that burning fossil fuels may cause acid rain or smog.

Minimizing disruptions is an important consideration in the design of regulations to address shortcomings in energy markets. Federal, state, and local regulations can have conflicting goals. If the conflicting goals are not balanced, competing regulations could lead to worse problems than the market failures the regulations attempt to address. Moreover, regulations need to be updated as markets evolve over time to ensure that their original goals still apply and that these regulations are still the lowest-cost means of meeting those goals.

The chapter also examines global trade in energy products. The United States benefits from international trade in energy products because meeting all U.S. energy needs from domestic sources would require significant and costly changes to the U.S. economy, including changes in the types of transportation fuels used by Americans. But this leads to the possibility of occasional supply disruptions. An important consideration is that the price of oil is set in global markets, so that disruptions to the supply of oil from areas that do not supply the United States affect domestic prices of oil even if U.S. imports are not directly affected. Fortunately, changes in the U.S. economy over the past three decades and the increasing sophistication of financial markets have diminished the impact of supply disruptions and temporary price changes on the United States.

Finally, the chapter considers the role for government in subsidizing research and development into new energy sources. In general, policy makers should avoid forcing commercialization of new energy sources before market signals indicate that a shift is required. One potential problem with forcing this process is that technological breakthroughs may lead to alternatives in the future that are hard to imagine today. Premature adoption of new technologies would raise energy costs before the need arises, causing society as a whole to spend more on energy than needed.

Chapter 9, *Protecting the Environment*, discusses market-oriented approaches to safeguarding and improving the environment. While the free-market system typically promotes efficiency and economic growth, the absence of property rights for environmental "goods" such as clean air and water can lead to negative externalities that reduce societal well-being. This problem can be addressed by establishing and enforcing property rights that will lead the interested parties to negotiate mutually beneficial outcomes in a market setting. If such negotiations are expensive, however, the government can design regulations that consider both the benefits of reducing the environmental externality as well as the costs of the regulations.

Regulations should be designed to achieve environmental goals at the lowest possible cost, promoting both environmental protection and continued economic growth. Indeed, economic growth can lead to increased demand for environmental improvements and provide the resources that make it possible to address environmental problems. Some policies aimed at improving the environment can entail substantial economic costs. Misguided policies might actually achieve less environmental progress than alternative policies for the same cost. Environmental risks should be evaluated using sound scientific methods to avoid possible distortions of regulatory priorities. Market-based regulations, such as the cap-and-trade programs promoted by the Administration to reduce common air pollutants, can achieve environmental goals at lower cost than inflexible command-and-control regulations.

REFORMS OF HEALTH CARE AND THE LEGAL SYSTEM

Chapter 10, *Health Care and Insurance*, discusses the roles of innovation, insurance, and reform in the health care market. U.S. markets provide incentives to develop innovative health care products and services that benefit both Americans and the global community. The breadth and pace of innovation in the provision of health care in the United States over the past few decades have been astounding. New treatment options, however, have also been associated with higher costs and concerns about affordability. Research suggests that between 50 and 75 percent of the growth in health expenditures in the United States is attributable to technological progress in health care goods and services. A strong reliance on market mechanisms will ensure that incentives for innovation are maintained while providing high-quality care in the most cost-efficient manner.

Health insurance plays a central role in the workings of the U.S. health care market. An understanding of the strengths and weaknesses of health insurance as a payment mechanism for health care is essential to the design of reforms that retain incentives for innovation while reining in unnecessary expenditures. Over-reliance on health insurance as a payment mechanism leads to an inefficient use of resources in providing and utilizing health care. Reforms should provide consumers and health care providers with more flexibility, more choices, more information, and more control over their health care decisions.

Chapter 11, *The Tort System*, discusses the role of the U.S. tort system and the considerable burden it imposes on the U.S. economy. The tort system is intended to compensate accident victims and to deter potential defendants from putting others at risk. Empirical evidence, however, is mixed on whether the tort system effectively deters negligent behavior. Moreover, the tort system is a costly method of providing insurance against a limited number of injuries. Research suggests that tort liability also leads to lower spending on research and development, higher health care costs, and job losses.

Ways to reduce the burden of the tort system include limits on noneconomic damages, class action reforms, trust funds for payments to victims such as in asbestos, and allowing parties to avoid the tort system contractually. The Administration has proposed a number of reforms to reduce the burden of the tort system while ensuring that people with legitimate claims can recover damages.

INTERNATIONAL TRADE AND FINANCE

Chapter 12, *International Trade and Cooperation*, discusses how growing trade helps to spur U.S. and global growth. Since the end of the Second World War, international trade has grown steadily relative to overall economic activity. Over time, countries that have been more open to international flows of goods, services, and capital have grown faster than countries that were less open to the global economy. The United States has been a driving force in constructing an open global trading system. The Administration has pursued, and will continue to pursue, an ambitious agenda of trade liberalization through negotiations at the global, regional, and bilateral levels.

New types of trade deliver new benefits to consumers and firms in open economies. Growing international demand for goods such as movies, pharmaceuticals, and recordings offers new opportunities for U.S. exporters. A burgeoning trade in services provides an important outlet for U.S. expertise in sectors such as banking, engineering, and higher education. The ability to buy less expensive goods and services from new producers has made household budgets go further, while the ability of firms to distribute their production around the world has cut costs and thus prices to consumers. The benefits from new forms of trade, such as in services, are no different from the benefits from traditional trade in goods. Outsourcing of professional services is a prominent example of a new type of trade. The gains from trade that take place over the Internet or telephone lines are no different than the gains from trade in physical goods transported by ship or plane. When a good or service is produced at lower cost in another country, it makes sense to import it rather than to produce it domestically. This allows the United States to devote its resources to more productive purposes.

Although openness to trade provides substantial benefits to nations as a whole, foreign competition can require adjustment on the part of some individuals, businesses, and industries. To help workers adversely affected by trade develop the skills needed for new jobs, the Administration has worked hard to build upon and develop programs to assist workers and communities that are negatively affected by trade.

The Administration has also worked to strengthen and extend the global trading system. International cooperation is essential to realizing the potential gains from trade. Trade agreements have reduced barriers to international commerce, and contributed to the gains from trade. A system through which countries can resolve disputes can play an important role in realizing these gains.

Chapter 13, *International Capital Flows*, discusses the economic benefits and risks associated with the transfer of financial assets, such as cash, stocks, and bonds, across international borders. Capital flows have become an increasingly significant part of the world economy over the past decade, and an important source of funds to support investment in the United States. Around $2 trillion of capital flowed into all countries in the world in 2002, with around $700 billion flowing into just the United States. Different types of capital flows—such as foreign direct investment, portfolio investment, and bank lending—are driven by different investor motivations and country characteristics. Countries that permit free capital flows must choose between the stability provided by fixed exchange rates and the flexibility afforded by an independent monetary policy.

Capital flows can have a number of benefits for economies around the world. For example, foreign direct investment can facilitate the transfer of technology, allow for the development of markets and products, and improve a country's infrastructure. Portfolio flows can reduce the cost of capital, improve competitiveness, and increase investment opportunities. Bank flows can strengthen domestic financial institutions, improve financial intermediation, and reduce vulnerability to crises.

A series of financial crises in emerging market economies, however, has raised some concerns that financial liberalization can also involve risks. In countries with weak institutions,

poorly regulated banking systems, or high levels of corruption, capital inflows may not be channeled to their most productive uses. One approach to limiting the risks from capital flows when legal and financial institutions are poorly developed is to restrict foreign capital inflows. Experience suggests, however, that capital controls impose substantial, and often unexpected, costs. Instead, countries are more likely to benefit from free capital flows and minimize any related risks, if they adopt prudent fiscal and monetary policies, strengthen financial and corporate institutions, and develop sound regulations and supervisory agencies. The Administration has promoted policies to help countries reap the benefits from the free flow of international capital.

Chapter 14, *The Link Between Trade and Capital Flows*, shows that trade flows and capital flows are inherently intertwined. Changes in a country's net international trade in goods and services, captured by the current account, must be reflected in equal and opposite changes in its net capital flows with the rest of the world. The large net inflow of foreign capital experienced by the United States in recent years has funded more investment than could be supported by U.S. national saving. Corresponding to these inflows is the large U.S. current account deficit. These patterns reflect fundamental economic forces, notably strong growth in the United States that has made investment in this country attractive compared to opportunities in other countries.

An adjustment of the U.S. current account deficit could come about in several ways. Faster growth in other countries relative to the United States could increase demand for U.S. net exports. Trade flows could also adjust through changes in the relative prices of U.S. goods and services compared to the prices of foreign goods and services. Any reduction in the U.S. current account deficit would also require reduced net capital inflows into the United States. This might occur if U.S. national saving increased, reducing the need for foreign funds to finance U.S. domestic investment, or if U.S. investment declined, so that the United States required less capital inflows. Lower investment is the least desirable form of balance of payments adjustment, however, as it could slow the expansion of U.S. productive capacity and reduce economic growth.

It is impossible to predict the exact timing or magnitude of any adjustment in the U.S. current account balance. After a large increase in the U.S. current account deficit in the 1980s, the ensuing adjustments were gradual and benign. Public policies can facilitate smooth changes in the U.S. current account and net capital flows by creating a stable macroeconomic and financial environment, promoting growth abroad, and encouraging greater saving in the United States.

CONCLUSION

The future of the U.S. economy is bright. This is a testament to the institutions and policies that have unleashed the creativity of the American people and their spirit of entrepreneurship. History teaches that the forces of free markets are the bedrock of economic prosperity.

In 1776, as the Founding Fathers signed the Declaration of Independence, the great economist Adam Smith wrote: “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things." The economic analysis presented in this *Report* builds on the ideas of Smith and his intellectual descendants by discussing the role of the government in creating an environment that promotes and sustains economic growth.