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THE ECONOMIC REPORT OF THE PRESIDENT

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED NINTH CONGRESS

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JOINT ECONOMIC COMMITTEE

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THURSDAY, FEBRUARY 16, 2006

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC

The Committee met, pursuant to call, at 10:40 a.m. in room 2322, Rayburn House Office Building, the Honorable Robert F. Bennett, Vice Chairman of the Committee, presiding.

Representatives present: Representatives Maloney, Paul, and Cummings.

Senator present: Senator Bennett.

Staff present: Chris Frenze, Nan Gibson, Colleen Healy, Brian Higginbotham, Bob Keleher, John Kachtik, Frank Sammartino, Jeff Schlagenhauf, Chad Stone, Rachel Thomson, and Katie Jones.

OPENING STATEMENT OF HON. ROBERT F. BENNETT, VICE CHAIRMAN, A U.S. SENATOR FROM UTAH

Vice Chairman Bennett. The Committee will come to order. I am here for Chairman Saxton, who will be here later. I appreciate the indulgence of our witnesses and those who have been here on time. The Senate has just conducted a vote, and I had to be there to help save the Republic before I came to these particular hearings. Why are you all laughing?

Today, the Committee will hear testimony from two of the members of the President's Council of Economic Advisers. They will be discussing the recently released Economic Report of the President, which is appropriate. The Council of Economic Advisers and this Committee were created by the same piece of legislation as to get economic advice into the Executive Branch and then provide a forum for economic discussions in the Legislative Branch. So we welcome you in this one legislatively sanctioned activity that we engage in.

Now, the President has nominated Dr. Edward Lazear of Stanford University to serve as the chairman of the Council of Economic Advisers. We had his confirmation hearing in the Senate Banking Committee earlier this week. When he is confirmed by the Senate, he will replace Dr. Ben Bernanke, who has been in the news with other assignments. We heard from him in the Congress yesterday as the new chairman of the Board of Governors of the Federal Reserve.

But we are pleased to welcome the Council's other two members, Dr. Kathleen Baicker—is that close enough?——

Dr. Baicker. Close enough.

Senator Bennett [continuing].—close enough—and Dr. Matthew Slaughter to the Committee.

Now, as we look at the Economic Report of the President, we do so against the backdrop of a strong and growing economy which created 2 million new jobs over the past 12 months and more than 4.7 million new jobs since August of 2003. Core inflation remains relatively contained, and interest rates are historically low despite recent increases by the Federal Reserve.

That does not mean that the economy does not face significant challenges in the future. Energy prices remain a concern, and, of course, the uncertainties of the global economy are always with us, and we face serious long-term fiscal challenges tied to the retirement of the baby boomers and the entitlement programs that have served us well in the past but that are threatened by demographic changes.

I found it interesting that in this morning's paper there was an op-ed piece by Robert Samuelson that posed a very interesting question, which is, how can the economy be doing so well and people feel so insecure and industries, like Ford and General Motors, be in trouble while the entire economy has performed better over the last 20-25 years than it ever has in a similar period in our history. His answer is competition, that the power of competition has made individual industries and, therefore, their employees feel more uneasy about their economic status even as it has improved the overall economic well-being of the Nation as a whole. It is an interesting thesis, and I would like to get into that with you as we go into the question period.

[The Washington Post editorial entitled, "The Fears Under Our Prosperity," appears in the Submissions for the Record on page 24.]

It is imperative that the Congress and the Administration work together to handle these challenges head on. We have to deal with entitlement spending. I have watched politicians, for the dozen years I have been here, all tell me, yes, Senator, we have to deal with that, and we will address it right after the election because both sides want to carry the election rhetoric to see if they can win just one more election on the past rhetoric, and then they will tackle the tough problems, and as we keep putting them off, the tough problems keep getting tougher.

We all recognize the challenges that are essential for a strong economy: improving our education system, not the direct responsibility of this Committee but something we have to pay attention to; the issue that Robert Samuelson raises of international competitiveness; and we are finally recognizing that our present tax system, born in the 1930s, is no longer adequate to the challenges of a global economy in the 21st century, and at least among some of my colleagues in the Senate, we are beginning to have conversations about that.

So I look forward to hearing our witnesses describe how the system, particularly the tax system, can be replaced, not altered, not tinkered with, not "reformed," but I think we ought to start conversations about replacing it. Maybe you are not prepared to do that today, but I am giving you the warning that that is at least something that I am concerned with, and I understand, having had conversations with your new chairman, that he has an interest in that subject, too. That is a very great understatement.

So we welcome you both to the Committee and look forward to your testimony. Mrs. Maloney, there being no ranking member present, why do not you assume that responsibility and give the opening statement from that perspective?

[The prepared statement of Vice Chairman Bennett appears in the Submissions for the Record on page 23.]

OPENING STATEMENT OF HON. CAROLYN B. MALONEY, A U.S. REPRESENTATIVE FROM NEW YORK

Representative Maloney. Thank you very much, Chairman Bennett. I have appreciated your thoughtful comments today and always your sincere dedication to understanding and moving forward the American economy in a stronger position.

Unfortunately, Senator Reed is not here right now. He will possibly be here later, and I request that his statement be in the record. Apparently, he is questioning Chairman Bernanke right now, the Financial Services Committee.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 26.]

Vice Chairman Bennett. Senator Reed has the same conflict I do, and that is where I will flee as soon as Chairman Saxton shows up, to go sit down with Mr. Bernanke and see if he is easier to understand than Chairman Greenspan.

Representative Maloney. He is, and he actually answers questions. I am shocked. I think he is great. He is a former teacher, and it shows.

I want to particularly welcome our two panelists, Dr. Baicker and Dr. Slaughter and mention that I am always delighted when competent women are appointed to policy positions. We are far underrepresented in our Government and in many industries in our country. I want to welcome our male friends, too.

The statute that created both the Council of Economic Advisers and the Joint Economic Committee mandates that the Joint Economic Committee should review the Economic Report of the President, and I am pleased that you are here today to discuss this truly important report for every American.

In its 11 chapters, this year's report covers a broad range of topics and reflects the talent and professionalism of you and the other economists on the CEA staff, but what concerns me is the disconnect between the policies that the Bush administration has been pursuing for the past five years and the policies that can be justified by sound economic analysis. I hope that you would agree that persistent, large budget deficits and debts are not conducive to long-term growth and our standard of living.

I hope you would also agree that even if there is not a lockstep relationship between budget deficits and international imbalances, it cannot be good for our national savings and our trade deficit when the Federal budget moves from a substantial surplus in 2000 to an even larger deficit in 2004, especially when our personal savings rate has fallen and is now a negative. Nor can it be good for our economy or our society when workers are not seeing the benefits of economic growth in their paychecks, and the gap between the haves and the have-nots is widening. I think this is a trend that every Republican and Democrat is deeply concerned about because that is a very bad trend for, I would say, the economic well-being and the spirit of America.

Your report wisely avoids trying to justify the President's budget and tax policies, but I think it is important that we try to understand what is really happening in the U.S. economy and how the President's policies are affecting the economic well-being of all Americans.

Foreign governments, as pointed out in the Financial Services Committee yesterday, are buying GSEs—Government-sponsored entities—instead of Treasury notes. In fact, they now hold a third of our debt. What they are buying now, a third of it is now GSEs, and I am concerned. Is that a warning sign that we are getting near the edge, that foreign governments may not continue to buy our debt at the rate that is needed to sustain our spending?

I am also concerned, since this is a shift that I have never seen before—possibly it has happened before, but I am not aware of it—where GSEs have become a major holding of our debt, and that, as you know, is a Government-private sponsorship that is moving to the private away from Government. What is the ramification, if any, on our economy?

I welcome you today. I congratulate you on your appointments. Some very good people have come out of the positions that you hold and have continued to lead and play important roles in our Government. I thank you for your service today and your service and commitment to our Government. Thank you.

Vice Chairman Bennett. Thank you very much. We will now hear from our panelists. Which one goes first?

Dr. Slaughter. I believe I shall.

Vice Chairman Bennett. Okay. Dr. Slaughter, and then we will hear from Dr. Baicker.

JOINT STATEMENT OF DR. MATTHEW SLAUGHTER AND DR. KATHERINE BAICKER, MEMBERS, COUNCIL OF ECONOMIC ADVISERS

Dr. Slaughter. Thank you. Vice Chairman Bennett and other members of the Joint Economic Committee, we are very pleased to testify today about the 2006 Economic Report of the President. The report reviews the state of the economy and the economic outlook, and it discusses a number of economic policy issues of continuing importance. Across its 11 chapters, the report highlights how economics can inform the design of better public policy and reviews Administration initiatives.

The performance of the U.S. economy continues to be strong. In 2005, the Nation's real GDP grew 3.5 percent for the year, above the historical average. Key components of demand that accounted for growth in 2004—consumer spending, business investment in equipment and software, and exports—continued to do so in 2005. Employment increased by about 2 million payroll jobs for the year, and the unemployment rate dropped to 4.7 percent last month, well below the averages of recent decades. Real disposable personal income increased, and real household net worth reached an all-time high. This growth comes on top of an already strong expansion, the foundation of which has been exceptionally rapid productivity growth. The Administration's forecast, consistent with consensus private forecasts, shows the economic expansion continuing for the foreseeable future.

Increases in investment spurred by the dividends and capital gains tax relief enacted in 2003 have played an important role in the strengthening of our economy. Since the Jobs and Growth bill became law, capital investment has increased by 25 percent, contributing to sustained job growth and directly benefiting workers in the broader economy. It is essential that this tax relief be extended.

American productivity growth, and thus competitiveness, in the 21st century will rely upon American ingenuity, entrepreneurship, and labor force talent. The President's American Competitiveness Initiative aims to support these forces. Promoting a flexible and skilled workforce through improved access to high-quality primary, secondary, and post-secondary education, through policies that attract the world's best and brightest to our shores, and through investment in research and development and the continuing education and retraining of our mobile labor force will help ensure that the United States remains a leader in this rapidly changing world economy.

But maintaining this leadership will also require a continued commitment to competition in and flexibility of U.S. product, capital, and labor markets that help transform innovations into the new products and processes in the marketplace that ultimately support rising incomes for workers and their families. Innovation alone is not sufficient to guarantee rising prosperity. It also requires the dynamism of the marketplace, for which America is uniquely positioned.

This continuing strength and competitiveness of the American economy in the global marketplace depends upon policies that open international markets to U.S. goods and that promote growth and investment at home. The performance of the U.S. economy depends on an effective financial services sector and on a tax system that promotes domestic growth and international competitiveness.

Further opening of foreign markets to U.S. goods would yield great rewards for Americans. Over the past 70 years, policymakers across political parties have consistently recognized the importance of international commerce and have achieved major trade liberalization both here and abroad. The net payoff to America from these achievements has been substantial.

The Administration's policies will make even greater gains possible. Support of the agricultural sector can be provided in ways that are less distortionary. We must work to eliminate further barriers to trade, especially in services, and to further open markets in global, regional, and bilateral negotiations. Americans will reap the greatest benefits from this trade when intellectual property rights are well defined and well enforced. The Administration continues to enforce vigorously the laws that protect the rights of American intellectual property owners.

Dr. Baicker. The continued expansion of energy markets and diversification of energy sources can further increase our resilience to energy supply disruptions. Hurricanes Katrina and Rita demonstrated that competitive markets play a central role in allocating scarce energy resources, especially during times of natural disaster or national emergency. Policies that build on economic incentives and that spur our development of alternative fuel sources can further reduce U.S. vulnerability to energy disruptions and dependence on foreign oil, encourage energy efficiency, and protect the environment.

Even as living standards rise, Americans are increasingly concerned about their retirement security and health care costs. Most working-age Americans are, in fact, on track to save as much as most retirees, but there are a number of risks to the retirement preparations of Americans. People today are living longer and can face higher health care costs in retirement than members of previous generations. In addition, both defined-benefit pension plans and Social Security suffer from fundamental financial problems that expose not just retirees but all U.S. taxpayers to risk of substantial losses. The Administration is focused on addressing these problems and protecting the Nation's retirement security.

Rising health care costs are of concern to all Americans, young and old. All Americans deserve access to reliable, affordable, high-quality, high-value health care. Health care in the United States is second to none, but it can be better. Both public and private health care spending have grown much more rapidly than general inflation or wages, straining consumers, employers, and Government budgets. The cost of finding new health insurance locks some workers into their current jobs if they or someone in their family is ill or in less-than-perfect health. Frivolous lawsuits can raise health care costs for everyone. Perverse tax and insurance incentives have led to inefficient use of our health care resources.

Promoting a stronger role for consumers can help create a health care system that is more affordable, more transparent, more portable, and more efficient. Health savings accounts should be strengthened by allowing people to contribute enough to them to pay for all of their out-of-pocket expenditures tax free. Individual purchasers should have the same tax advantages as those who get insurance from their employers. We need to ensure that patients and their doctors have the information they need to use this control to get the health care that is best for them and that electronic health records are widely used to reduce costs and to improve the quality of medical treatment.

The report provides an analytical backdrop for the President's agenda, which includes restraining Government spending, making tax relief permanent, making health care more affordable and accessible, creating an economic environment that encourages innovation and entrepreneurship, continuing to open markets to American goods and services, and reducing America's dependence on foreign oil by diversifying our energy supply. These policies will help maintain the economy's momentum, foster job creation, and ensure that America remains a leader in the global economy.

Thank you all for this opportunity to discuss the 2006 Economic Report of the President, and we would be happy to answer any questions you might have.

[The prepared joint statement of Dr. Slaughter and Dr. Baicker appears in the Submissions for the Record on page 29.]

Vice Chairman Bennett. Thank you very much. We appreciate your testimony and the hard work that went into the creation of the report. You have touched on a number of issues that I find fascinating, and let me just explore a few of them with you.

The Samuelson column and the comments you have made demonstrate how changed this economy is from the one that I grew up in and, indeed, the one that many people thought was normal. "Normal" meant you graduated from high school or college, and you got a job. You went to work at Sears & Roebuck as a stock boy, and then you became a salesman on the floor, and then you became a standpoint manager, and if you were really good, you got to be an assistant store manager, and at the end of your career, you had been a store manager, and you got your pension and a gold watch, and life was good.

If you graduated and went to work at Ford or Delphi or one of the giant companies, the unions negotiated on your behalf. Your wages were not only stable, but they rose with virtually every negotiation in both real terms as well as with respect to inflation. Your job may not have been all that stimulating, but you stayed on the manufacturing line, you did a good job, you were there for 40 years, and you retired with or without the gold watch but with a pension and lifetime health benefits.

That world is gone, and it is never coming back, however much we in the Congress might want to legislate its return. The world in which we now live is a world of intense competition, and the emphasis is on the word "world," a world of intense competition, and those who meet the competitive challenge thrive, and those who do not are almost ruthlessly left behind.

I just came back, a few weeks ago, from a trip to the Far East, and we went to China, and the Chinese are very concerned about losing jobs to Vietnam, and, interestingly enough, the Chinese are worried about intellectual property rights because as their economy matures, and they begin to invent things of their own, they get very upset when somebody in some other country steals their patents without protecting their intellectual property rights. It was very interesting to hear Chinese officials say, we have to have tough international intellectual property right regulations, to which we could only say, hooray, we are glad you finally got the message.

When we did go to Vietnam, the people in Vietnam said, "Do not look to China as the place to go; look to us." And in both cases they said, "We do not want an economy built on cheap labor. We are making sure that our economy is built on technological breakthroughs and high quality." That is not the image you get reading the op-ed pages of the New York Times, but that is the image that you get when you get out into the world.

I think Samuelson is exactly right: People are doing better than they have ever done before, and they are more uneasy and feel more threatened than they ever have before, and I am not sure his analysis that that is due to competition is the right one, but that is certainly probably the place to start. However much we might want to not live in such a competitive world, the fact is we are there, and there is nothing we can do about it except accept it, compete, and be the ones that survive.

I wish I had brought it with me. Again, a recent piece pointed out that Europe is almost in a death spiral and that the average European, within 15 to 20 years, will be half as wealthy as the average American because they are not competitive, they have tried to hang onto the model that I have described as the past as their view of the future, and the net result has been to say that Europe is dropping out of the global competition, and the countries that will survive and thrive in the future will be the United States, China, and India, and I am not so sure that China will, given their population problems and the demographic challenges they have.

[The Washington Post editorial entitled, "The End of Europe," appears in the Submissions for the Record on page 23.]

They were talking to us about the difficulties of what they call the "one-two-four pyramid." They will have one worker, because of their one-child program, who will have to support two parents and four grandparents, and they have no safety net of the kind that we take for granted in that society. So the parents are looking to their child to support them, but the grandparents are still alive, and the economic burden of the one-two-four pyramid in China is something we can be grateful we do not face.

All right. I apologize. I am making a speech here, and I should be asking a question, so let me do the standard senatorial thing. What do you think?

Dr. Slaughter. I believe the answer is yes. I will offer a few reactions to that, if I may, Senator. You raise an excellent set of points.

There is a famous labor economist named Richard Freeman who refers to the change in the nature of the global economy in the past 15 years. He has coined the phrase "the great doubling." If you take the populations of China and India and the former Soviet Union and many eastern European countries, that is about half of the world's population, and if we go back even just 15 years, that set of countries economically was effectively sort of on the moon. They were very isolated and not part of the global economic system.

So one of the things that is very different today from the past when we think about global integration, if we go back, say, 10 to 15 years ago in the United States, there was a lot of discussion about the implications and ramifications of the North American Free Trade Agreement and extending our free trade agreement with Canada, to include Mexico. Candidly, Mexico is sort of rounding error when you are trying to get a hold on the number of people effectively that are now part of the population with the great doubling that we have experienced.

So that is something that is qualitatively different, and during that period the sense of unease that Robert Samuelson has talked about, he is correct. If you look at public opinion surveys on people, how they view the nature of their labor market attachment, for about 15 years now throughout the United States and also in many other countries you see rising self-reports of worker uncertainty and worker unease. That speaks to the fact that the nature of labor market attachment for people, it just does not depend on their earnings; it depends on the reliability of those earnings. There are many dimensions of labor force attachment that people think about.

In the United States, as I alluded to in my comments, we have been enjoying this productivity acceleration that started in 1995 and that has continued even further since the year 2000, which is wonderful from the standpoint of average living standards in the United States because productivity growth is the only sustainable foundation for rising average living standards for America.

One of the notable features about this productivity acceleration, especially since the year 2000, has been the critical role played by what economists call "total factor productivity growth," not the growth of capital per worker but sort of the organization and the innovations that combine workers with their capital in terms of what products firms are going to make and how they are going to make it. There is now substantial evidence from academic research, from the business community research, that the force of competition, especially international competition, is an important spur to productivity growth for firms and, therefore, for countries as a whole, and that is just based on a lot of empirical studies of lots of industries around the world. One example that I will give is retail trade.

So one of the important industries that has contributed to the productivity growth in the United States in the past several years has been the retail trade sector. The United States has had a very different experience from many continental European countries like you cite. We have had a lot of innovations in retail trade that have been implemented thanks to competition and flexible capital and labor markets in the United States.

So Wal-Mart, Costco, Target, those types of firms, have been able to establish and expand new types of retailing services in the United States, very different from in Europe where they have made a different set of choices, where there are much more qualitative and quantitative restrictions on land use, labor market use, and capital market turnover that have inhibited the ability of retailers to replicate the kind of performance we have seen in the United States.

So I broadly agree with what Robert Samuelson is talking about, that the forces of competition are very important for contributing to rising living standards in the United States, but that competition has certain dimensions to it, and, again, one of them is thinking about what is the distribution of the overall productivity gains and the sense of certainty or uncertainty that that imparts to different segments of the workforce.

Dr. Baicker. To build on what Dr. Slaughter discussed about the uncertainties that workers face in the modern economy, technology is evolving much more quickly, and the labor market is changing much more quickly than it had in the past, as you said, so it is especially important that we provide the support that workers need to move from shrinking sectors of the economy to growing sectors of the economy, whether those changes are generated by trade or internal development of new technologies, or by changing tastes in the marketplace.

Any source of displacement for workers necessitates that they get additional training and that they have the support that they need to get that training and income support during the time when they are transitioning between jobs. That is an important component to ensure that everyone in the economy can benefit from overall economic growth.

To build on that as well, you mentioned retirement security of workers who expect a lifetime pension, and one of the important supports for retirement security is that pension promises are kept. Through the defined-benefit pension system, workers were promised a stream of income in their retirement. It is important that we make sure the incentives are in place and the regulatory oversight is in place that those promises to those workers are kept to them so they can feel more secure about their retirement security as they move from job to job.

Vice Chairman Bennett. Thank you. I will not monopolize. I have got a lot of reactions to what you have had to say, but just one quick one. As we go into this new world, I think we need to get the mentality that pensions and health care are no longer tied to the employer but to the employee so that the employee who accrues pension benefits working for his first job takes those with him to his second job and this third and his fourth and his fifth and so on.

It is now very clear that people will normally and routinely in their lifetimes have 10 jobs at 10 different places and sometimes change fields entirely. A veterinarian may end up as a stockbroker or vice versa. If you can accumulate and bring with you your pension benefits, which is what the 401(K) program is supposed to do, and do the same thing with health care, you own your health care benefit rather than your employer so there is no concern about a preexisting condition because it is your plan, and you take it with you and ultimately control it.

We are not used to thinking like that. We are so tied to the old paradigm—we keep trying to keep the old paradigm alive because it worked for so many years—that we are actually putting ourselves ultimately in the position of jeopardizing what has to be done for our children and our grandchildren. Mrs. Maloney?

Representative Maloney. Thank you so much for your statement, all of you. It gives all of us a great deal to think about.

I would like to go back to one of the areas that I mentioned in my opening statement, and that is the growing divide between the haves and the have-nots in this country. Last fall, we had a Democratic forum on the economy where one economist, Alan Blinder, gave some very interesting testimony on this topic, and he argued that there had been a long-term trend toward greater inequality interrupted for a short while in the late 1990s. He did not use this particular chart, but I think it illustrates how we are all on the wrong track on this particular issue.

The blue bars show the usual weekly earnings of full-time wage and salary workers at different points in the earnings distribution between 1995 and 2000, a time of great economic growth, and the red bars show the same thing between 2000 and 2005. You see that during the Clinton years, the divide between the poorest people and the richest people was just a little over one percentage point, where now the divide between the poorest and the richest is now a clear six points. That is a growing inequality that I find disturbing.

[The bar chart entitled, "The Bush Economy: The Distribution of Earnings Has Become More Unequal," appears in the Submissions for the Record on page 28.]

Professor Blinder went on to argue that it was market forces, rather than Government policy, that is the major source of earnings inequality. That is what he argued. I just want to understand what is different about these market forces in the 1990s compared with now.

Do you agree with him that it is market forces, not Government policies, that lead to this inequality? If so, what is different now than before? Some people argue that inequality is present because we have cut some spending on domestic programs. He argued that that was not the point. He said it was market forces causing this. Could you elaborate and further explain your take on this to me and to others?

Dr. Slaughter. Sure. I will offer some initial comments on that and turn it over to Dr. Baicker.

I broadly agree with Dr. Blinder's assessment of rising income inequality in the United States.

Representative Maloney. Do you agree that it is market forces, not Government policy?

Dr. Slaughter. Yes.

Representative Maloney. I am sorry. I have to hand it back to him and read your statements in the published record. I am sorry. I have to go vote, first responsibility. We have got to vote. Okay.

Vice Chairman Bennett. We are going to have a lot of fun without anybody from the House to monitor us.

Representative Maloney. I do not think you need to be monitored. I wish I was here to hear what you have to say, quite frankly.

Vice Chairman Bennett. Thank you.

Representative Maloney. I want to add to what you have to say, and this is just an observation. I am going to miss a vote on this. I am amazed at New York's economy after 9/11. I just thought we would never recover because of the devastation. We blew out so many jobs and I have to tell you that practically everyone I meet tells me they lost their job. Yet our economy has rebounded, so it must have rebounded with new jobs, which illustrates what you are saying—this tremendous, dynamic change. It is really amazing, practically everyone I talk to tells me they lost their job. How can unemployment be worse than the rest of the country? But it is still not that bad in New York even when everybody I talk to says they lost their job. It is amazing. I would like to hear your comments on that, too.

Vice Chairman Bennett. Okay. Go back to the chart and comment on it.

Dr. Slaughter. Sure.

Vice Chairman Bennett. I think that is a legitimate issue she has raised.

Dr. Slaughter. Absolutely. They definitely are. So there are two features of that chart that I will highlight and expand on. One is that on most measures income equality in the United States across skills has been rising since the late 1970s, so the red bars there are more reflective of what the U.S. economy has been experiencing since, as I said, the late 1970s.

So one of the features of the U.S. economy that has been quite different in the past generation from previous generations is the distribution of gains. It has not been the rising tide lifting all boats. There has been something going on, and this, again, is in pretax earnings. There are some changes in the nature of supply and demand in the U.S. labor market that have been raising the returns to skills, in particular. There are other dimensions of income inequality that have been rising as well. What economists call "within-group inequality" has been increasing as well.

But if you focus on the returns to skills and different parts of the income distribution that are shown in that figure, the late 1990s that are shown there are actually the exception rather than the rule for how the U.S. labor market has been performing for quite some time. That is one fact I will highlight.

The other is that one of the striking features is that this is not a uniquely U.S. phenomenon. Most other countries around the world over the same time period of the past generation have also been experiencing rising income inequality. So the U.K. and many continental European countries; there sometimes the inequality has been manifested more in rising unemployment for less-skilled workers, even countries where you might think opposite trends would be expected, so middle-income countries like Mexico. Even today we see in China and India substantial evidence of rising income inequality as well.

A substantial amount of academic research has looked at this question, and the preponderance of evidence and conclusions from researchers has been that the main force driving up the returns to skills and contributing to the rising inequality has, again, been technology innovations that tend to favor the demand for skills.

So it sort of comes back to some of the issues we were talking about before, which is that we have got these technology innovations that firms are implementing that raise the need for more-skilled workers and, as the figure shows, raise the returns to more-skilled workers, and that speaks to the broad policy challenge of how do we try to ensure that as many Americans as possible have the kinds of skills that firms are increasingly demanding in the workplace.

Dr. Baicker. To elaborate on those points, the returns to education have been going up over time, and it is especially important, then, to ensure that all children have access to high-quality education through primary and secondary school and that people have the financial resources to continue their education beyond secondary school, such as through the expansion of grants to community colleges that disproportionately train people in growth industries. So ensuring access to those educational institutions is particularly important in the modern economy.

One other point I would like to make is that those bars would look a little bit different if you took out the full income of those different groups. So the earned income tax credit has been an important component of increasing the resources available to people at the low end of the income distribution. It has been a very successful program in both giving people income stability and the resources that they need and also in promoting participation in the labor force.

So while the point that income inequality has been rising is well taken and true, it is important to also consider the total bundle of resources available to people across the income distribution.

Vice Chairman Bennett. Thank you. Is there any parallel with the fact that from 1995 to 2000—the recession started in 2000, or the downturn started in 2000, the last quarter—those were five years of expansion and growth. The recession hit in 2001. How can 2000 be 11.1 and minus 2.1? You have got 2000 up there twice. Oh, this is fourth quarter to fourth quarter. Okay. Well, then that shows that the recession started in the fourth quarter of 2000 with the minus 2.1.

Does that impact the visual message coming off the chart, the fact that you have got five years of expansion and three years of the recession and the slow recovery? The recovery really did not begin to take hold until 2003, so is that a factor here, or is that just coincidence?

Dr. Baicker. That is a very important point, and I thank you for making it. It highlights the fact that a growing economy is a prerequisite for everyone in the economy to do better, and so policies that encourage economic growth will help people at all points in the income distribution.

Dr. Slaughter. That is right. I believe, if I remember the statistics correctly, by the peak that is in around 2000, the aggregate unemployment rate in the United States briefly dipped below 4 percent to about 3.9 percent. So the strength in the labor market overall is a force that does tend to help pull up the incomes of everyone, including those at the lower end.

Vice Chairman Bennett. Yes. Okay. But your overall conversation says that the real source of the income gap is a skill gap. Is that an acceptable statement, or is that too simplistic?

Dr. Baicker. It is an important component.

Vice Chairman Bennett. Okay. It is an important component. That is an economist's way of saying, you are not quite right, Senator. How big a component is it? You are an economist; put a number on it. Is the skill gap 50 percent of the problem, 70 percent of the problem?

Dr. Slaughter. Again, there has been this ongoing secular increase in demand for more-skilled workers relative to less-skilled workers. I think if you took a look at the body of research evidence here, the majority of that shift in demand for skills gets attributed to the technology innovations that favor skilled workers.

Other forces that have been looked at that seem to have played some role but a much smaller role include freer international trade and immigration inflows also. So some dimensions of greater international commerce and global engagement have played a role, it appears, in shifting demand in the United States towards more-skilled workers, but it played a relatively small role compared to these technology innovations.

Vice Chairman Bennett. So we have got a skill gap, we have got the impact of international trade, we have got the impact of technology, and we have got the question of whether we are in a growth period or a recessionary period, and all of those play into it. Okay.

Dr. Slaughter. Correct.

Vice Chairman Bennett. Okay. Mrs. Maloney raised another issue that I would like to explore with you. She talked about the savings rate. We now have a negative savings rate. As I have looked at that, we had a savings rate in the United States that was fairly stable and then started to tip downward in the 1980s and has continued downward on a very even trajectory since the 1980s to the point that it finally turned negative. It did not turn down and flatten out; it just started down in the 1980s and has kept going down in the 1980s.

So this is not a phenomenon of the last five years or the last 10 years; it is the last quarter century that we have been dealing with a falling savings rate. Talk about that. Tell me why that is the case.

Dr. Slaughter. So the decline in personal household savings rates that you mention has been another long-term feature of the U.S. economy. The report discusses that trend and looks at some of the possible reasons behind it.

One of the reasons that has been contributing to it, especially in recent years, that the report talks about is it kind of looks at the overall financial picture of households and points out that one of the positive features of productivity growth and the aggregate income gains over time has been rising household wealth. So net worth of households in terms of the assets they own minus the liabilities such as home mortgages; that has been rising, especially in recent years, with increases in equity prices and, more recently, home prices.

Vice Chairman Bennett. Have the two gone in lockstep, the savings down and the housing, over 25 years?

Dr. Slaughter. Not as much over 25 years, in part, I think, because the increases in household net worth have been more noticeable in recent years. A lot of research has shown that when households have increases in their wealth, they tend to take some of that wealth in terms of higher consumption, and so the report looks at some analysis that says, given what we know about the propensity of households to increase their consumption when they have more wealth, especially in recent years as household net worth has increased quite well, that explains some of the decline of the overall national personal savings rate.

The other broad feature of savings I would mention is, as Mrs. Maloney had correctly pointed out, when we think about savings for the United States in a global context, an important source of savings for the U.S. economy overall to finance investment of firms in recent years has been foreign savings. So we have domestic savings, which consists of savings by households, there is savings by the Government, there is savings by companies, and then to the extent that we have open borders, we also can use some of the savings of the rest of the world.

So the economic report talks in detail about how our current account deficit reflects the fact that on net, in recent years, the United States has been using some foreign savings to finance the investment by our companies.

Vice Chairman Bennett. That brings up the other subject that she mentioned in her opening statement about foreign investors buying paper from the GSEs. Do you want to comment on the comment that she made in that regard?

Dr. Slaughter. Sure. The data are correct. I do not know the exact details offhand, but GSEs are one of the assets that foreign private investors and public investors have been purchasing, but it speaks to the point that when we look at the range of assets that the rest of the world is purchasing from the United States in recent years, it is a pretty broad portfolio, actually. So the range of assets that are tracked in our statistics that we have in the United States include Treasury securities, and they include the GSE bonds. They also include corporate bonds, corporate equities, bank loans, and another major component of that investment is foreign direct investment, so companies with an ownership statement.

When we look at the data that are collected by the Treasury Department and also by the Bureau of Economic Analysis, the distribution of all of the assets on net that are owned by the rest of the world is pretty evenly distributed actually across those different classes of assets.

So foreign investors, both public and private, are thinking about what is the right mix of assets to own, and over time I think it is reasonable to expect there to be some evolution in the composition of the net foreign debt position of the United States.

Vice Chairman Bennett. So they are not necessarily targeting GSEs as a preferred investment; they are simply diversifying their investments and say we can do a little of this and a little of that.

Dr. Slaughter. I think that is right. On net, when you look at, again, the total stock of U.S. assets that are owned by the rest of the world, again, I do not have the exact statistics in front of me, but it is distributed pretty smoothly across those different asset classes. There is no one class, for example, that I listed that constitutes over 50 percent of the total assets that are owned.

Vice Chairman Bennett. There is not a disparate preference for GSE over Treasury?

Dr. Slaughter. I would have to look at the changes over time in recent years. Offhand, sir, I do not know the exact changes in the distribution of Treasury securities versus GSEs. I would need to look at those data in particular. I just do not have them handy.

Vice Chairman Bennett. It is my impression that there is not, that the appetite for Treasuries remains as strong as it has ever been.

Dr. Slaughter. That very well may be.

Vice Chairman Bennett. But I cannot prove it, so I will not claim it.

Dr. Slaughter. We need the statistics.

Vice Chairman Bennett. Okay. I am sure someone would raise the issue of the trade deficit. Every time we had Chairman Greenspan before us, he would say that the trade deficit in the short-term is not a problem and in the long-term is unsustainable, so you got a headline either way, depending on how you felt about it. Talk to us about the trade deficit, short-term and long-term——

Dr. Slaughter. Absolutely.

Chairman Bennett [continuing]. And what we can do about it.

Dr. Slaughter. Sure. The report has substantial discussion on the trade deficit. The facts as we know is that the trade deficit has been rising, so the recent data for 2005, the trade deficit for the United States with the rest of the world in goods and services came in at about $726 billion. A better metric is the share of GDP. It is a share of 5.8 percent of GDP.

Vice Chairman Bennett. What is the breakdown between goods and services?

Dr. Slaughter. We actually run a surplus with the rest of the world in services.

Vice Chairman Bennett. That was my sense because many times the newspapers focus on the goods trade deficit and say the sky is falling, and they do not understand that we are recovering some of that with services.

Dr. Slaughter. That is correct, sir. So for 2005, our trade surplus in services with the rest of the world was a little over $56 billion. That increased from the previous year, and it comes back to some of the issues you raised earlier. There is more change in the global economy, and part of that means a lot more activities that used to not be tradable now can be traded across borders, like business-processing services that we hear a lot of anecdotes about recently. That increases the possibility for U.S. companies, which tend to be quite good at a lot of service activities, which reflects the fact that over 80 percent of jobs in the U.S. economy are in the service sector. That raises the potential for more export opportunities for U.S.-based companies. So we run a bigger trade deficit in goods, then, that leads to the total trade deficit.

So the rise in the trade deficit that has been ongoing is definitely a source of concern, and thinking about the underlying causes and possible transitions going forward is very important, I think. We know that some of the features of the strength of the U.S. economy in recent years account for the rising trade deficit. One, in particular, is the fact that we have had much faster economic growth that we have been discussing than have most of our major trading partners.

So about two-thirds of our trade is still with other high-income advanced countries, such as Japan, Germany, and France, and they have been growing at much slower rates than has the United States, which means our faster growth rates and faster income growth tend to mean we are importing a rising amount of their goods and services compared to how much of our exports they are taking in with their income growth. That said, some of the forces that account for the increases in the trade deficit are more worrisome, and you correctly point out that the ongoing decline in personal household savings is one of those.

Going forward, then, we can think about different market-based and policy-based adjustments in the rest of the world and in the United States that would contribute to a moderation in the global imbalances that we see in the world today. In the United States, raising national savings relative to investment would be changes that would contribute to an amelioration of the trade deficit, so that would be savings by households perhaps. Again, that is a difficult issue, given that we have seen household savings falling for some time. One of the broad motivations for the tax reform panel was to think about putting in place a different set of incentives that might stimulate savings.

For the rest of the world, I think policy challenges include things like trying to undertake policy reforms that would stimulate faster economic growth that would contribute to more exports from the United States going to those countries if they were enjoying faster growth.

Vice Chairman Bennett. Well, let us look into our crystal ball and say Europe is not going to grow. Japan, aging economy, shrinking population. They do not encourage immigration. India and China, yes, they are growing at dramatic rates, but they are still not major sources for American exports.

Dr. Slaughter. Right.

Vice Chairman Bennett. How do you turn this around?

Dr. Slaughter. That is an excellent question to which I do not have the perfect crystal ball.

Vice Chairman Bennett. All right. What happens if we do not?

Dr. Slaughter. I would say two things. One is you are correct to point out that both China and India have been growing quite quickly. Of our major trading partners, our exports to China have been growing faster than any other country, over 20 percent per year in the past five years.

So one of the broad forces that we can hope for is faster economic growth and productivity growth, in particular, in China and India that will raise average incomes there and allow them to have the earning power to purchase more goods and services from the United States.

For Europe and Japan, you are absolutely correct, sir, that the growth challenges there are, at some level, daunting, given the underlying demographics that are going to limit the population and labor force growth and given that, again, in recent years, at least, they have not enjoyed the kind of productivity performance that the United States' economy has. In the near term, at least, there are signs of strengthening both business and consumer sentiment in Japan and in Germany, in particular. So for those two countries, which are two of our largest trading partners, if capital investment and productivity growth could strengthen, those would be forces that would lead to greater trade between the United States and those countries.

Going out, then, it will remain to be seen what other sources of growth there might be abroad and then what sorts of adjustments, again, both from a policy standpoint and from a market-based standpoint, of what firms and households choose to do around the world to see the distribution of U.S. trade and the total amount of U.S. trade with the rest of the world.

Vice Chairman Bennett. You have not answered my question about looking out. Say that things do not change dramatically. Okay. Europe gets a little stronger here and there, but over the next 30 years, things do not change, and the trade deficit just continues to grow every year, not every year, but the trend line continues to go up every year for the next 30 years. What does that mean to us at that point? Is there a day of reckoning out there, or can we go on like this indefinitely?

Dr. Slaughter. Again, that is an excellent question. As the report talks about, the companion of the trade deficit in goods and services that we run is this surplus in trade in assets. So another way to think about the question going forward is to what extent will the rest of the world continue to be willing to purchase more and more U.S. assets. To the extent that there is a shift in demand away from U.S. assets towards other countries' assets, either from private actors or public actors, that will be a force that will slow the rate of growth, if not start to bring down the global imbalances that we see today. What we would see in the marketplace, in part, might be a change in the market prices of currencies and also of interest rates as well.

But, again, one of the broad puzzles, I think, that we are not quite sure about how it will play out, is that the imbalances that we have seen arise in recent years are qualitatively different from the ones we have seen in previous decades and generations in part because many countries around the world have relaxed policy restrictions on the flows of capital across borders, and so we are now in an environment with a much greater degree of capital mobility across borders than we had in earlier times, and the underlying economics.

We know, kind of like trade in goods and services, that when we liberalize, there should be imbalances across borders, and so one of the challenges for policymakers, for researchers, for the business community going forward is trying to ascertain to what extent now this sort of new environment with greater capital mobility, what degree of imbalances might be sustainable.

Vice Chairman Bennett. You are not drawing a doomsday scenario. You are basically describing a readjustment and a soft landing. As long as the U.S. economy remains strong, we do not worry about the trade deficit?

Dr. Slaughter. No. We continue to worry about the trade deficit, absolutely.

Vice Chairman Bennett. But you have not given me, and I do not think there is, any prescription of what to do about it. As long as we remain stronger than other people, and our economy is growing faster, we are going to run a trade deficit. We do not want to slow us down just for the sake of statistically getting rid of the trade deficit.

Dr. Slaughter. Correct.

Vice Chairman Bennett. But what is the problem? What will be the consequence, long-term, as these adjustments occur? Will the U.S. economy slow down? Will there be greater income imbalance? What will be the consequences?

Dr. Slaughter. That is the excellent and correct question to ask. Again, it is going to be a mix of changes in the United States and changes in the rest of the world in terms of the balance of the United States on net having much higher investment than the pool of national savings, and the converse holds in many of our many trading partners like Japan and Germany. So those countries, for example, have seen sharp declines in their investment rates in recent years relative to their savings.

So, again, I could foresee a number of different scenarios in which there is greater capital investment in countries like Japan and Germany, as I talked about, related to their savings, which would mean that they would run smaller trade surpluses. In the United States, then, some mix of greater national savings related to our investment would be the offsetting change. Again, how quickly that happens and the kind and extent of adjustment of prices of currencies and interest rates depends; there is just a number of different scenarios that one could envision there.

It is hoped for that the adjustment would not be sudden and dramatic, the kind of hard landing that you are referring to. Instead, it is hoped for that, given market flexibility that we have been discussing, that the adjustment would be more gradual over a longer period of time.

Vice Chairman Bennett. Well, we have been here an hour, and I have taken up almost all of it with my questions and your answers, which, for me, is just great, but it looks as if our House colleagues will not be returning, and I have run out of things to ask in their behalf. So thank you very much for being here, and the Committee is adjourned.

Dr. Slaughter. Thank you.

Dr. Baicker. Thank you.

[Whereupon, at 11:37 a.m., the Committee was adjourned.]

Submissions for the Record

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

CHAIRMAN JIM SAXTON

PRESS RELEASE

For Immediate Release
February 16, 2006

Press Release #109-59
Contact: Christopher Frenze
Executive Director
(202) 225-3923

OPENING STATEMENT OF CHAIRMAN JIM SAXTON

ECONOMIC REPORT OF THE PRESIDENT

WASHINGTON, D.C. – I am pleased to welcome Dr. Katherine Baicker and Dr. Matthew Slaughter of the President's Council of Economic Advisers before the Committee this morning. The subject of today's hearing is the *Economic Report of the President*. I would also like to note that the Joint Economic Committee and the Council of Economic Advisers share a common history, and we value our long-standing relationship with the Council.

As the *Economic Report of the President* states, U.S. economic performance has been very strong in recent years. Economic growth has been healthy, the unemployment rate has been falling and is now 4.7 percent, core inflation has been contained, and long-term interest rates remain relatively low. Since May of 2003, payroll employment has increased by 4.7 million jobs. It is worth noting that tax policy and Federal Reserve policy have made important contributions to the economic expansion in recent years.

The tax incentives contained in the 2003 tax bill are among the key reasons for the strong pace of economic growth in recent years. Before 2003, the expansion had been undermined by persistent weakness in business investment. This weakness in investment was the legacy of the many bad investments made before the bursting of the stock market and technology bubbles in the first quarter of 2000. This drag on the economy was overcome by the investment incentives contained in the 2003 tax bill.

Once investment rebounded, the pace of economic growth picked-up sharply. By 2004, the economy was growing at a 4.2 percent rate. Battered by hurricanes and oil price increases, the economy was still able to expand at a rate of 3.5 percent in 2005. Although GDP growth slowed temporarily in the fourth quarter of 2005, the Council, the Federal Reserve, and the Blue Chip consensus forecasts all project continued healthy economic growth through 2006.

The recent historical record shows that the tax incentives in the 2003 Act have worked as designed to restore investment and boost the economy. These tax incentives should be made permanent to sustain investment, economic expansion, and employment growth in the future. The biases against saving and investment ingrained in the tax code should not be permitted to undermine economic growth later in this decade.

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PREPARED STATEMENT OF SENATOR ROBERT F. BENNETT, VICE CHAIRMAN

Today, the Committee will hear testimony from two members of the President's Council of Economic Advisors relative to the recently released Economic Report of the President. As members of the Committee are aware, the President has nominated Dr. Edward P. Lazear of Stanford University to serve as Chairman of the Council of Economic Advisors. When confirmed by the Senate, Dr. Lazear will replace Dr. Ben Bernanke who was recently confirmed as the new Chairman of the Board of Governors of the Federal Reserve. We are pleased, however, to welcome the Council's two other members, Dr. Katherine Baicker and Dr. Matthew J. Slaughter to the Committee.

As we examine the Economic Report of the President, we do so against the backdrop of a strong and growing economy. The economy has created two million new jobs over the past twelve months and more than 4.7 million new jobs since August 2003. Core inflation remains relatively contained. Interest rates remain historically low despite recent increases by the Federal Reserve.

This does not mean that our economy does not face significant challenges in the future. We are faced with high energy prices and ever increasing competition in an increasingly global economy. Additionally, we face serious long term fiscal challenges as a result of promises made in entitlement programs and the demographic reality of an aging population.

It is imperative that Congress and the Administration work together to meet these and other challenges head on. We must work to reign in entitlement spending. We must work together to improve our educational system. We must improve our competitiveness in the global economy. And we must reform a tax system that is overly complex and highly inefficient if we hope to compete effectively in the future.

I believe this is of particular importance and I look forward to hearing our witnesses describe how that system can best be replaced—yes replaced—not simply altered. The time has come to start with a clean sheet of paper and the novel concept that the purpose of the tax system is to raise money to run the government and not to engineer society. We need a system built on three straightforward principles—it must be simple, it must be efficient, and it must be competitive.

Again, welcome to the Committee. We look forward to your testimony.

[From the Washington Post, June 15, 2005]

THE END OF EUROPE

(By Robert J. Samuelson)

Europe as we know it is slowly going out of business. Since French and Dutch voters rejected the proposed constitution of the European Union, we've heard countless theories as to why: the unreality of trying to forge 25 E.U. countries into a United States of Europe; fear of ceding excessive power to Brussels, the E.U. capital; and an irrational backlash against globalization. Whatever their truth, these theories miss a larger reality: Unless Europe reverses two trends—low birthrates and meager economic growth—it faces a bleak future of rising domestic discontent and falling global power. Actually, thatfuture has already arrived.

Ever since 1498, after Vasco da Gama rounded the Cape of Good Hope and opened trade to the Far East, Europe has shaped global history, for good and ill. It settled North and South America, invented modern science, led the Industrial Revolution, oversaw the slave trade, created huge colonial empires, and unleashed the world's two most destructive wars. This pivotal Europe is now vanishing—and not merely because it's overshadowed by Asia and the United States.

It's hard to be a great power if your population is shriveling. Europe's birthrates have dropped well below the replacement rate of 2.1 children for each woman of childbearing age. For Western Europe as a whole, the rate is 1.5. It's 1.4 in Germany and 1.3 in Italy. In a century—if these rates continue—there won't be many Germans in Germany or Italians in Italy. Even assuming some increase in birthrates and continued immigration, Western Europe's population grows dramatically grayer, projects the U.S. CensusBureau. Now about one-sixth of the population is 65 and older. By 2030 that would be one-fourth, and by 2050 almost one-third.

No one knows how well modern economies will perform with so many elderly people, heavily dependent on government benefits (read: higher taxes). But Europe's economy is already faltering. In the 1970s annual growth for the 12 countries now using the euro averaged almost 3 percent; from 2001 to 2004 the annual average was 1.2 percent. In 1974 those countries had unemployment of 2.4 percent; in 2004 the rate was 8.9 percent. Wherever they look, Western Europeans feel their way of life threatened. One solution to low birthrates is higher immigration. But many Europeans don't like the immigrants they have—often Muslim from North Africa—and don't want more. One way to revive economic growth would be to reduce social benefits, taxes and regulations. But that would imperil Europe's "social model," which supposedly blends capitalism's efficiency and socialism's compassion.

Consider some contrasts with the United States, as reported by the Organization for Economic Cooperation and Development. With high unemployment benefits, almost half of Western Europe's jobless have been out of work a year or more; the U.S. figure is about 12 percent. Or take early retirement. In 2003 about 60 percent of Americans ages 55 to 64 had jobs. The comparable figures for France, Italy and Germany were 37 percent, 30 percent and 39 percent. The truth is that Europeans like early retirement, high jobless benefits and long vacations.

The trouble is that so much benevolence requires a strong economy, while the sources of all this benevolence—high taxes, stiff regulations—weaken the economy. With aging populations, the contradictions will only thicken. Indeed, some scholarly research suggests that high old-age benefits partly explain low birthrates. With the state paying for old age, who needs children as caregivers? High taxes may also deter young couples from assuming the added costs of children.

You can raise two objections to this sort of analysis. First, other countries are also aging and face problems similar to Europe's. True. But the aging is more pronounced in Europe and a few other nations (Japan, for instance), precisely because birthrates are so low. The U.S. birthrate, for example, is 2.1; even removing births to Hispanic Americans, it's about 1.9, reports Nicholas Eberstadt of the American Enterprise Institute. Second, Europeans could do something about their predicament. Also, true—they could, but they're not. A few countries (Britain, Ireland, the Netherlands) have acted, and there are differences between Eastern and Western Europe. But in general Europe is immobilized by its problems. This is the classic dilemma of democracy: Too many people benefit from the status quo to change it; but the status quo isn't sustainable. Even modest efforts in France and Germany to curb social benefits have triggered backlashes. Many Europeans——maybe most—live in a state of delusion. Believing things should continue as before, they see almost any change as menacing. In reality, the new E.U. constitution wasn't radical; neither adoption nor rejection would much alter everyday life. But it symbolized change and thereby became a lightning rod for many sources of discontent (over immigration in Holland, poor economic growth in France).

All this is bad for Europe—and the United States. A weak European economy is one reason that the world economy is shaky and so dependent on American growth. Preoccupied with divisions at home, Europe is history's has-been. It isn't a strong American ally, not simply because it disagrees with some U.S. policies but also because it doesn't want to make the commitments required of a strong ally. Unwilling to address their genuine problems, Europeans become more reflexively critical of America. This gives the impression that they're active on the world stage, even as they're quietly acquiescing in their own decline.

[From the Washington Post, Feb. 16, 2006]

The Fears Under Our Prosperity

(By Robert J. Samuelson)

A puzzle of our time is why the economy has become increasingly stable while individual industries have become increasingly unstable. The continuing turmoil at General Motors and Ford simply reflects this more pervasive industrial instability—also in airlines, telecommunications, pharmaceuticals and the mass media, among others. Hardly a week passes without layoffs from some major company, which is "downsizing," "restructuring" or "outsourcing." And yet, the broader economy has undeniably become more stable. Since the early 1980s, we've had only two recessions, lasting a combined year and four months and involving peak unemployment of 7.8 percent. By contrast, from 1969 to 1982, we had four recessions lasting altogether about four years and having unemployment as high as 10.8 percent.

A cottage industry of economists is cranking out studies on these questions. One intriguing theory—completely counterintuitive—is that the greater overall stability stems in part from the increased instability of individual industries. You would, of course, expect the opposite: As individual industries became less stable, so would the larger economy.

But the reality may be more complex. Different industries may go through cycles that are disconnected from each other, argue economists Diego Comin and Thomas Philippon of New York University. All don't rise and fall simultaneously. To simplify slightly: Housing, autos and farming might strengthen, while computers, airlines and chemicals weaken.

Assuming there's something to this theory—which seems a good bet—it helps explain the riddle of why there's so much anxiety amid so much prosperity. As Americans stock up on BlackBerrys and flat-panel TVs, it's hard to deny the affluence. But people also look to their employers for a sense of confidence about the future—and here doubts have multiplied, because more companies and industries seem assailed by menacing forces. We can all identify the usual suspects. Globalization. Deregulation. Greater domestic competition. In a series of papers, Comin, Philippon and various colleagues have shown that, for most businesses, sales, profits and employment have all become more volatile in recent decades. They bounce around more from year to year, suggesting greater industry instability. Competitive pressures have dramatically intensified. One telling statistic: In 1980 a firm in the top fifth of its industry had about a 1-in-10 chance of losing that position within a five-year period; by 1998 the odds had increased to 1 in 4. Feeling threatened, corporate managers have altered pay and employment practices. In 1994, economists Peter Gottschalk of Boston College and Robert Moffitt of Johns Hopkins University showed that annual wage gains also had begun to bounce around more in the 1980s (in technical lingo, there was more variation around the average). Now, Comin and Erica Groshen of the Federal Reserve Bank of New York and Bess Rabin of Watson Wyatt Worldwide have connected these erratic wage increases to firms' fluctuating fortunes. In good years, companies enlarge the pot for wage and salaries, says Groshen; in bad years, the pot grows less or shrinks. About four-fifths of big U.S. firms also resort more to bonuses, personal incentives and stock options, Hewitt Associatesreports.

The same sort of cost-conscious behavior also leads to more layoffs, even among career workers. In 1983, 58 percent of men ages 45 to 49 had been with their current employer 10 years or more, reports the Bureau of Labor Statistics. By 2004, the comparable figure was 48 percent. Little wonder that we have rising job insecurity, despite lower average unemployment.

Not by accident do many of these trends begin, or strengthen, in the 1980s. From 1980 to 1983, the Federal Reserve crushed inflation, which fell from 12.5 percent to 3.8 percent. Inflation dulls competition. Sloppy managers can simply raise prices. Because most companies are rapidly increasing prices, customers have a harder time discriminating. Inflation also comes to dominate the business cycle. It overwhelms other influences. Once inflation declined, competition—based on prices, new products and technologies—intensified. Differences among sectors became more pronounced. So we return to the original puzzle: Why does an economy of greater stability have industries of lesser stability? The answer is competition. An intensely competitive economy enhances overall stability by holding down inflation (which is itself destabilizing) and spreading economic disruptions throughout the business cycle (rather than letting them accumulate for periodic, massive downturns). But the solution to one problem creates other, though smaller, problems. Except during unsustainable booms, say, the late 1990s, even good times are punctuated with insecurities, disappointments, job losses, broken promises and shattered expectations. What may be good for us as a society may hurt many of us as individuals. The unending challenge is to find the necessary social protections that help the most vulnerable without frustrating desirable, if sometimes painful, change.

SEN. JACK REED (RI)
RANKING DEMOCRAT

SEN EDWARD M KENNEDY (MA)
SEN PAUL S. SARBANES (MD)
SEN JEFF BINGAMAN (NM)
REP CAROLYN B MALONEY (NY)
REP MAURICE HINCHEY (NY)
REP LORETTA SANCHEZ (CA)
REP ELIJAH E CUMMINGS (MD)

Congress of the United States
Joint Economic Committee
Democrats

109TH
CONGRESS

804 HART SENATE OFFICE
BUILDING
WASHINGTON, DC 20510-6602
202-224-0372
FAX 202-224-5568
www.jec.senate.gov/democrats

CHAD STONE
STAFF DIRECTOR

Opening Statement
Senator Jack Reed
Joint Economic Committee Hearing
February 16, 2006

Thank you, Chairman Saxton. I want to welcome Dr. Baicker and Dr. Slaughter from the President's Council of Economic Advisers, and thank them for testifying here today.

This year's Economic Report of the President is an interesting collection of chapters on various economic issues. I have to commend the President's council members for finding a silver lining for every dark cloud over the economy. Indeed, the Wall Street Journal noted this week that the President's report struck "a more optimistic tone than many economists" and observed that "the U.S.'s rock-bottom personal-saving rate and record trade deficit aren't major worries" for the White House.

There is another curious disconnect between the analysis in the report and the President's policy priorities. The report does analyze many key aspects of the U.S. economy, but it reveals little about how the President's policies would actually help average families or bring down the deficit.

The centerpiece of the President's message to Congress is the benefits of making his tax breaks for the wealthiest permanent, yet there is no analysis in the report to justify the claim that taxes are too high and are hurting the economy. In fact, the chapter on taxes shows something that has been true for a long time—the United States has a relatively low tax burden compared with other developed countries.

The report tells us why energy prices are high, but we see no proposal from the President to bring relief to the majority of American households who find their budgets squeezed by rising energy costs on the one hand, and stagnation in their take-home pay on the other.

The President's report extols the benefits of trade, but the focus is on the long run. While the report acknowledges that 'any job loss involves hardship, and any job change can involve challenge,' the President has no meaningful plan to address the problems of those who are hurt by trade.

A whole chapter is devoted to the large U.S. international payments imbalance and low national saving rate, including an acknowledgement of federal government dissaving

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as the federal budget balance went from a surplus equivalent to 2.4 percent of GDP in 2000 to a deficit equivalent to 3.6 percent of GDP in 2004. But President Bush's FY 2007 budget proposals would increase the size of the deficit rather than reduce it.

The one area where the President's policies do reflect the Administration's philosophies is health care. The Administration seems to believe that Americans have too much health care coverage, so they plan to cut Medicare spending and also move toward making consumers finance care below a catastrophic, high-deductible limit.

The President's budget slashes Medicare spending by $36 billion over the next five years by cutting funding for hospitals and other providers, inflicting pain on the nation's elderly without solving the problem of the growing cost of health care. Similarly, the President's "consumer-driven" health care proposals would do little to reduce the number of uninsured, lower costs, or improve the quality of coverage. If the chaos surrounding the Administration's Medicare prescription drug plan is any indication of how the President's health care proposals will play out, I think the public should be very concerned about this approach.

Unfortunately, middle- and lower-income families are paying the price for the President's tax cuts for the wealthiest, as programs that help ordinary Americans cope with economic or health insecurity have become candidates for budget cutting.

I look forward to our discussion of this report and the economic outlook.

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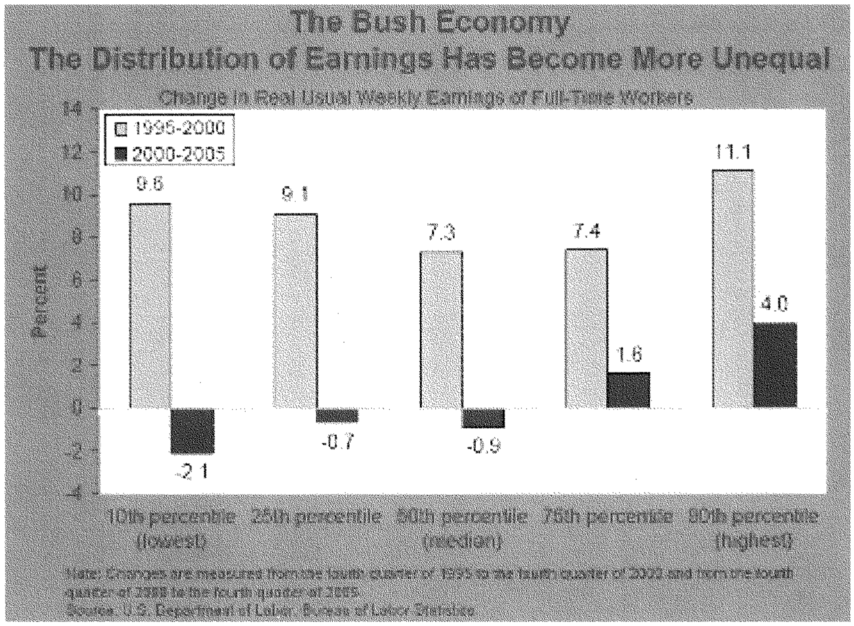
The Bush Economy
The Distribution of Earnings Has Become More Unequal
Change in Real Usual Weekly Earnings of Full-Time Workers
1995-2000
2000-2005
Percent
14
12
10
8
6
4
2
0
-2
-4
9.6
-2.1
9.1
-0.7
7.3
-0.9
7.4
1.6
11.1
4.0
10th percentile (lowest)
25th percentile
50th percentile (median)
75th percentile
90th percentile (highest)
Note: Changes are measured from the fourth quarter of 1995 to the fourth quarter of 2000 and from the fourth quarter of 2000 to the fourth quarter of 2005.
Source: U.S. Department of Labor, Bureau of Labor Statistics

PREPARED JOINT STATEMENT OF DR. MATTHEW SLAUGHTER AND DR. KATHERINE BAICKER, MEMBERS, COUNCIL OF ECONOMIC ADVISERS

Chairman Saxton, Vice-Chairman Bennett, Ranking Member Reed, and other members of the Joint Economic Committee, we are pleased to testify today about the 2006 Economic Report of the President. The Report reviews the state of the economy and the economic outlook, and discusses a number of economic policy issues of continuing importance. Across its 11 chapters, the Report highlights how economics can inform the design of better public policy and reviews Administration initiatives.

The performance of the U.S. economy continues to be strong. In 2005, the Nation's real GDP grew 3.5 percent for the year, above the historical average. Key components of demand that accounted for growth in 2004—consumer spending, business investment in equipment and software, and exports—continued to do so in 2005. Employment increased by almost 2 million payroll jobs over the year, and the unemployment rate dropped to 4.7 percent last month, well below the averages of recent decades. Real disposable personal income increased, and real household net worth reached an all-time high. This growth comes on top of an already strong expansion, the foundation of which has been exceptionally rapid productivity growth. The Administration's forecast, consistent with consensus private forecasts, shows the economic expansion continuing for the foreseeable future.

Increases in investment spurred by the dividends and capital gains tax relief enacted in 2003 have played an important role in the strengthening of our economy. Since the Jobs and Growth bill became law, capital investment has increased by 25 percent, contributing to sustained job growth and directly benefiting workers. It is essential that this tax relief be extended.

American productivity growth and thus competitiveness in the 21st century will rely upon American ingenuity, entrepreneurship, and labor-force talent. The President's American Competitiveness Initiative aims to support these forces. Promoting a flexible and skilled workforce—through improved access to high-quality primary, secondary, and post-secondary education, through policies that attract the world's best and brightest to our shores, and through investment in R&D and the continuing education and re-training of our mobile workforce—will help ensure that the United States remains a leader in this rapidly changing world economy.

But maintaining this leadership will also require a continued commitment to competition in and flexibility of U.S. product, capital, and labor markets that help transform innovations into the new products and processes in the marketplace that ultimately support rising incomes for workers and their families. Innovation alone is not sufficient to guarantee rising prosperity. It also requires the dynamism of the marketplace for which America is uniquely positioned.

This continuing strength and competitiveness of the American economy in the global marketplace depends upon policies that open international markets to U.S. goods, and that promote growth and investment at home. The performance of the U.S. economy depends on an effective financial-services sector and on a tax system that promotes domestic growth and international competitiveness. Further opening foreign markets to U.S. goods would yield great rewards for Americans. Over the past 70 years, policymakers across political parties have consistently recognized the importance of international commerce, and have achieved major trade liberalization both here and abroad. The net payoff to America from these achievements has been substantial.

The Administration's policies will make even greater gains possible. Support of the agricultural sector can be provided in ways that are less distortionary. We must work to eliminate further barriers to trade, especially in services, and to further open markets in global, regional, and bilateral negotiations. Americans will reap the greatest benefits from this trade when intellectual property rights are well-defined and well-enforced. The Administration continues to enforce vigorously the laws that protect the rights of American intellectual-property owners.

The continued expansion of energy markets and diversification of energy sources can further increase our resilience to energy-supply disruptions. Hurricanes Katrina and Rita demonstrated that competitive markets play a central role in allocating scarce energy resources, especially during times of natural disaster or national emergency. Policies that build on economic incentives and that spur our development of alternate fuel sources can reduce U.S. vulnerability to energy disruptions and reliance on foreign oil, encourage energy efficiency, and protect the environment.

Even as living standards rise, Americans are increasingly concerned about their retirement security and health care costs. Most working-age Americans are in fact on track to have more retirement wealth than most current retirees. There are, however, a number of risks to the retirement preparations of Americans. People today are living longer and could face higher health-care costs in retirement than members of previous generations. In addition, both defined benefit pensions and Social Security suffer from fundamental financial problems that expose not just retirees but all U.S. taxpayers to risk of substantial losses. The Administration is focused on addressing these problems and protecting the Nation's retirement security.

Rising health care costs are of concern to all Americans, young and old. All Americans deserve access to reliable, affordable, high-quality, high-value health care. Health care in the United States is second to none, but it can be better. Both public and private health care spending have grown much more rapidly than general inflation or wages, straining consumers, employers, and government budgets. The cost of finding new health insurance locks some workers into their current jobs if they or someone in their family is chronically ill. Frivolous lawsuits raise health care costs for everyone. Perverse tax and insurance incentives have led to inefficient use of health care resources.

Promoting a stronger role for consumers can help create a health care system that is more affordable, transparent, portable, and efficient. Health Savings Accounts should be strengthened by allowing people to contribute enough to them to pay for all of their out of pocket expenditures tax free. Individual purchasers should have the same tax advantages as those who get insurance from their employers. We need to ensure that patients and their doctors have the information that they need to use this control to get the health care that is best for them, and that electronic health records are widely used to reduce costs and improve the quality of medical treatment.

The Report provides an analytical backdrop for the President's agenda, which includes restraining government spending; making tax relief permanent; making health care more affordable and accessible; creating an economic environment that encourages innovation and entrepreneurship; continuing to open markets to American goods and services; and reducing America's dependence on foreign oil by diversifying our energy supply. These policies will help maintain the economy's momentum, foster job creation, and ensure that America remains a leader of the global economy.

We will briefly outline for you the highlights of the Report. Chapter 1, The Year in Review and the Years Ahead, reviews the economic developments of 2005 and discusses the Administration's forecast for the years ahead. The expansion of the U.S. economy continued for the fourth consecutive year in 2005, with strong growth in real GDP. Most components of demand that accounted for growth in 2004—consumer spending, business investment in equipment and software, and exports—continued to do so in 2005. Labor markets continued to strengthen, with almost 2 million new jobs created in 2005 and a year-end unemployment rate of 4.9 percent. Productivity growth remained well above its historical average. Overall inflation rose substantially at mid-year, but came down by year-end as it reflected the movement of energy prices, while core inflation (which excludes food and energy prices) has remained in the moderate 2-percent range. The Administration's forecast, consistent with consensus private forecasts, shows the economic expansion continuing for the foreseeable future.

Chapter 2, Skills for the U.S. Workforce, discusses the economics of education, immigration, and job training. Promoting a flexible and skilled labor force—through improved access to high quality primary, secondary, and post-secondary education, through policies that attract the world's best and brightest to our shores, and through investment in the continuing education and training of our mobile workforce—will ensure that the United States remains a competitive leader in this rapidly changing world economy.

Chapter 3, Saving for Retirement, addresses the concern that Americans have been preparing inadequately for retirement. Most working-age Americans are in fact on track to have more retirement wealth than most current retirees. There are, however, a number of risks to the retirement preparations of Americans. People today are living longer and could face higher health-care costs in retirement than members of previous generations. In addition, both defined benefit pensions and Social Security suffer from fundamental financial problems that expose not just retirees but all U.S. taxpayers to risk of substantial losses. The Administration is focused on addressing these problems and protecting the Nation's retirement security.

Chapter 4, Improving Incentives in Health Care Spending, reviews the causes and consequences of health care spending growth and discusses how the President's consumer-driven proposals can improve the health care system. Growth in spending on health care has been much more rapid than general inflation, straining consumers, employers, and government budgets. Perverse tax and insurance incentives have led to inefficient levels and composition of spending on health care. Promoting a stronger role for consumers is a promising strategy for improving health care value and affordability.

Chapter 5, The U.S. Tax System in International Perspective, examines U.S. tax system choices in the context of other countries. These choices matter because they affect living standards and economic growth. The United States has a different tax structure from most other advanced economies, raising more of our revenue through a tax on personal income instead of consumption. While the U.S. system has been significantly improved in recent years, it could benefit greatly from additional reforms, particularly those focused on the taxation of capital income.

Chapter 6, The U.S. Capital Account Surplus, discusses the enormous number of trade and financial transactions the U.S. has with other countries. In 2004, the United States ran a current account deficit of $668 billion—meaning that the United States imported more goods and services than it exported, and that foreign investors purchased more U.S. assets than U.S. investors purchased in foreign assets. The size and persistence of U.S. net capital inflows reflect a number of U.S. economic strengths, as well as some shortcomings. Greater global balance of capital flows can be promoted by higher domestic savings, better growth and investment opportunities in Europe and Japan, and greater exchange rate flexibility and financial sector reforms in Asia.

Chapter 7, The History and Future of International Trade, notes that while economic research and historical evidence show that the benefits of trade outweigh the costs, trade liberalization has always generated concerns in the United States and throughout the world. Over the past 70 years, policymakers across political parties have consistently recognized the importance of international commerce, and have achieved major trade liberalization both here and abroad. The net payoff to America from these achievements has been substantial. The Administration is working to eliminate further barriers to trade, especially in services, and to further open markets in global, regional, and bilateral negotiations.

Chapter 8, The U.S. Agricultural Sector, examines the effects of agricultural support payments and trade policy on domestic prices, the wellbeing of the agricultural sector, and of the economy overall. In 2005, the Federal Government spent approximately $20 billion on agricultural support payments, but most farmers do not benefit from these subsidies. In addition, the United States maintains barriers to the import of some commodities, and these barriers raise the domestic prices of these commodities relative to world prices. Support to agriculture can be provided in many forms that are potentially less market-distorting.

Chapter 9, The U.S. Financial Services Sector, explores what financial services do for an economy, how financial development relates to economic performance, and how financial services can be effectively regulated. The U.S. financial services sector improves economic performance by addressing informational problems and facilitating innovation. An effective financial regulatory system appropriately balances the costs and benefits of public regulation.

Chapter 10, The Role of Intellectual Property in the Economy, notes that intellectual property rights create incentives for investment in research, development, and innovation. Well-defined and enforced intellectual property rights are an important element of the American economy and can contribute to the economic growth of all countries. The Administration continues to enforcevigorously the laws that protect the rights of American intellectual property owners.

Chapter 11, Recent Developments in Energy, discusses crude oil, refined petroleum products, natural gas, and electricity markets. Increased scarcity and rising prices over time will encourage conservation, increase incentives for exploration, and stimulate the development of new, energy efficient technologies and alternative energy sources. In the near term, unexpected disruptions to energy supply and distribution networks may continue to affect consumers and businesses. Hurricanes Katrina and Rita demonstrated that competitive markets play a central role in allocating scarce energy resources, especially during times of natural disaster or national emergency. The continued expansion of energy markets through regional and global trade can further increase our resilience to energy supply disruptions. Policies that build on economic incentives can reduce U.S. vulnerability to energy disruptions, encourage energy efficiency, and protect the environment.

Thank you for this opportunity to discuss the 2006 Economic Report of the President. We would be happy to answer any questions you might have.

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