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Congress of the United States

JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)

Washington, DC 20510–6602

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February 25, 2004

The Honorable Don Nickles
Chairman
Committee on the Budget
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Pursuant to the Congressional Budget Act of 1974, I am writing as the Chairman of the Joint Economic Committee to bring to your attention the committee's views on the current state of the economy as well as on the short- and long-term outlook for fiscal policy. It is our hope that this guidance will be of assistance as you and your committee craft the Budget Resolution for the upcoming fiscal year.

Current State of the Economy

As you know, during the last few years, the American economy has faced a myriad of challenges. The economy slowed dramatically in 2000 as the boom of the 1990s came to an end. The shocks of terrorism, corporate scandals, and the wars in Afghanistan and Iraq then slowed and weakened the recovery. Absent intervention, these shocks might have sparked a second economic downturn, but a combination of well-timed tax relief, accommodative monetary policy, and the remarkable resilience of our markets have kept the recovery going.

That recovery hit its stride in the second half of 2003. The year ended with strong growth, new job creation, falling unemployment, increasing manufacturing activity, rallying stock prices, and forecasts of continued robust growth for 2004. More specifically:

- 2003 ended with rapid economic growth. Real gross domestic product (GDP) grew at a 6.1 percent annual rate in the second half of 2003, the fastest six-month pace in almost 20 years. Over 2003 as a whole, GDP grew by 4.3 percent, faster than the average rate (3.7 percent) of the 1990s expansion (see Chart 1 attached). Forecasters believe that GDP growth will be sustained at around 4 percent throughout 2004.

- Productivity continued its rapid growth in 2003, growing in excess of 4 percent for the second consecutive year, well above historical averages. Rising productivity is the key to rising incomes in the years ahead.

- Employment is strengthening. The unemployment rate fell to 5.6 percent in January 2004, well below its recent peak of 6.3 percent last June. Five straight months of job gains have now added 366,000 jobs to U.S. payrolls, and many forecasters expect more robust job growth in the months ahead. Further evidence of strengthening employment comes from the household survey, used to calculate the unemployment rate, which has shown stronger employment – a gain of about 2 million jobs since November 2001 – than the payroll survey.

- Business activity is increasing. The Institute for Supply Management's (ISM) manufacturing index has risen to its highest value since 1983. The ISM services index has also been rising and in January was the highest in its history (Chart 2). Index values above 50 indicate expansion, so current values that are well above 60 indicate vigorous expansion in both manufacturing and services.

- Measures of consumer confidence have generally been on the rise for a considerable period of time. After-tax incomes also continue to grow, boosted by tax relief. Improved sentiment and incomes have boosted consumer spending, which grew at a 2.6 percent annual pace in the 4th quarter after hearty spending in the 3rd quarter. After-tax incomes will improve further as taxpayers receive higher refunds.

- Remarkably strong home sales have boosted the homeownership rate to a new high of 68.5 percent. Many signs point to more strength in housing in the near term. Mortgage applications have risen again on a renewed dip in mortgage rates; housing starts rose in December to the highest in about 20 years; and permits for home construction were up in the 4th quarter.

- Stock markets continue to rally. Since May of last year, shareholder wealth has increased by 28.5 percent, which translated into a $2.5 trillion gain. Shareholder wealth has now recouped 52 percent of all the losses from May 2000 to October 2002. The American Shareholders Association reports that 62.7 percent of the increase took place after the tax cut agreement was reached on May 20, 2003.

- Many measures of inflation are at their lowest since the 1960s, a key reason the Federal Reserve has "accommodated" strong growth without raising rates.

These factors indicate that the U.S. is well-positioned for strong growth in the quarters and years ahead. Of course, some risks and uncertainties remain, as they always do. Energy prices remain elevated. The economies of many of our trading partners remain weak, limiting markets for U.S. goods. Commitment to free trade appears to be weakening in some quarters, and the global risks of terrorism and unrest in the Middle

East remain. Moreover, growth in the current account deficit – it grew to $550 billion in 2003 (roughly 5 percent of GDP) – combined with sustained federal budget deficits implies that the U.S. must borrow increasing amounts in global markets. While the deficits remain manageable, especially when viewed in their proper context as percents of GDP, current account and budget deficits cannot grow without bound.

Looking further ahead, the nation has not yet fully addressed its future fiscal challenges. Americans are not yet saving enough for their future, reflecting the saving penalty inherent to the income tax code. Our health care system delivers too little care at too high a cost. And our tax system remains needlessly complicated, inefficient, and uncertain, undermining economic growth. While we remain optimistic about America's economic future, much work remains.

Short and Long-Term Fiscal Outlook

In its January 2004 *Economic and Budget Outlook*, the Congressional Budget Office (CBO) projected that the federal budget deficit would reach $477 billion this year and $362 billion in fiscal year 2005. In the president's budget submission, the Office of Management and Budget (OMB) forecasted even larger deficits in these years.

These projections have highlighted recent concerns about the course of U.S. fiscal policy. These concerns are justified because continued increases in the deficit could pose significant economic problems in the future, but they must be tempered with an understanding of how large the deficits really are, how they arose, and how the U.S. can rebound from them.

- Current deficits are large, but manageable. At $477 billion, this year's deficit will be the largest ever in nominal terms (i.e., in current dollars). However, to compare deficits across different years, it is important to account for the economy's capacity to absorb the deficits and the government's ability to finance them. Both of these factors depend on the size of the economy, so economists typically measure deficits relative to GDP. As shown in Chart 3, the annual budget deficit is projected to be 4.2 percent of GDP this year and 3.0 percent of GDP next year. These deficits are not small, but they are lower than many of the deficits experienced in the U.S. in the 1980s and the early 1990s.

- The recent emergence of large federal budget deficits reflects the near "perfect storm" that has rocked the federal government's budget: 1) revenues plummeted due to a weak economy and a sharp drop in the stock market, 2) spending increased because of two wars and new homeland security requirements, and 3) fiscal discipline weakened following the emergence of budget surpluses in the late 1990s. As Chart 3 illustrates, it is common for deficits to increase, often substantially, following periods of economic weakness. For example, the deficit increased to 6 percent of GDP following the recessions of the early 1980s and increased to almost 5 percent of GDP following the recession of the early 1990s. Today's somewhat smaller deficits continue this pattern.

The best way to reverse the recent growth of deficits is to encourage economic growth – thereby boosting tax revenues – and to restrain spending. The rapid improvement in the U.S. fiscal position in the late 1990s demonstrates that a combination of strong economic growth, encouraged by sound economic policies, and spending restraint can return the budget to balance.

Recent growth rates in federal spending are unsustainable and must be addressed in order to strengthen the nation's fiscal footing. Focusing on spending is imperative, especially since it can be more easily controlled than revenues, which are more dependent on economic factors. While many recent spending increases have been justified by the need to combat terrorism here and abroad, discretionary spending cannot continue to grow faster than the economy.

In the long run, we must also recognize that controlling discretionary spending is only part of the solution. Discretionary spending now constitutes less than 40 percent of the current federal spending pie, and it will likely constitute an even smaller share in the future. The bigger problem America faces in the long-run budget, therefore, is rapidly escalating entitlement spending. According to the president's budget, entitlement spending is on track to increase from 10 percent of GDP to more than 20 percent in coming decades. Long-run fiscal discipline demands that we consider serious reforms before this massive spending growth comes to pass.

One particular problem that we must address is the enormous burden that will be placed on the economy once the baby boomers begin to retire toward the end of the decade. While history tells us that budget projections are never accurate, no one can argue with current demographic trends. We know for certain that as the baby boom generation begins to retire in the not so distant future, the nation will face a serious challenge with fewer workers available to support each retiree. We will see increasing pressure on Social Security and Medicare. In order to manage this change, the government will need to undertake serious reforms of these programs.

Some have suggested that one step in returning to fiscal discipline would be to allow the president's tax relief to expire in the years ahead. This is short-sighted and counterproductive. As Chairman Alan Greenspan recently suggested to the Senate Banking Committee, "In addressing this budget issue, it is crucially important that we try to find, wherever we can, reductions in outlays before reverting to the question of revenues to fill in the gap …"

Rescinding the tax relief would do little to improve the long-run fiscal situation of our government, but would weaken our economy today and in the future. The tax relief had an immediate beneficial effect on the economy and contains important elements that will encourage work, saving, and investment and keep the economy growing for years to come. Understanding that all government revenues are generated by the underlying economy and that the strength of incoming tax receipts relies fundamentally on the

soundness of our economic policies, we must not short circuit these pro-growth incentives by failing to maintain them in law.

Reform of the Budget Process

Since spending restraint and entitlement reform are fundamental elements of addressing our current and long-term fiscal situation, we are encouraged by the President's inclusion of budget process reform proposals in his budget submission. Among other things, these reforms include the reinstatement and modification of statutory provisions that expired in 2002, namely the discretionary spending caps and *PAY-AS-YOU-GO* procedures for mandatory spending.

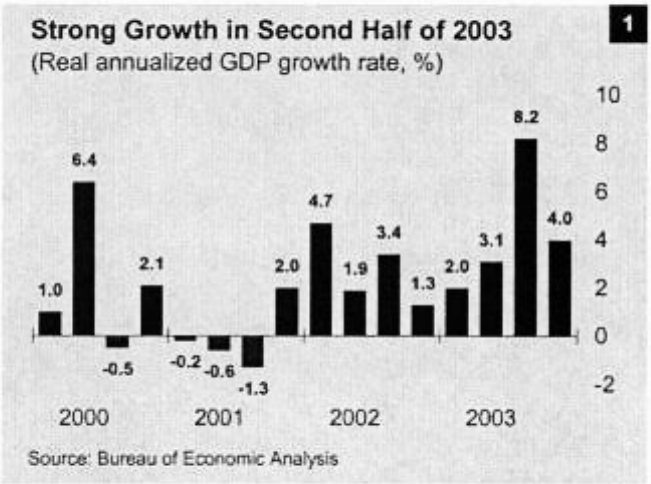
We are particularly heartened by the President's interest in devising new mechanisms to focus on the long-term financial condition of entitlement programs, such as Medicare, Social Security and other federal retirement programs. The committee should consider the creation of legislative procedures to discourage the passage of bills that would cause an increase in the unfunded liabilities of entitlement programs. The committee should also consider proposals to improve federal accounting and reporting by requiring both OMB and CBO to highlight any and all legislation that would worsen unfunded obligations within specified programs. We agree with the President's assessment of the need for measures that "will highlight the long-term financial challenges facing the Nation and prevent the enactment of policy changes that appear to cost little in the short-run but result in massive increases in the spending burdens passed on to future generations."

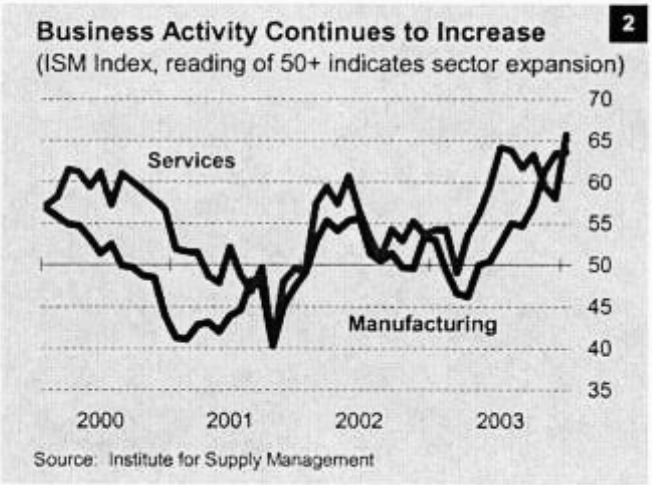
Conclusion

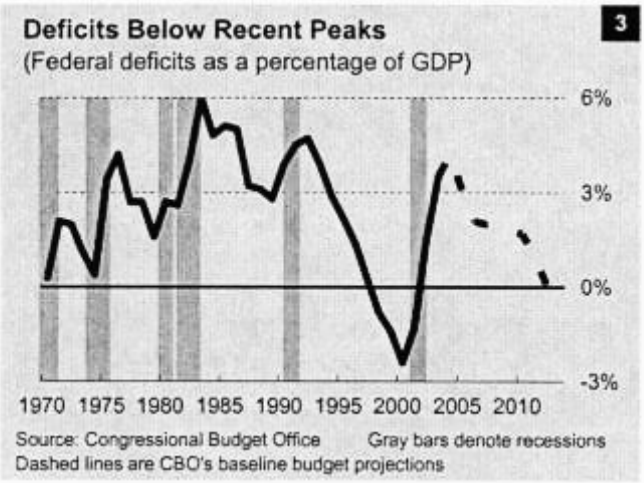
Recent economic indicators are encouraging. The economy has weathered the shocks of the last few years and appears ready for continued economic growth, job creation, and the boosts in tax revenues that will naturally follow. Nonetheless, the choices facing the Budget Committee in the near and distant futures remain challenging. We hope that these views will assist you in the difficult task of preparing the Fiscal Year 2005 Budget Resolution. Please let us know if we can provide any additional assistance.

Sincerely,

Robert F. Bennett
Chairman


Strong Growth in Second Half of 2003
1
(Real annualized GDP growth rate, %)
10
8
6
4
2
0
-2
1.0
6.4
-0.5
2.1
-0.2
-0.6
-1.3
2.0
4.7
1.9
3.4
1.3
2.0
3.1
8.2
4.0
2000
2001
2002
2003
Source: Bureau of Economic Analysis


Business Activity Continues to Increase
2
(ISM Index, reading of 50+ indicates sector expansion)
70
65
60
55
50
45
40
35
Services
Manufacturing
2000
2001
2002
2003
Source: Institute for Supply Management


Deficits Below Recent Peaks
3
(Federal deficits as a percentage of GDP)
6%
3%
0%
-3%
1970 1975 1980 1985 1990 1995 2000 2005 2010
Source: Congressional Budget Office
Gray bars denote recessions
Dashed lines are CBO's baseline budget projections