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THE ECONOMIC OUTLOOK: APRIL 2005

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

APRIL 14, 2005

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THE ECONOMIC OUTLOOK: APRIL 2005

THURSDAY, APRIL 14, 2005

UNITED STATES CONGRESS,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 9:33 a.m., in room 2212, Rayburn House Office Building, Hon. Jim Saxton (Chairman of the Committee) presiding.

Present: Representatives Saxton, Maloney, Hinchey, Sanchez of California, and Cummings; Senator Reed.

Staff Present: Chris Frenze, Robert Keleher, Brian Higginbotham, Colleen Healy, John Kachtik, Jeff Schlagenhauf, Natasha Moore Hickman, Suzanne Stewart, Chad Stone, Matthew Salomon, Daphne Clones-Federing, Nan Gibson, and Pamela Wilson.

OPENING STATEMENT OF HON. JIM SAXTON, CHAIRMAN, A U.S. REPRESENTATIVE FROM NEW JERSEY

Representative Saxton. It is a pleasure to welcome Chairman Rosen of the President's Council of Economic Advisers before the Committee this morning. Chairman Rosen's testimony on the economic outlook continues the productive exchange between the Council and the JEC that has existed for many years.

A variety of standard economic data show that the U.S. economic expansion continues to be on track. According to recent figures, the U.S. economy grew at a rate of about 4 percent last year, after adjustment for inflation. The U.S. economy has been growing at a healthy pace since the second quarter of 2003, when the rebound in business investment started to broaden and bolster the expansion.

The tax incentives for investment adopted in the second quarter of 2003 played an important role in jump-starting investment growth. The previous weakness in business investment was replaced by double-digit increases in equipment and software investment in six of the last seven quarters.

The acceleration of economic growth is reflected in other economic statistics as well. For example, industrial production is trending upward. Over the past 22 months payroll employment has risen by 3.1 million jobs. The unemployment rate stands at 5.2 percent. Household net worth is at a record level. Homeownership has hit record highs. Interest rates remain fairly low by historical standards. Consumer spending continues to grow, and inflation appears to be under control, with a key core measure of price changes still below 2 percent on a year-over-year basis.

In summary, overall economic conditions remain very positive. Recently released minutes of the Federal Reserve suggest that the central bank expects this economic strength to continue. There is justifiable concern about the increase in oil prices, however it is important to note that this primarily seems to reflect strong demand from international economic growth and not a plunge in oil supplies.

Another challenge is the tax bias against savings and investment embedded in the tax system. Further reducing the multiple taxation of savings and investment would lessen the economic burden imposed by the Tax Code and increase economic growth over the long run. The Administration's proposals to protect more personal savings from multiple taxation, in my opinion, are right on target.

The consensus of blue chip forecasts projects that the economic expansion will continue through 2005 and 2006. This is very consistent with the Council's projections for economic growth over the next 2 years or so. The bottom line is that the U.S. economy remains strong, and that the overall economic outlook is positive.

At this point, I would like to yield to my friend, the Ranking Member.

[The prepared statement of Representative Jim Saxton appears in the Submissions for the Record on page 29.]

OPENING STATEMENT OF HON. JACK REED, RANKING MINORITY MEMBER, U.S. SENATOR FROM RHODE ISLAND

Senator Reed. Thank you very much, Mr. Chairman. And let me say how much of a pleasure it is to once again work with you on this Committee in the 109th Congress. I certainly do look forward to working with you and all of my colleagues on the Committee.

It is fitting that this hearing is with the Council of Economic Advisers, which was created at the same time as the JEC in the Employment Act of 1946.

I also certainly want to welcome Chairman Rosen and Dr. Forbes. Thank you very much for your service and also for your presence here today. I know that your backgrounds are not necessarily in economic forecasting, but I am confident that you will be able to give us useful insights on current economic conditions and where you think the President's policies are taking us.

I have three major concerns about the economic outlook. First, I am concerned about what appears to be an extremely disappointing economic recovery for the typical American worker. I know that the Administration is proud of the fact that the economy has created jobs for 22 consecutive months, but the pace of job creation over that period works out to just 141,000 jobs per month. That is barely enough to keep up with normal growth in the labor force. Last month indeed we did not match that pace; only 110,000 jobs were created.

The slow pace of job creation is disappointing, but what is happening to the take-home pay of the average worker is even more disappointing. Since May 2003, when the economy finally began creating jobs, the average hourly earnings of production workers in nonfarm industries have fallen by .7 percent after accounting for inflation. In addition, we are finding that the distribution of earn-

ings is becoming more unequal, and American families are having to shoulder more risk in today's economy.

I think these issues are the other side of the President's plan for an ownership society, and I think they are concerns that need to be addressed.

My second major concern about the economic outlook is the effects we are seeing in the trade deficit and the foreign exchange market from the fiscal policy we have been pursuing over the past 4 years. This week we learned that the trade deficit is still widening with February's deficit of $61 billion, a record for a single month. The broader current account deficit rose to a record 6.3 percent of GDP in the fourth quarter of 2004. The large drain on national savings from the Federal budget deficit has put us in the position where we must borrow $650 billion to $700 billion per year from the rest of the world to sustain our spending. That money will have to be paid back with interest, which will be a drain on our national income and our future standard of living.

Finally, I am concerned that the President wants to extend these policies, which are in many respects fiscally irresponsible policies, to Social Security. Analysis by the JEC Democratic staff and others shows that the President's private accounts would require a massive increase in the public debt that is not simply a short-run transition cost. Rather, the additional debt associated with private accounts would reach 35 percent of GDP by 2060. That would be on top of the debt we already have, which is estimated to be 37 percent of GDP. We would be at a figure of 70 percent for the debt-to-GDP ratio. I don't think we have seen figures like that since the end of World War II.

The President's plan for private accounts makes Social Security solvency worse by diverting payroll taxes from the trust fund. That drain on the trust fund moves up the date that Social Security can no longer pay full benefits and increases the present value of the 75-year financing gap from $4 trillion to $5.6 trillion.

Finally, the President's plan for private accounts does nothing to increase national saving and could lower it still further. The private saving that would be generated by the creation of private accounts would be completely offset by the reduction in private savings from the larger budget deficits, and people might reduce other private saving, such as their contributions to 401(k)s and IRAs.

Raising national saving is the key to economic growth and one of the ways to reduce the trade deficit. Moreover, as Federal Reserve Chairman Alan Greenspan recently testified, it is the best way to address the challenges posed by the retirement of the baby boom generation. Unfortunately, the President's proposals for large tax cuts for those who are already well off seem to be taking us in exactly the wrong direction.

Now, I look forward to your testimony about the economic outlook today. I must gracefully withdraw, because I have two hearings on the Senate side. But I am ably assisted by Carolyn Maloney and Elijah Cummings and Loretta Sanchez, who I am sure have interesting questions.

Thank you very much.

Representative Saxton. Thank you, Senator.

[The prepared statement of Senator Jack Reed appears in the Submissions for the Record on page 29.]

Representative Saxton. We have with us this morning the Chairman of the Council of Economic Advisers of the President, Harvey S. Rosen, as well as Kristen J. Forbes, who is a member of the Council. Thank you for being with us this morning.

Mr. Chairman, the floor is yours.

STATEMENT OF HARVEY S. ROSEN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS; ACCOMPANIED BY KRISTEN J. FORBES, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Dr. Rosen. Thank you, Mr. Chairman. Chairman Saxton and Members of the Committee, thank you for this opportunity to testify at the Joint Economic Committee. We appreciate the longstanding 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. I will first talk about 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, Sociality Security and tax reform. Our written testimony also discusses this year's Economic Report of the President.

Let me start with the U.S. economy. Economic growth in the United States is robust and 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 first 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 projecting real GDP growth of 3.9 percent in the first quarter and 3.6 percent in the second quarter.

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.

Turning now to 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 this debate. By now the numbers are familiar. In 1950, there were 16 workers for every 1 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 around 2017, the program will begin paying out more in benefits than it receives in revenue. 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 prefunded system. Instead their taxes are 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 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 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. Second, there should be no increases in the payroll tax rate. Third, the program must be permanently fixed. Short-term funding fixes are not acceptable. Finally, the Social Security system 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.

Reforms in addition to personal retirement accounts 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 would permanently fix the system.

Turning now to taxes. This year's Economic Report of the President highlights the need and opportunities for reforming our Tax Code. It outlines the pros and cons of various reform prototypes. The report does not make recommendations, which will be the responsibility of the tax 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 lead to inefficient use of resources. Consequently, taxes reduce economic welfare by an amount that exceeds revenue collected. Economists call costs above and beyond the revenue collected the excess burden of the tax system.

One recent academic study estimated that for the tax system, the excess burden associated with increasing taxes by $1 was $0.27 before President Bush took office. In other words, the total cost of collecting $1 in additional 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.

The tax relief over the last 4 years has reduced the excess burden of income tax by also enhancing progressivity, but there is more to be done. The President has appointed a bipartisan blue ribbon panel to study tax reform and report back to the Secretary of Treasury by July 31st of this year. The Administration looks forward to working with Congress to achieve the much-needed goal of tax reform.

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 address trade, enact legal reform, improve access to health care, use our energy resources efficiently, and rationalize the regulatory system.

Mr. Chairman, I ask that the written testimony be included in the Committee record. We welcome your questions.

My colleague Dr. Kristen Forbes handles international economic issues for the Council and will need to leave at around 10:45. We would appreciate any questions for her to be asked before that time. Thank you very much.

Representative Saxton. Thank you very much.

[The prepared statement of Harvey S. Rosen appears in the Submissions for the Record on page 30.]

Representative Saxton. Dr. Forbes, do you have a statement?

Dr. Forbes. No, actually.

Representative Saxton. OK.

We are going to operate the Committee under a 5-minute rule, so each of the Members will have 5 minutes to ask their questions, including the Chairman, I might add.

I have noticed that many economic forecasters project first quarter growth was about 4 percent. The Blue Chip consensus for 2005 quarterly growth rates are as the chart here indicates, 3.9, 3.6, 3.5, and 3.3, respectively.

Can you give us your take on those projections? Do your projections track along that general line? Would you comment on that for us?

Dr. Rosen. Yes, sir. Our forecasts for the year were made last December, based on November data, and at that time we were projecting GDP growth for the year more or less along these lines. Unlike the blue chip, we do not periodically update our forecasts, but what we have noticed is that the blue chip has not really changed theirs very much. And so it seems to me that, you know, the economy is on track, and the expansion is moving forward. And, you know, the blue chip story about the next year is also quite consistent with what we show moving forward.

Representative Saxton. And what do you show for 2006?

Dr. Rosen. OK. We have 3.5 for 2006; the blue chip is showing 3.4, I believe, for 2006. So, you know, I think the basic point is that the GDP forecasts that we are making are quite in line with the consensus among the private sector forecasts, and that consensus is for continued expansion that is sustainable and solid.

Representative Saxton. And I expect that, given those positive numbers, that we can expect expansion as well in terms of job growth?

Dr. Rosen. Sir, yes. We are predicting substantial job growth. The forecast that we put out back—that we made back in December, calls for job growth of about 175,000 a month. That is moving forward nicely. As you mentioned in your remarks, sir, the record for the last year has been very good on job growth. The job market is showing strength. The most recent data we have on that just came out this morning, which is that new unemployment insurance claims for the past month were at a level that is another independent piece of information that the job market is firming up. So yes, we see continued job growth.

Representative Saxton. Thank you.

Dr. Forbes, I have noted that the European Union is in the process of making changes, reforms if you will, to try to boost their job growth in particular. But I also noticed that in countries like Germany and Italy and other European Union countries, the unemployment rate seems to be significantly higher than ours. In Germany, I believe it may be in double digits. I am not sure exactly what the numbers are in Italy. But there seems to be a systemic set of issues in Europe, and Japan as well, that appears to be causing a high rate of unemployment.

Can you speak to what their problems are and perhaps explain why it is that we are doing so much better than they are?

Dr. Forbes. That is an excellent question, and actually very good timing in conjunction with the World Bank/IMF meetings that are taking place this weekend. There is a lot of discussion on this topic, and new growth forecasts were just released for the U.S. and Europe and the global economy. And the IMF new data released confirms what you just mentioned. Growth in Europe is expected to be very slow this year. The IMF projects that growth in the Euro zone will be 1.6 percentage points. Growth in the U.S. is projected to be 3.7 percent. Growth in Japan is projected to be less than 1 percent this year. So the U.S. this year is expected to grow more than twice as fast as Germany, Italy and Japan.

It is just a remarkable contrast. And at the same time, as you pointed out, unemployment is very high in Europe. Unemployment is in double digits in Germany, France and Italy as compared to 5.2 percent in the United States.

There is a sharp contrast in economic performance in the U.S. compared to the other developed countries in the world, and a major reason for this difference is structural rigidities in Europe; very inflexible labor markets; excessive regulation, especially in product markets. So it makes it very hard for companies to compete and do business and hire new workers.

A great example is how hard it is to start a new business. New businesses—entrepreneurship—has been a key driver of growth in

the U.S. In the U.S., it takes about 5 days to start a new business. In Germany it takes 45 days to start a new business. In Japan it takes over 30 days to start a new business. So it is regulation such as that that makes it hard to just start a new business in Europe and Japan, which are key factors causing their slower growth compared to in the U.S.

Representative Saxton. I am just going to take the liberty here to ask you to comment on the differences in tax systems among those several countries and our country.

Dr. Forbes. Different countries in Europe and Japan do have different tax systems. One major difference, though, is that the tax systems in Europe are more biased toward taxing consumption. The VAT is more prevalent in Europe than in the United States.

One big difference is that if you look at the tax rate on savings in the U.S. versus consumption in the U.S., we tend to tax savings relatively more; consumption relatively less. In Europe they tend to tax consumption relatively more and savings relatively less. That is one area where, according to some standard economics, there is room for improvement in the U.S. economy. And those differences in tax rates are one reasons why savings does tend to be lower in the U.S. and higher in Europe.

Representative Saxton. Thank you. We are going to move on. We have this 5-minute rule that we use to make sure that everybody has an equal chance to ask questions, so we will move at this point to Mrs. Maloney, and we will be back for more questions in a bit. Thank you.

Representative Maloney. Thank you, Mr. Chairman. And welcome, Chairman Rosen and Dr. Forbes.

Basically why are we not seeing stronger wage growth? This week the *L.A. Times* ran this story: Wages Lagging Behind Prices. Inflation has outpaced the rise of salaries for the first time in 14 years, and workers are paying a bigger share of the cost of their health care.

Then the next day, *The New York Times* ran this article: The Falling Fortunes of Wage Earners.

So my first question is why, when we have experienced very strong growth in labor productivity, why are we not seeing a stronger growth in wages? Dr. Rosen or anyone.

Dr. Rosen. I will give it a try. From an analytical perspective, it is a challenging problem to characterize what has been happening to wages. One has to know what growth of wages we are looking at, whether before tax or after tax, whether it includes benefits or not. Personally, I think that the single best measure for looking at whether, you know, how a typical person is doing is that person's disposable income, the amount of money they have left in their pocket, and in the latest year disposable income per person has gone up by about 2.3 percent. That is progress. I think the President believes more work needs to be done.

Representative Maloney. But has not, Chairman Rosen, most of the growth in labor productivity boosted the profits but not wages?

Dr. Rosen. We have witnessed astounding increases in productivity in the last several years.

Representative Maloney. But that has translated into profits but not wages? Is that——

Dr. Rosen. Ultimately that increase in productivity, both in terms of theory, common sense and historical evidence, will increase real wages as well.

The other thing, ma'am, I would just want to point out is that one should also take into account benefits when looking at compensation. And when we look at compensation per person, including the value of health benefits and so on, that has been increasing as well. Again, certainly more needs to be done.

Representative Maloney. But haven't wages been growing more slowly than prices recently? Haven't wages lagged behind the increases in prices? That is what these articles are saying.

Dr. Rosen. There are a variety of measures for looking at what has been happening to the return to labor, and I think the more comprehensive ones that include benefits and taxes show some increase, although I think that more work needs to be done in this area to assure that we have an economy where workers can realize their full potential and where the productivity gains will translate into——

Representative Maloney. And you mention that while you are looking at wages, that you have to also look at the benefits that they have. So when employers' costs go up because they have to pay more for health insurance, how does that affect our measure of wage growth?

Dr. Rosen. When employers' health costs go up, some of that will be translated into the total compensation package that workers receive. And another important issue is whether or not health costs are, you know, increasing at a greater rate than is reflective of what we are getting out of the increased health care dollars. And an important issue going forward, actually, I think, is trying to rein in excessive health care growth.

Representative Maloney. Because workers are subject to a squeeze basically in their take-home pay as employers have to pay more for health insurance, and if employers then are shifting more of the burden of rising health care costs onto their workers, does not that reduce the purchasing power and the take-home pay even more?

Dr. Rosen. I think that rising health care costs is a serious issue. There are several proposals on the table to try and deal with this problem. One of the most important, I think—it is not a proposal, it is enacted legislation—is health savings accounts, which would allow individuals——

Representative Maloney. And I am very concerned about the growing wage inequality that this chart shows. And basically why hasn't the Administration's tax cuts—they failed to boost the earnings of middle- and moderate-income families, according to this chart from the Department of Labor. I don't know if you are familiar with it. They publish the data on the usual weekly earnings of full-time workers. They show that since the end of 2000, median earnings have increased by just 0.2 percent per year. After inflation, earnings at the 90th percentile have risen by 0.9 percent per year, and earnings on the 10th percentile have fallen by 0.3 percent.

Is this satisfactory as to wage inequality at the same time that overall wage growth is stagnating so that wages in the lower part of this distribution are actually falling? Are you familiar with the chart?

Dr. Rosen. I am not familiar with the specific graph, ma'am; however, a couple of comments. Again, one needs to be looking at aftertax measures and all groups—all income groups experienced tax relief as a consequence of the President's tax proposals.

The other is that I think that one of the most gratifying things about the expansion that we have been experiencing the last year or so is how widespread the benefits have been across all groups and populations. Unemployment rates have fallen for college-educated people, high-school-educated people, people without high school degrees, for all ethnic groups in all regions, for all income classes. And I think it is a very important aspect of the expansion to note.

Representative Saxton. Thank you very much. The gentlewoman's time has expired, and we are going to go at this point to Mr. Cummings.

STATEMENT OF HON. ELIJAH E. CUMMINGS, A U.S. REPRESENTATIVE FROM MARYLAND

Representative Cummings. Thank you very much, Mr. Chairman, and Chairman Rosen, Dr. Forbes.

Tell me, talk about how the economy is affecting jobs in manufacturing. We are seeing in my district a GM plant closing, a lot of jobs gone. We look at the South and look at a State like Ohio and see jobs disappearing. During the election that seemed to be a major theme. And I am just wondering exactly is that a fact that we are losing these jobs? And are we getting any of them back? And if we are getting them back, are we getting them back with wages as they were, say, before President Bush came into office?

Dr. Forbes. I would be glad to answer that question. Manufacturing has faced an extremely challenging few years. There is no doubt about that. And when you look at why manufacturing has faced such a challenging few years, and especially the cause for a lot of the job losses in manufacturing, it basically comes down to two major factors. One is short-term causes in the nature of the recession we just faced. The recession we just went through was largely caused by a sharp slowdown in investment and by slow growth of exports, largely due to slow growth abroad. And the manufacturing sector is most closely linked to investment in the export sector. So the two sectors of the economy which most influence manufacturing—investment and exports—were most severely hurt in the recent recession, and that is the reason for the falling manufacturing employment over the last few years.

A second major cause for the challenges manufacturing has faced are longer term, and it is actually a mixed blessing in a sense. Manufacturing in the U.S. has been very productive. Productivity growth in the manufacturing sector has been much higher than in the U.S. economy as a whole, and, as a result, manufacturing in the U.S. has been able to produce more output at a lower cost, which is good. It increases the competitiveness of U.S. manufacturers.

But the flip side of that is that manufacturers in the U.S. can produce more at a lower cost with fewer workers, and this is a longer-term trend that not only the U.S. but all developed economies and even developing economies like China are struggling with. Even China has lost 15 million manufacturing jobs since 1995.

So this longer-term issue, higher productivity growth in manufacturing, which often translates into lower employment, is a challenge that countries around the world are facing.

You put these two factors together, this longer-term high productivity growth in manufacturing combined with a shorter-term nature of our recession, focused on investment and exports, has meant a very difficult few years for manufacturing, as you have experienced. So that is the bad news.

The good news, though, is what has been happening the last year or so, and the evidence suggests that manufacturing is turning around in the U.S. as a whole. Manufacturing employment has increased by 33,000 jobs since February of last year. Many of the indicators which we track to follow the manufacturing sector are showing continued strong growth. For example, one that we follow closely is the ISM Manufacturing Index for Employment, and that has been above 50 for 20 months. When the index is above 50, that suggests continued expansion in manufacturing. So that is another very positive indicator.

Also we are seeing a turnaround in exports. Export growth has picked up after the recession as growth around the world has picked up. Also, we are seeing a sharp pick-up of investment. Investment growth last year, investment of business in equipment and software, was very, very strong, and early indicators for this year suggest that investment growth will continue to be strong.

We are seeing a turnaround in investment and exports, which are the two sectors most closely linked to manufacturing; this suggests we should see a continuation of this turnaround we have seen in manufacturing, and we do expect continued strength in that sector.

Representative Cummings. Thank you.

Chairman Rosen, you talked about disposable income.

Dr. Rosen. Yes, sir.

Representative Cummings. In your opening statement, you also talked about things like gas prices, gasoline prices being volatile. When you talk about disposable income, are you excluding the costs of gasoline?

Let me tell you why I say that, because it is really hitting my constituents, as I am sure all over the country, very, very hard. That is the number one complaint I am hearing right now. And I realize it is going to change, it goes up and down. But I am just wondering when you talk about disposable income in reference to an earlier question, is that included?

Dr. Rosen. Yes, sir. The answer is that disposable income is computed by taking into account changes in all prices, including gasoline. So that would be included.

I should go on to say that the increase in fuel prices is causing distress to families, to businesses, and creating headwinds for the

economy as well. And the President has a package of proposals on the table to try and address this problem.

Representative Cummings. Thank you, Mr. Chairman.

Representative Saxton. Mr. Cummings, thank you very much. Ms. Sanchez.

Representative Sanchez. Thank you, Mr. Chairman. And thank you both for being before us today.

The first question I have is one that I have been pondering for a while, and it really has to do, I guess, looking out into the future; future meaning, you know, you spoke about Social Security, so I guess future could be 40 years from now. But this is what I worry about. At a time when the load of workers versus the people who are retired is becoming smaller, as you said, and if you go around the country—I mean, it is incredibly evident in California, but I have been to almost every State, and I see this trend, and you look at fact that the children who are in our kindergarten-through–12th system are increasingly majority Hispanic. In California, in particular, we see it, and where California goes, so does the rest of the Nation.

And then when I look at the fact that the Hispanic dropout rate is about 25 or 29 percent out of high school, and, quite frankly, I think it is a lot closer to 50 percent, because if a kid drops out in the 11th grade to get a job at McDonald's, that is not considered a dropout. At least in California we do not count it that way.

So when I look at the fact that the workforce of tomorrow for the United States to a large extent is going to be who we have in our school systems right now, and I see them dropping out; and then I see the President's policies with respect to education, the elimination of GEAR UP, for example, a program that starts in the eighth grade, and mentors and works with kids, and makes them take the right classes, Hispanics in particular, so that they will go on to university; when I look at the universities today, and I see half of the kids at least in our graduate programs in math and science are foreigners, at least half of them—and by the way, most of those classes are being taught by foreigners—and when we look at the crunch that we have on H1-B visas and other issues with respect to bringing foreigners in for these types of work, I guess the question I have for you is have you thought about the fact that we are not investing in education to the extent we should be, and that the kids who are coming up through the system are increasingly kids that have a known trend of not even graduating high school? What do you think about the fact that the President is cutting these programs in education? How do you factor that into the future—have you factored it into the future in your calculations as to how productive we will be?

Dr. Rosen. I think that education is incredibly important for the growth of the economy, for the growth of the economy and for the welfare of the individuals in that economy. I know the President believes that as well. And that is one of the reasons why he endorsed the No Child Left Behind program, which goal is to increase accountability at schools and to get a better job for all of American kids.

Representative Sanchez. But, you know, he shorted it $9 billion. I know you do not know education policy. I am just trying to

understand if in your calculations you guys are even looking at what the future really holds for Americans here. I am very worried that when I retire, there aren't going to be our people working jobs because we are not going to have the education base for it if we are losing all of these manufacturing jobs, and do not worry, we are going to have the high-value jobs.

Dr. Rosen. We are certainly concerned about the future productivity of the labor force, and a vibrant education sector is critical for that. I mentioned programs at the grade-school level. Opportunity to go to college, I think, is very important as well, and to community colleges. California, of course, has a wonderful community college system.

Representative Sanchez. And we would like to keep it that way.

Dr. Rosen. I think the Administration has been allocated funds to help the community colleges, beefed up Pell grants.

Representative Sanchez. I had my community colleges in yesterday, and I know this is not your area of expertise. Maybe you could go back to the President and tell him, maybe you should take a look at this and sit down with the Secretary of Education. Frankly, my community colleges came in, and they are beside themselves as to how this President could be cutting programs and Title III and things that I know are not your area of expertise. I do not mean to put you on the spot about that.

I am very concerned about the productivity of our workers, and I know that it depends on the type of education that we are providing, just as it was for me. And I don't think this President is doing a good job there. So maybe you could go back and kind of tell him, look, there are some people very concerned, we are all concerned, about the productivity of America.

I have a second question. This has to do with the textiles dumped by China. Have you figured that in? I think I read, and I don't know the numbers, but this past month was just—you know, the gap was very wide. The dumping is just coming in. Maybe you could talk to us a little bit about that and how you see that playing out.

And I tell you, I have a large manufacturer in my district and it is very rare to see: American-made clothes, for example. I know within a year or two, the CEOs at the top who are making lots of money are, you know, just scrambling to get their plants into China and wanting to dump 5,000 workers out on the streets. So I am very concerned about this textile dump happening, especially coming from China, but, of course, from all places.

Dr. Forbes. The increased imports of textiles from China is something that we have been paying very close attention to and a concern that has been on our plate for a while. When we negotiated China's extension into the WTO, we knew this would be a challenge. We also know that having China join the world trading system and become a member of the WTO would yield substantial benefits for the U.S. and the global economy. Right now China is our fifth largest export market, and we have seen exports to China increase by 115 percent since the year 2000.

Representative Sanchez. What about the imports from China coming in? The trade gap is getting wider.

Dr. Forbes. Right. It is important to realize we get tremendous benefits from trade with China, but as part of China coming into the WTO, one of the challenges for us was going to be increased imports from China and especially in textiles. And we knew that is where we would face large competitive pressure.

So when we negotiated China WTO extension, we actually put in place a number of mechanisms to try to help ease this adjustment. We knew it would not be easy, but we specifically put greater restrictions on China's imports of textiles. So we phased that in much more slowly than other imports of other goods to try to give U.S. companies the time to adjust.

Representative Sanchez. But that is over.

Dr. Forbes. Right. Now that is gone. And so we are facing that challenge. So what we are trying to do now is use some other mechanisms we included in the WTO negotiation. One was we negotiated a very specific mechanism, called a safeguard mechanism, which would let U.S. companies that have faced increased textiles from China file special cases and get protection where imports from China would be limited to only increase by a small percent a year. We have this special mechanism in place only for textiles because of the concerns which you raised, and we have already accepted three cases under the safeguard petition last year. We just accepted another set of cases to consider to enact these safeguards for.

So it is something we are looking at. We are using the mechanisms we specifically put in place, because we were worried about these surge of imports. But we realize that is not going to make up for the full adjustment. There will be increased imports of textiles from China, and so we also have expanded some of our adjustment programs in the U.S. to help workers who could lose their jobs because of the textile imports. In just since January 2002, we have actually expanded trade adjustment assistance, and we have given special trade adjustment assistance to 100,000 textile workers to try to help them get new training and get new skills and adjust to getting new jobs in new sectors.

We fully sympathize with the challenges you are facing. We know it is a big concern, and it is something that we have been working on for years to try to get the mechanisms in place to try to help ease this adjustment and ease this transition process.

Representative Saxton. Dr. Forbes, thank you very much.

Ms. Sanchez, thank you.

I am going to go to the gentleman from Binghamton, New York, Mr. Hinchey.

Representative Hinchey. I would like to have been from Binghamton, Mr. Chairman. It is a little bit further east of there.

Representative Saxton. OK.

Representative Hinchey. Good morning, Dr. Forbes and Chairman Rosen. It is very nice to see you and have an opportunity to listen to you about the Nation's economy. You seem, in your testimony to me, Chairman Rosen, to be very optimistic about the future of the economy as well as its present conditions, and I certainly hope you are correct. But when we look at the actual figures, I think that there is reason to suspect otherwise.

The principal economic strategy of the Administration seems to be focused almost exclusively on tax reductions that would benefit

primarily the wealthiest, most affluent people in the country, and the belief that that would somehow favorably affect others as well. But the consequences of that and other actions seem to have taken the economy in a very different direction.

If you look at the history of the budget deficits, for example, we went from a period of 3, 4 years of continuing budget surpluses to now a situation where we are facing continuing and rising budget deficits, record budget deficits as a matter of fact. The national debt in the last 4 years has almost doubled. The trade deficit has now reached record proportions.

So we have records in terms of the annual budget deficits, the national debt, and the annual trade deficits. In recent months we have seen records on a monthly basis in terms of the trade deficits as well.

And in addition to that, we do not seem to be experiencing a situation where any of the economic benefits are affecting the majority of people. In fact, the situation seems to be going in the opposite direction. The median annual income of the average working family has dropped by $1,400, and the number of people working in our country as a percentage of the population has gotten down to the point where it was in 1988. So there are more jobs being created, but they are not being created at a pace that is sufficient to employ people in our economy.

So I am wondering how you respond to those situations. You made some statements, I think, earlier about the situation here in the United States, or maybe it was you, Dr. Forbes, with regard to circumstances here vis-a-vis those in Europe. But when you look at certain other factors, we have 2 million people in prison in this country. Europeans do not have anything like that. Those people are taken out of the picture. And there are an awful lot of people who simply have dropped out of the job market. And that number seems to be increasing as well.

So what do you make of all of those figures and the fact that there are observers out in the private sector who are increasingly becoming pessimistic, particularly in regard to all of that data, coupled with the fact that interest rates are now going up, and the main factor in our economy, which seems to have been sustaining whatever growth we have had, the housing sector, is going to be threatened, the continuation of that growth in the housing sector is going to be threatened by these rising interest rates?

Dr. Rosen. One of the issues you mentioned, sir, were the deficits. OK. I think to begin it is useful to put the deficits in context. In terms of nominal dollars, they are very high. When you look at them as a proportion of GDP, which is the way economists normally do, they are still high, but within the realm of recent experience.

That said, the deficits are higher than the President wants them to be, and, therefore, he is committed to halve the deficit between 2004 and 2009, and the budget that he submitted several months ago puts us on that path. The path is one that achieves its goal in terms of spending restraint.

In terms of the effect of the tax cuts on the fiscal status of the Government, of course a very critical question. According to the estimates that were done in the last midsession review, which I think

was the last time we did computations of this kind, about 35 to 40 percent of the—of the change in the fiscal status of the government was associated with the tax cut. The rest was due to the slowdown in the economy and increased spending, much of it for the war on terrorism.

Representative Hinchey. Or the war in Iraq.

Dr. Rosen. Yes, sir. And as a consequence, one might ask, well, were running those deficits toward the beginning of the Administration sensible fiscal policy? I think that the President decided that it was more important to put people back to work, put them back to work sooner, get the economy back to its full employment path sooner by running those deficits. That is a sensible short-term strategy. Medium-term strategy, though, as I mentioned before, is to get that down again. And that is the path outlined in the budget that the President submitted to Congress.

With respect to the trade deficit, do you want——

Dr. Forbes. Sure. With respect to the trade deficit, you are correct, the trade deficit is very large in absolute value as well as a percent of GDP. There are some people who urge us to reduce the trade deficit, and I agree I would like to see the trade deficit fall at some point, but we also have to be careful about how to reduce the trade deficit. There are so many factors that cause a trade deficit, it is hard to sort out which are signs of strength and which are signs of weakness.

And again, making the comparison to Europe, which you raised, in the U.S. we do have a large trade deficit; the growth is very high. The UK also has a fairly large trade deficit; growth is fairly high. Australia and New Zealand have large trade deficits comparable to the U.S. Their growth is very strong. Germany, Japan, growth is very slow; growth has been contracting or stagnated. And they have large trade surpluses. So I don't think anyone would want to get Germany's trade surplus or Japan's trade surplus if it comes at the expense of much slower growth.

And there is this relationship where countries which grow faster do tend to buy more imports from the rest of the world. Countries which grow slower buy less imports. And therefore, that can contribute to larger trade deficits for fast-growing countries and smaller trade deficits for slower-growing countries.

So I do agree I would like to see the trade deficit fall, but we do need to be careful about how that is accomplished and realize that in some ways the trade deficit actually reflects the strong growth in the U.S. economy compared to strong growth in our trading partners.

Representative Hinchey. If I may for one second, I think a lot of it has to do with the propensity of the American Government and the American people to go into debt, and the personal debt of this country is at a record level as well as the Federal Government's debt being at a record level. One might come to the conclusion that it is not a function of the strength of the economy, it is the willingness of people to borrow enormous amounts of money and spend it without any clear indication that that borrowing is going to stop at any point in the future, or if it does, it will have cataclysmic results.

Dr. Forbes. You are right. As I said, there are many factors that cause the trade deficit, and the low level of savings in the U.S. is a major cause for a trade deficit. Basic economics is the trade deficit is equal to the shortfall of national savings relative to investment.

And you are right, if savings increase in the United States, that would decrease the trade deficit. But I do want to make the point I think people overstate the relationship between our budget deficit and our trade deficit. There definitely is a relationship. Holding everything else equal, a larger budget deficit means a larger trade deficit. But if you actually look at the numbers, it is a very weak relationship. Look at the late 1990's. Our budget deficit actually went from a deficit to a budget surplus, and our trade deficit——

Representative Hinchey. I am not suggesting any strong relationship. I am just suggesting that the two things are working out there, and they both have negative consequences.

Representative Saxton. Thank you, Mr. Hinchey. The gentleman's time has expired.

Mr. Hinchey brought up a good subject. As I look back at the last couple of decades in terms of economic growth, we saw the economy begin to grow strongly in the early 1980s, 1983, 1984, timeframe. And with the exception of a very short and shallow recession in 1990–1991, and another short and shallow recession just a couple of years ago, we have seen some fairly remarkable long-term economic growth during the decade of the 1980's and during the decade of the 1990s. And we see economic growth taking place again today.

We had some tax relief legislation that we passed in 2001, 2002, and 2003, which appears to have, as you may have mentioned, Mr. Chairman, some effect on economic growth. Over the last couple of decades, Dr. Forbes, what do you think has been the result of tax policy on the economy? This is a fairly remarkable period of economic activity that we have had over the last couple of decades. What has tax policy had to do with that, and, more specifically, the most recent tax relief programs that Congress has put into place?

Dr. Forbes. Actually I will give that to Harvey Rosen, who is a leading expert in tax policy.

Dr. Rosen. Mr. Chairman, I think taxes play a very important role in the growth of the economy; that in order to have a resilient economy, you have to have people working, saving, investing, and all of those decisions are in principle affected by the tax rates they face.

So we need a tax system to sustain growth that provides good incentives for working, saving, investing and other useful economic activity.

And I think that one of the reasons why we have done so well is that in this country, compared to many others, we have tax rates that are relatively low. I think that we can do better if we make rates lower yet, particularly on saving and investment.

In that context, I would like to focus particularly on business taxation and make a couple of points. First of all, as Kristen mentioned before, entrepreneurship is really important when you are talking about growth. And entrepreneurs are—especially S-corps and sole proprietors are taxed at individual tax rates. So when we

talk about tax relief, we are not only helping out American families, but we are providing the wherewithal for businesses to grow.

The second thing I want to point out in the context of taxation and its relationship to growth, we have to be mindful of the way the corporate sector is being treated. We have a very odd system in this country where we double-tax corporate income. First it is taxed at the corporate rate, and then when it is distributed to individuals as dividends, it is taxed again. This creates a bias against the organization in a corporate form, one of our most productive vehicles for economic growth. It biases firms in favor of debt rather than equity finance and creates a variety of distortions that keeps growth lower than it would have been otherwise.

And one of the, I think, most important aspects of the President's tax relief is the lowering of taxes on dividends and capital gains, which is in effect lowering the double taxation on corporate income.

So in sum I think that the tax environment is important for growth. It is common sense, it has been documented in economics literature. And, you know, when the President constituted the advisory tax panel on tax reform, part of his charge to them was to consider ways in which the tax system would be reconfigured so that it would even be more friendly to growth.

Representative Saxton. Would you talk about that for a moment? What do you think, or what does the Administration think, that tax policy should be going forward?

Dr. Rosen. The key thing at the moment is that the tax cuts be made permanent, that the tax relief be made permanent, that the estate tax be eliminated, and all of those programs be made for the long term.

With respect to tax reform, I think the President has laid out certain principles that he thinks should guide the reform. It should be—it should enhance growth. It should reduce the complexity of the tax system. He has called the tax system a complicated mess, and I think many Americans use less gentle language when they are talking about their tax returns. I guess tomorrow is Tax Day, so this is on everyone's mind at the moment.

He has emphasized that future movements of the tax system should try to enhance fairness, that people should all pay their fair share. He has emphasized that the system should be progressive. That is very important to him, that higher-income people pay a higher share of their incomes.

He has also emphasized that the tax system should take into account the special role of housing and charitable giving in the American system.

So, Mr. Chairman, the President has not made any decisions on a particular prototype, and, in fact, he is awaiting the recommendations of the tax panel. He has laid out some principles which show the direction he would like the tax system to move.

Representative Saxton. Uncertainty in the economy can play havoc. I have noticed in recent days uncertainty existing in the economy because of energy prices. Recently we have seen uncertainty exist in the minds of people who are working in the economy because of the global war on terror.

Likewise, does not the temporary nature of the tax cuts that we put in place create uncertainty and play havoc with the economy?

Dr. Rosen. Yes, sir. I think that uncertainty makes it very hard to make decisions. Many of the most important decisions we make in life, both as individuals and in our professional roles, are long-term. If you are starting a business and you want to know should I invest in this or invest in that, is this innovation worth following up, you need to know something about what the returns are going to be over time, and that depends in large part on the tax system. And if you do not know what the tax system is going to be, I believe it will tend to inhibit people from making those sorts of decisions.

So, yes, sir, I think that it would be a wonderful thing to have a more settled tax system so that people have some certainty with respect to the tax environment that they will be facing.

Representative Saxton. Thank you very much.

Mr. Cummings, would you like another round here?

Representative Cummings. Yes, please.

Dr. Rosen, going back to Social Security and private accounts, it is estimated that we are going to spend billions with regard to these private accounts. And the President has been not very clear on where this money is going to coming from. Do you know? We have been trying to get an answer to this, and maybe you know, since you are the man for these issues.

Dr. Rosen. Sir, the personal accounts do involve transition financing, and here is the way I think about it. Social Security has promised some benefits to people in the future. Under the President's proposal, if you voluntarily choose to set up a personal account, then some of your—some of your payroll taxes are diverted into your personal account.

Now, this requires some transitional borrowing in order to help finance current benefits. But really what is going on, I think, is that we are just putting on the books obligations that the government already has; that is, we have promised these benefits in the future. What the transition borrowing does, the transition funding does, is puts those obligations on the books and in effect is prefunding those obligations.

Maybe let me put it another way. When we think about conventional debt finance, the debt is being used to buy more stuff, whatever the government is buying in terms of goods and services. Here we are not expanding the size of the public sector. All we are doing is putting on the books obligations that have already been made. In a way it is like prepaying a mortgage. So it is not changing the long-term fiscal stance of the government.

Now, with respect to magnitudes, there will be substantial amounts involved. The President's proposal would have the personal accounts phased in in a way so that—which is prudent, I think—so that financial markets will have a time to adjust and, you know, not have undue effects on financial markets.

Representative Cummings. Well, you know, the analysis by our staff and others—and this is what Senator Reed said earlier—shows that the President's private accounts plan would require a massive increase in the public debt that is not simply a short-run transition cost. Rather the additional debt would reach 35 percent of GDP by 2060 on top of a debt already equal to 37 percent of the GDP today. Is that accurate, do you think?

Dr. Rosen. The numbers do not resonate.

Representative Cummings. Is that because you disagree with them? What do you mean, they do not resonate?

Dr. Rosen. What it means is from the point of view of the long-term fiscal stance of the government, the personal accounts are approximately neutral, and the reason is because the transition funding that is needed is offset by—for the people who elect the personal accounts, is approximately offset by benefit reductions from traditional Social Security that they will have in the future. So it is a wash.

Basically we are saying, I am going to take some of my payroll taxes, put it into a personal account. That means that there is going to have to be some borrowing to make up for the fact that that money is not available to pay current beneficiaries, but in the future your traditional Social Security is going to be reduced by an amount that takes into account what the government—the government borrowing rate so that from the point of view of the long-term fiscal stance of the government, it is about neutral.

Representative Cummings. Well, what are the chances that that person, the person who participates in these savings accounts, what are the chances that they are going to get what they would have gotten had Social Security just stayed the way it is and we did some things like upping—going above the 90,000 and other things like that and kept it solvent, since personal accounts do nothing for solvency? I am just curious. That is the question that my constituents—they are trying to figure out what is this all about? Will it be a wash? Why are we going through these changes for a, quote, wash? And they worry about that, and because they do not know whether these figures are accurate. They have seen some inaccurate figures in the past; i.e., the costs of the prescription drug program. So they are not sitting there just thinking that everything is accurate.

Dr. Rosen. The promises associated with scheduled benefits can't be kept. We know that we are $11.1 trillion in net liability to the system. The personal accounts allow individuals who voluntarily opt for them to make up for the fact that these scheduled benefits can't be kept. That is by investing in a prudent portfolio, diversified assets, that individuals will be able to make a return that will give them the chance to make up for the fact that the scheduled benefits simply can't be kept.

Now, in terms of trying to deal with the solvency problem by raising the cap, I think it is important to note that raising the cap by itself, it won't do the trick. That is in terms of filling the $11.1 trillion shortfall, it just does not go very far.

Representative Saxton. Since Mr. Cummings has graciously brought up this subject, we know that Social Security has got long-term problems as it is currently configured. We know that it can't sustain—we know that we can't sustain the program without significant changes.

Could you just take a minute and discuss—you discussed what the President has suggested, his basic parameters. What are the options? We hear a lot about the personal voluntary investment accounts. What are the other options? Can you just discuss them for a few minutes?

Dr. Rosen. Yes, sir. The President has indicated that when it comes to reform of the system, he is willing to consider a wide variety of options; that he wants people to understand there is a problem, work together to solve that problem. And, in fact, he mentioned several of those options in his State of the Union Address that have been proposed over time from people from both sides of the aisle.

Representative Saxton. Dr. Rosen, excuse me.

Dr. Forbes, I know you have to leave. Feel free when you have to go.

Dr. Forbes. Thank you. I was going to wait until he finished and then apologize. Thank you very much.

Dr. Rosen. So, some of the options, you know, that came up—I feel lonely.

Representative Sanchez. Now we are really going to go after you.

Representative Saxton. We are still here.

Representative Hinchey. We are your friends. Don't worry.

Representative Sanchez. We are?

Dr. Rosen. Some of the options that came up, that the President listed in the State of the Union, were reexamining the indexing system by which benefits are calculated. Another one that came up was——

Representative Saxton. In plain language that means benefit cuts?

Dr. Rosen. The—plain language? The—if we were to move from a system of wage indexing to price indexing, benefits in real terms would actually increase. They would not be as high as the scheduled benefits, but the scheduled benefits are not sustainable. So what we are talking about is cuts relative to the unsustainable promises that have been made.

Another option that the President discussed was longevity—or mentioned was longevity indexing, which essentially relates to increasing the age at which benefits can be received. A third possibility, I believe, that was listed in the State of the Union was changing the benefit formula.

So there is a variety of ways in which reform could be achieved. And as I mentioned before, the President is interested in getting a dialog going to find a set that will achieve some kind of bipartisan acceptance.

Representative Saxton. One of the options which the President apparently believes is off the table is to remove the cap, which—and I say "believes it is off the table" because that is, in effect, a tax increase. But if Congress were to decide to remove the cap, what would that do to solve the problem?

Dr. Rosen. I do not have the specific numbers on what proportion of the gap——

Representative Saxton. Would it provide a permanent fix?

Dr. Rosen. Oh, no, sir, it would not provide a permanent fix. The Social Security actuaries have done some estimates. I just do not have the numbers.

Representative Saxton. Would lifting the cap have any effect on economic growth?

Dr. Rosen. In general, I think when tax rates go up, the effect is to reduce labor supply, which would have a negative impact on growth.

Representative Saxton. Any other options that are out there that we have not discussed?

Dr. Rosen. Nothing is coming to mind at the moment.

Representative Saxton. So we have a system that is unsustainable, and the options that have been talked about involve tax increases and potentially lower levels of benefits.

Dr. Rosen. Relative to the scheduled benefits. And, of course, the personal accounts, which I think when we are talking about reform of the system, it is something we should not just put off to the side, because the personal accounts will give people the opportunity to make up some of the loss from the scheduled benefits that are no longer possible. And, in addition, they have the further advantage, which is by taking the money, putting it into individuals' accounts with their names on it and over which they have ownership, it makes it much less likely that any Social Security revenues coming in will be spent on other items as opposed to actually being saved to fund retirement benefits in the future. So I see the personal accounts as an inherent part of the whole package, including reform.

Representative Saxton. Thank you.

If my colleagues will give me one of the prerogatives of the Chair here for one final question. What would happen in the life of a 30-year-old person who is currently in the Social Security system who opts to voluntarily set up a savings program for himself or herself? What would happen long term? Just kind of walk us through it.

Dr. Rosen. Sure, I would be happy to. You are shaking your head already?

Representative Sanchez. I just want to hear your response. I am—speak to it, because I have more important things to ask you about than to go through this silly Social Security thing, but let's hear it.

Representative Saxton. My constituents do not think Social Security is silly, Loretta.

Representative Sanchez. This is being discussed in every corridor. I would love to hear this answer.

Dr. Rosen. Here is what happens to the 30-year-old. What she does is she can take 4 percent of her payroll tax, put it into a personal account. In return, I mean just for fairness, the benefit that she gets from Social Security, traditional Social Security, in the future will be reduced by an appropriate amount.

Then, now she has her own personal retirement account, and she can invest it as—within certain guidelines. And the guidelines that the President has proposed are very similar to the Thrift Savings Plan that we all have as an option. There are certain broad-based accounts, broad-based securities, stock, mutual funds, that kind of thing. And then they can invest in a portfolio depending on their preferences. It has their name on it.

Now, when they turn 47, unless they specifically opt out, their assets would be reinvested in what is called a life cycle portfolio, and what that does, it gradually moves the composition of your portfolio from the relatively risky assets like stock into the rel-

atively safer assets such as bonds. So that we know that over the long term stocks are quite reliable, but as generating a good rate of return, but we also know in the short term they can fluctuate. So the purpose of the life cycle account is to protect you as you near retirement.

Then at retirement, what happens then? Again, the money is yours, and you can start taking it out, and with the condition that the money there be taken out in a way so that the combination of what you are taking out from your personal account and from traditional Social Security keeps you above the poverty line. So we are definitely keeping the safety net in mind.

I should also add that if our hypothetical 30-year-old unfortunately passes away before she reaches retirement age, she can bequeath what is in the personal account to her loved ones.

Representative Saxton. Thank you.

Ms. Sanchez.

Representative Sanchez. Thank you, Mr. Chairman. I have some questions. And just for the record, I don't think Social Security is silly. I just think the President's proposals are pretty ridiculous.

I want to talk to you. I recently spoke to—over an op-ed piece from one of my former professors, economic professors, out in Orange County who had written an op-ed, a discussion piece, in a very Republican newspaper in my area, and he is a pretty conservative guy, and he said that he thinks that in the near term we will have a recession, and in the long term we will have stagflation.

He based it on now that the Feds have a lot of different situations to deal with versus what we did in the recovery of 2002, which was based on the President's tax cuts, the rapid increase in our Government spending, and a very good stimulative monetary policy, and that carry trade allowed us to have low mortgage rates, run up housing prices, create a strong refinancing boom, and created strong consumer spending.

But now we have different conditions. Our productivity growth is slowing. Our employers, therefore, have to hire more workers to satisfy the demand that they have for their goods and services. That has an upward pressure in nominal wages at the same time when employers are gaining pricing power, which increases the price of goods and services, meaning higher inflation.

Also the higher energy costs that we see, the higher rates in construction, housing markets, ARMs kicking in, and no demand for refinancing, obviously, which all turns to a lower disposable income or a slowed down or basically a recession. That is what Esse Adibi is saying. And in the long run he is not very optimistic because of the budget trade deficit situation going on, the adjustment of our currency, which you would think would be helping us on that trade deficit, but the trade deficit continues to grow anyway.

Which points to probably, well, currently a lower standard of living—if you go to Europe, you are not going to buy what you used to buy a year ago or 2 years ago; a much larger currency adjustment than is probably needed; the accompanying inflation that we just talked about, that I just spoke about; the implication of a lower dollar, which would force the Feds to increase interest rates. So higher inflation, higher interest rates, stagflation.

What do you think of that? What do you think of his not very optimistic outlook with respect to what is going on right now versus, you know, your very glowing everything is all right, do not worry about it? And I did not add to that the entitlement programs which are—we just spoke about Social Security, but also Medicare, where this Republican Congress, you know, added a Part D that is not sustainable, in my opinion, and does not bring value to the actual consumer.

Dr. Rosen. We certainly monitor the economy very closely to see whether there are risk factors that might work toward lowering growth as we move forward. As we noted at the beginning of the testimony, our forecasts about what is happening moving forward are not idiosyncratic. So it is not like CEA has some rosy scenario, and the rest of the world disagrees. The consensus of the private sector forecasters is not for recession and stagflation; rather it is for sustainable growth moving forward.

One of the most important things that you raised is the condition of household balance sheets, which is always a matter of importance when you are trying to figure out where the economy is going to be.

Representative Sanchez. It has to be scaring you to death those ARMs out there.

Dr. Rosen. Well, here is what you see. If you look at the ratio of households' debt obligations to their disposable income, it has been quite steady. In other words, household balance sheets seem to be in pretty good shape.

Representative Sanchez. But these will kick in. They haven't kicked in yet.

Dr. Rosen. Well, the obligations that people face could go up or down, depending on the course of interest rates. We are predicting mild increases in interest rates. But I think the fact is that we are not observing problems with consumers with respect to their balance sheets at this time.

Representative Sanchez. What do you consider "mild interest rates," Mr. Chairman? I'm sorry, "mild interest rate increases"?

Dr. Rosen. What I am talking about is that we have been forecasting interest rates in the middle 4.5 percent range, whereas the long-term average is about 6.6. So interest rates are below historical averages. Mortgage rates are below historical averages, and we do not see threats to consumer balance sheets on this basis.

Representative Saxton. Mr. Chairman, we are going to move over to Mr. Hinchey, but on the way to doing that, these red bars on this chart indicate the consensus forecast for the economy. Can you comment on what consensus forecast means? Who is this that is saying that we are going to have 3.9 to 3.3 percent growth?

Dr. Rosen. Yes, sir. There is a group of business economists who represent either major consulting firms or major businesses, and they submit their forecast to a central group who then just reports them all. So you can literally get the page with what is it 30 or 40—50—there are 50 of them, and the consensus is the median or the average of them. So this is distilling the opinions of people who do this kind of thing for a living.

Representative Saxton. Thank you.

Mr. Hinchey.

Representative Hinchey. Thank you, Mr. Chairman.

We have had an interesting discussion on Social Security, which reflects, I think, the attention that you paid to that subject in your testimony. But it is interesting, in looking at your testimony, that there is no mention in your testimony of budget deficits, the looming Medicare crisis, which is much larger and much more imminent than any problem in Social Security. No mention of lack of health insurance, the wage disparities that we are confronting in our country, the increases in poverty rates or rising energy costs, all of which impact severely on our economy. I am not going to ask you to go into detail on those subjects, but at some point I would be very interested in hearing what you have to say about it.

I would like to just go back to Social Security, since so much time and attention has been paid to that today. You mention at some point an $11 trillion deficit. Now, that projection, I assume, is somewhere out here—into infinity; is that right?

Dr. Rosen. Yes, sir.

Representative Hinchey. Is it customary for us in the Federal Government to project programs into infinity?

Dr. Rosen. I think different times it is——

Representative Hinchey. I don't think it is. I think it is unusual to project the needs of any program out to infinity. Normally what we do is project them out over 20 or 30 or 50-year basis.

And you mentioned a number of things in response to the chairman's question that could be done to deal with the Social Security problem, and those things have been done in the past. In 1983, for example, there were changes made which raised the retirement level and also brought more money into the system by raising the cap. And I think that your response saying that raising the cap would not solve the problem is not correct. If you eliminate the cap, it certainly would solve the problem. And it would solve the problem far into the next century; not just the 21st century, but on off into the 22nd century based on the demographics that we are familiar with.

There are other ways to deal with it, too. If you were, for example, or if we were, for example, to repeal the tax cuts, the President's tax cuts that go to the wealthiest 1 percent of Americans, that would essentially solve the problem for the rest of this century.

So there are some very simple things that we could do to deal with whatever problem is perceived in Social Security, but it is interesting that we are talking about a program whose solvency under the most pessimistic cites is secure until at least 2041, and the CBO says 2052. And interestingly enough, if we have a higher growth rate, it would go beyond that.

In your testimony and your statements here today, I believe that you are suggesting that we are going to continue to experience a growth rate of something in the neighborhood of 3.7 percent. Am I right about that?

Dr. Rosen. That is for this year, sir.

Representative Hinchey. For this year, 3.7 percent. What are you projecting for next year?

Dr. Rosen. Next year, 3.4, 3.5? What are we saying?

Representative Hinchey. Can I have a lapse of my time, here, Mr. Chairman?

Dr. Rosen. 3.5 for this year, and 3.4 for next year. So we are a little bit more modest than the consensus forecast.

Representative Hinchey. In your estimates with regard to the problems in Social Security, what are the estimates of economic growth used for the Social Security estimates into the future?

Dr. Rosen. The Social Security actuaries make those estimates. I don't know specifically what figures they have.

Representative Hinchey. I understand that the figures that they use are less than 2 percent. I believe the figures they use may be 1.7 percent. I am not absolutely positive about that, but I am sure it is less than 2 percent, and I think it is 1.7.

You are projecting economic growth at the rate of 3.4 and 3.5. But when you are looking at Social Security, the Social Security actuaries, your testimony and a lot of the actions that are being contemplated by the Administration and Members of Congress are based upon the numbers used by the actuaries at Social Security who predict that they system will run out of funds in 2041 you essentially cut in half the growth rate. You are not playing with a straight deck here. You are loading the dice. You are giving people false information.

So you are going to have to settle, I think, on one of those figures or the other. Either the economy is growing at the same rate for Social Security as it is for everything else, 1.7 or 3.4 or 3.5, or it is not. But it cannot be growing at two different rates.

Dr. Rosen. A couple of points, I guess. One is that in recent reports, the Social Security actuaries looked at long-term calculations as a function of different assumptions in the growth rate. And what they found, it does not move those long-term net liabilities around very much. And the reason is because if the economy is growing faster, and people have higher wages, then we know, according to the Social Security benefit formula, that just means people get higher benefits.

Representative Hinchey. Excuse me for interrupting. There is no argument with that, but that does not address the disparity in the statistics. If you are using two separate growth rates, you will have to come to a conclusion as to which number you are going to estimate that the economy is going to grow at. And in the case of Social Security also, if you have a growth rate of 3.4, 3.5 percent over the course of the next decade, then the extended life of Social Security is not going to be 2041. In other words, the money is not going to run out by 2041. It is not going to run out based upon the formula that the actuaries use, if they use 3.4 or 3.5 for a growth rate. That money will extend Social Security viability out into 2050 or 2055 easily and beyond.

And also if you have the growth rate in the economy which you are predicting now, not Social Security, but you are predicting now for the President in the economy, then the amount of money that people will be collecting—let's use the pessimistic numbers of the actuaries of Social Security—the fund stops growing and becomes stagnant, runs out of funds about 2041. Benefits paid after 2041, according to the actuaries, would be 73 percent of what they would be under 100 percent. But 73 percent of benefits in 2041, based

upon the index currently in effect, has a higher buying power than 100 percent of benefits in 2005.

Dr. Rosen. I think, sir, you raise a key point at the beginning, which is what time horizon should we look at when we are thinking about the Social Security system. I think that since this is driven to a large extent by demographics, we know which way the demographics are going. We know that if you fix it—we know what the lines look like after 1975 and 1976, and revenues are staying below the cost line.

Representative Hinchey. Those lines depend upon which numbers you use to create those lines. And if you are going to use different numbers to create the lines for the economic growth and for the strength of Social Security, you are going to come up with very different results.

So, the lines that you are talking about are projections. And no one knows for sure what those lines are going to be. Those projections are based upon numbers that you create now. And you are creating those numbers—you are creating one set of numbers, the actuaries are creating a different set of numbers, but you are using your set of numbers to predict how good the economy is now and how good it is going to be for the duration of this Administration. But when you talk about Social Security, you put your numbers aside, and you pick up the actuaries' numbers, which are much more pessimistic about economic growth, and therefore you can predict that Social Security is in trouble. But if you used your numbers in terms of growth of economy, you would have to predict that Social Security is much more strong than is being predicted now by the Administration.

Representative Saxton. Mr. Hinchey, your time has long since expired. Let's give the chairman a chance to answer this question.

Dr. Rosen. We always use the Social Security actuaries' numbers when we are analyzing Social Security. I think otherwise we would really have problems in terms of deciding which number to use for which kind of analysis.

Representative Hinchey. Very interesting.

Representative Saxton. Mr. Chairman, thank you very much for being with us today, and we look forward to working with you in the future. The hearing is adjourned.

[Whereupon, at 11:12 a.m., the hearing was adjourned.]

Submissions for the Record

PREPARED STATEMENT OF HON. JIM SAXTON, CHAIRMAN,
U.S. REPRESENTATIVE FROM NEW JERSEY

It is a pleasure to welcome Chairman Rosen of the President's Council of Economic Advisers (CEA) before the Committee this morning. Chairman Rosen's testimony on the economic outlook continues the productive exchange between the Council and the Joint Economic Committee that has existed for many years.

A variety of standard economic data show that the U.S. economic expansion is on track. According to recent figures, the U.S. economy grew at a rate of about 4 percent last year, after adjustment for inflation. The U.S. economy has been growing at a healthy pace since the second quarter of 2003, when the rebound in business investment started to broaden and bolster the expansion.

The tax incentives for investment adopted in the second quarter of 2003 played an important role in jumpstarting investment growth. The previous weakness in business investment was replaced by double-digit increases in equipment and software investment in six of the last seven quarters.

The acceleration of economic growth is reflected in other economic statistics as well. Industrial production is trending upward. Over the last 22 months, payroll employment has risen by 3.1 million jobs. The unemployment rate stands at 5.2 percent. Household net worth is at a record level. Homeownership has hit new record highs. Interest rates remain fairly low by historical standards. Consumer spending continues to grow. Inflation appears to be under control, with a key core measure of price changes still below 2 percent on a year-over-year basis.

In summary, overall economic conditions remain very positive. Recently released minutes from the Federal Reserve suggest that the central bank expects this economic strength to continue. There is justifiable concern about the increase in oil prices, but it is important to note that this primarily seems to reflect strong demand from international economic growth, not a plunge in oil supplies.

Another challenge is the tax bias against saving and investment embedded in the tax system. Further reducing the multiple taxation of saving and investment would lessen the economic burden imposed by the tax code, and increase economic growth over the long run. The Administration's proposals to protect more personal saving from multiple taxation are right on target.

The consensus of Blue Chip forecasters projects that the economic expansion will continue through 2005 and 2006. This is very consistent with the Council's projections for economic growth over the next two years or so. The bottom line is that the U.S. economy remains strong and that the overall economic outlook is positive.

PREPARED STATEMENT OF HON. JACK REED, RANKING MINORITY MEMBER,
U.S. SENATOR FROM RHODE ISLAND

Thank you, Chairman Saxton. It is a pleasure to be here at the first hearing of the Joint Economic Committee in the 109th Congress, and I look forward to working with you. It is fitting that this hearing is with the Council of Economic Advisers, which was created at the same time as the JEC in the Employment Act of 1946.

I want to welcome CEA Chairman Rosen and CEA member Forbes. I know that your backgrounds are not in economic forecasting, but I am confident that you will be able to give us useful insights on current economic conditions and where you think the President's policies are taking us.

I have three major concerns about the economic outlook. First, I am concerned about what continues to be an extremely disappointing economic recovery for the typical American worker. I know that the Administration is proud of the fact that the economy has created jobs for 22 consecutive months. But the pace of job creation over that period works out to just 141,000 jobs per month. That is barely enough to keep up with normal growth in the labor force. Last month, we did not even match that pace, as only 110,000 jobs were created.

The slow pace of job creation is disappointing, but what is happening to the take-home pay of the average worker is even more disappointing. Since May 2003, when the economy finally began creating jobs again, the average hourly earnings of production workers in nonfarm industries have fallen by 0.7 percent after accounting for inflation. In addition, we are finding that the distribution of earnings is becoming more unequal and American families are having to shoulder more risk in today's economy. I think these issues are the darker side of the President's plan for an ownership society, and I think they are concerns that need to be addressed.

My second major concern about the economic outlook is the effects we are seeing in the trade deficit and the foreign exchange market from the irresponsible fiscal policy we have been pursuing over the past four years. This week we learned that the trade deficit is still widening, with February's deficit of $61.0 billion a record for a single month. The broader current account deficit rose to a record 6.3 percent of GDP in the fourth quarter of 2004. The large drain on national saving from the federal budget deficit has put us in a position where we must borrow $650 to $700 billion per year from the rest of the world to sustain our spending. That money will have to be paid back with interest, which will be a drain on our national income and future standard of living.

Finally, I am concerned that the President wants to extend this fiscal irresponsibility to Social Security. Analysis by the JEC Democratic staff and others shows that the President's private accounts plan would require a massive increase in the public debt that is not simply a shortrun transition cost. Rather, the additional debt associated with private accounts would reach 35 percent of GDP by 2060, on top of a debt already equal to 37 percent of GDP today.

The President's plan for private accounts makes Social Security solvency worse by diverting payroll taxes from the trust fund. That drain on the trust fund moves up the date that Social Security can no longer pay full benefits and increases the present value of the 75-year financing gap from $4.0 trillion to $5.6 trillion.

Finally, the President's plan for private accounts does nothing to increase national saving, and could lower it still further. The private saving that would be generated by the creation of private accounts would be completely offset by the reduction in public saving from the larger budget deficits, and people might reduce other private saving such as their contributions to 401(k)s and IRAs.

Raising national saving is the key to economic growth and one of the ways to reduce the trade deficit. Moreover, as Federal Reserve Chairman Alan Greenspan recently testified, it is the best way to meet the fiscal challenges posed by the retirement of the baby boom generation. Unfortunately, the President's policies of large tax cuts for those who are already well off and private accounts that add to the debt and worsen Social Security solvency seem to be taking us in exactly the wrong direction.

I look forward to your testimony about the economic outlook, and I will listen with interest to anything you can tell me that will allay my concerns about that outlook.

PREPARED STATEMENT OF HARVEY S. ROSEN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS; AND KRISTEN J. FORBES, MEMBER, COUNCIL OF ECONOMIC ADVISERS

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 indicates 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 ECONOMV

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 re-

search. 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.

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