Overview

The expansion of the U.S. economy continued for the fourth consecutive year in 2005. The President has laid out an agenda to maintain the economy's momentum, foster job creation, and ensure that America remains a leader of the global economy.

The President is advancing plans to make tax relief permanent; restrain government spending to reduce the budget deficit; strengthen retirement systems; make health care more affordable and accessible; create an economic environment that encourages innovation and entrepreneurship; enhance private incentives for research and development; boost math and science education and worker training; reform the immigration system and strengthen our borders; continue to open markets to American goods and services; and reduce America's dependence on foreign oil by diversifying our energy supply.

This *Report* reviews the state of the economy and the economic outlook, and discusses a number of economic policy issues of continuing importance. The *Report* highlights how economics can inform the design of better public policy and reviews Administration initiatives.

The Year in Review and the Years Ahead

The economy has shifted from recovery to sustained expansion, having absorbed the effects of the Gulf Coast hurricanes and large increases in energy prices in 2005. 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 key points of this chapter are:

- Real GDP grew strongly during 2005. 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. Employers created 2 million new jobs in 2005, and the unemployment rate dropped to 4.9 percent by year-end.
- Productivity growth remained well above its historical average in 2005.
- Inflation rose substantially at mid-year, but came down by year-end as it reflected the movement of energy prices. In contrast, inflation in the core consumer price index (CPI) (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.

Skills for the U.S. Workforce

Chapter 2, *Skills for the U.S. Workforce*, discusses the economics of education, immigration, and job training. The key points are:

- Education is a key contributor to economic growth and individual income.
- Advances in education levels have slowed over the past 25 years. The No Child Left Behind Act is working to reverse this trend by making schools more accountable. If, however, we do not continue to improve our schools, the U.S. standard of living could be jeopardized in years to come.
- High-skilled immigrants make up a vital part of the U.S. economy, particularly in the science and engineering sectors.
- Workers need to upgrade their skills continually to adapt to and take part in an ever-changing economy.

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.

Saving for Retirement

Over the past few decades, concerns have mounted that Americans have been preparing inadequately for retirement. The main points of Chapter 3, *Saving for Retirement*, are:

- Most working-age Americans are on track to have more retirement wealth than most current retirees. It is inherently difficult, however, to assess whether these preparations are adequate for most households.
- The decline in an often-cited aggregate personal saving rate may not be cause for much alarm for retirement preparedness. Much of this decline can be attributed to spending triggered by wealth increases from capital gains on housing and financial assets.
- 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, Social Security and many defined-benefit pension plans are at risk.
- 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.

Improving Incentives in Health Care Spending

Health care spending in the United States has increased rapidly over the past several decades, rising 44 percent in real per capita terms in the past ten years alone. Some of the reasons for this marked rise reflect higher-quality health care, such as improved technological options for enhancing health and quality of life. Other factors, however, such as poorly functioning markets for health care, may have led to excessive spending and inefficient patterns of medical care utilization.

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. The key points are:

- 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.

The U.S. Tax System in International Perspective

All governments face two important decisions. They must choose the scope and scale of public goods and services to provide for their citizens, and they must also decide how to collect the funds to finance those public services. Chapter 5, The U.S. Tax System in International Perspective, examines U.S. choices in the context of other countries. It makes three key points:

- Fundamental choices about tax systems matter because they affect the living standards of citizens.
- The United States has made different choices from other countries. The United States has a relatively low tax burden compared to the rest of the world, and we finance more of that burden with a tax on personal income instead of consumption.
- When viewed in an international perspective, the U.S. system has been significantly improved in recent years but could benefit greatly from additional reforms, particularly those focused on the taxation of capital income.

The U.S. Capital Account Surplus

The United States conducts an enormous number of trade and financial transactions with other countries. In 2004, the U.S. ran a current account deficit of $668 billion. This deficit meant the U.S. imported more goods and services than it exported. The counterpart to the U.S. current account deficit was a capital account surplus of an equal amount. This surplus meant that foreign investors purchased more U.S. assets than U.S. investors purchased in foreign assets, and the U.S. received net foreign capital and financial inflows. Chapter 6, *The U.S. Capital Account Surplus*, makes several key points:

- The size and persistence of U.S. net capital inflows reflects a number of U.S. economic strengths as well as some shortcomings.
- The recent rise in U.S. net capital inflows in part reflects global economic conditions as well as policies in some Asian countries and weak growth in several European economies that led to greater net capital outflows from these countries.
- Encouraging greater global balance of capital flows would be helped by steps in several countries, such as higher domestic saving in the U.S., stronger economic growth in Europe and Japan, and greater exchange rate flexibility and financial sector reforms in Asia.

The History and Future of International Trade

While economic research and historical evidence show the benefits of trade outweigh the costs, trade liberalization has always brought anxieties in the United States and throughout the world. There have always been temptations to retreat to economic isolationism, but the Administration rejects that notion. The key points in Chapter 7, *The History and Future of International Trade*, are:

- 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. For example, studies have estimated the annual payoff from U.S. trade and investment liberalization thus far averages $5,000 per American.
- A number of barriers to trade remain, especially in services, and the benefits of eliminating these barriers are significant. One study found removing all remaining barriers to trade in services would lead to an additional $7,000 in annual income for the average American family of four. The Administration is working to open these markets in global, regional, and bilateral negotiations.

The U.S. Agriculture Sector

In 2005, the Federal government spent approximately $20 billion on agricultural support payments in a sector forecast to produce approximately $270 billion of output. 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. To what extent do these many payments and trade barriers serve a public purpose? Are they needed to maintain a healthy U.S. agricultural sector? Could alternative policies achieve this goal? Chapter 8, *The U.S. Agricultural Sector*, addresses these and other questions. The key findings of this chapter are:

- Most farmers do not benefit from commodity subsidies.
- Support to agriculture can be provided in many forms that are potentially less market- distorting than existing commodity subsidies.

The U.S. Financial Services Sector

Most people interact regularly with the financial services sector, such as when they make deposits at banks or obtain loans from them. Nevertheless, understanding what this sector does can be difficult. Why do individuals go to intermediaries like banks for mortgages, rather than skip intermediaries and deal directly with savers? And why do financial service firms ask for so much information before making a loan and, afterward, place so many restrictions on borrowers?

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 key points are:

- The U.S. financial services sector addresses informational problems that can otherwise keep financial capital from finding productive uses. The sector tends to deliver these services in a cost-effective manner.
- Financial services facilitate innovation and thus encourage economic growth. They might also bolster economic stability.
- Financial regulation should protect consumers and ensure the system's safety and soundness. Moving too far in the direction of public regulation, however, can stifle the productivity and innovation necessary for the economy to enjoy fully the benefits of financial services. An effective financial regulatory system appropriately balances the costs and benefits of public regulation.

The Role of Intellectual Property in the Economy

The founders of this country believed that intellectual property was so important that one of the grants of power to Congress under the Constitution was "To promote the Progress of Science and the useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." Economic research over the past two centuries confirms the importance of intellectual property. The key points of Chapter 10, *The Role of Intellectual Property in the Economy,* are:

- Intellectual property rights create incentives for individuals and firms to invest in research and development, and to commercialize inventions by allowing them to profit from their creations.
- Well-defined and enforced intellectual property rights are important to economic growth.
- The Administration continues to enforce vigorously the rights of American intellectual property owners.

Recent Developments in Energy

Chapter 11, *Recent Developments in Energy*, discusses energy markets—systems that connect consumers and suppliers of energy products, where prices are determined by what buyers will pay and what sellers will accept. The chapter reviews developments in markets for crude oil, refined petroleum products, and natural gas, as well as developments in the electricity-generation sector. The key points are:

- 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 reduce U.S. vulnerability to energy disruptions, encourage energy efficiency, and protect the environment can be beneficial supplements to markets. These policies can be made more effective and less costly when designed based on economic incentives.