Joint Economic Committee
Republicans
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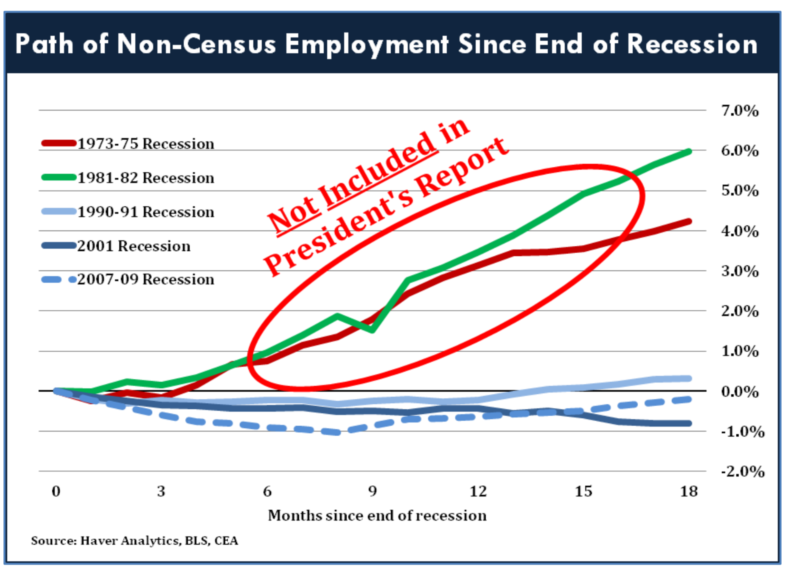
REPUBLICAN STAFF COMMENTARY

White House Releases Economic Report of the President without Fanfare

Greatly Exaggerates Contribution of Administration Policies, Reaffirms Faith in Government over Free Markets

March 1, 2011

Without fanfare, the White House released the *Economic Report of the President together with the Annual Report of the Council of Economic Advisers* (ERP) on Wednesday February 23, 2011. The ERP greatly exaggerates any contribution to the recovery from the Administration's economic policy. For example, the ERP touts a relatively quick turn to "modest" monthly payroll job growth after the trough of the severe recession of December 2007–June 2009, in comparison with the longer turns after the troughs of the very mild recessions of July 1990–March 1991 and March 2001–November 2001.[1] However, as the chart below shows, payroll job creation during the current recovery (see dashed blue line) is failing to keep pace with job creation in most other recoveries despite unprecedented federal intervention and massive federal spending. Nevertheless, the ERP indicates the Administration has no intention of changing course.



[1] ERP, 46

Highlights

- The Economic Report of the President (ERP) exudes the Administration's unshakeable and misguided faith in government intervention to foster economic growth.
- The ERP advocates more federal spending on transportation and infrastructure. While investment in transportation and infrastructure can generate economic benefits, that does not mean the federal government has to fund it, or that whatever the federal government decides to invest in will have a net positive payoff.
- The ERP largely ignores the negative effects that unprecedented deficit spending, burgeoning federal debt, and ballooning interest payments have on the economy.
- In reality, our precarious fiscal position is heightening uncertainty about future tax rates, deterring business investment, and slowing economic growth and job creation.
- The ERP trumpets the *Patient Protection and Affordable Care Act* (PPACA) based on unrealistic assumptions and flawed economics. Higher taxes used to pay for expanding coverage will substantially reduce business investment and employment, while the resulting increase in demand will likely generate higher prices for health care services.
- The ERP downplays a number of significant risks to the U.S. economic outlook. These include: (1) a resurgence in general price inflation, (2) energy price shocks that are exacerbated by the Administration's hostility toward the domestic development of conventional sources, and (3) a further decline in housing prices.
- On a positive note, the ERP recognizes that "growth abroad is good for the United States – the global economy is not a zero sum game." However, the Administration must now move from rhetoric to meaningful actions to liberalize trade.

The ERP began with a hopeful discussion of the importance of private fixed nonresidential investment and exports in generating sustainable economic and job growth. The report discusses the outsized role that personal consumption expenditures and residential investment played in the economic growth of the 2000s. The ERP expressed the need to adopt policies that encourage exports and private investment. Unfortunately, when setting out the Administration's policy prescriptions, one was left perplexed. In fact, one was left wondering if the writers of the policy chapters had even read the report's introductory chapters. Throughout the policy chapters, the ERP consistently exudes an unshakeable and misguided faith in the importance of government intervention to foster desirable economic growth. Of the 40 times that the ERP discusses investment, fewer than 10 references are to purely private investment and most of those are references to historical data or the 2010 extension of tax cuts.

Especially troubling is the ERP's failure to give serious consideration to the negative effects that unprecedented deficit spending, burgeoning federal debt, and ballooning interest payments have on the economy. While the Administration feigns fiscal responsibility by proposing a "*five-year freeze on nonsecurity discretionary spending, a two-year freeze on Federal wages, a slowdown in the growth of defense spending, and eliminating earmarks from the appropriations process,*"[2] most economists recognize that such modest proposals are wholly insufficient to reduce federal budget deficits as a percentage of GDP or stabilize federal debt as a percentage of GDP. Our precarious fiscal position is heightening uncertainty about future tax rates, deterring business investment, and slowing economic growth and job creation. The adverse consequences from the Administration's fiscal irresponsibility will only grow over time. To accelerate growth and job creation, there must be a meaningful reduction in federal spending relative to the economy, including realistic solutions to unsustainable entitlement programs.

Unfortunately, the Administration uses the ERP to reassert its faith in government control of the economy rather than using the report to acknowledge the power of the free market as the primary source of growth, opportunity and prosperity.

COMMENTARY ON ADMINISTRATION POLICIES DISCUSSED IN THE ERP

- **Energy:** The ERP finds little virtue in conventional energy sources and no faults in new energy sources. Questionable numbers are frequently used to justify the benefits of Administration policies,[3] but there is inadequate citation or discussion of how the numbers were derived. Many of the ERP's assertions are difficult, if not impossible to measure, but they are used as though they were widely accepted.

  The ERP fails to discuss the contributions that coal, nuclear energy, or natural gas can make to energy supplies in the future; and it acknowledges no problems with ethanol, biofuels, or the presumed causes of global warming. The Administration takes pride in the various programs that it has enacted and proposed. However, the ERP does not explain how choices ultimately are made among divergent technologies that require separate infrastructure, or how coherent systems of energy generation and transportation evolve out of scatter-shot subsidies and mandates.

- **Environment:** The ERP focuses on the Administration's use of environmental policy to incentivize the transition to a "clean energy future." In particular, the ERP addresses the benefits, costs, externalities (third party effects), and means (e.g., regulations, tax subsidies, cap-and-trade) of its environmental policies. Emphasis is given to various theories, by which economic benefit would allegedly be realized from shifting away from carbon-based energy. These theories involve energy security, technology development, increased international competitiveness, the decline in world energy prices due to decreased U.S. demand, and decreased government storage costs for the Strategic Petroleum Reserve.

  However, the ERP's assessment falls short. It uses the term, "Social Cost of Carbon," which is not adequately defined, and which was criticized after it was introduced in a draft August 2010 EPA study.[4] The Administration fails to recognize the detrimental effects of its environmental policies on economic efficiency.

[2] ERP, 42-43
[3] ERP, e.g., 126-127
[4] USEPA Office of Air and Radiation, August 2010, "The Benefits and Costs of the Clean Air Act: 1990 to 2020 - Revised Draft Report," Washington, D.C. See also, Interagency Working Group on Social Cost of Carbon, 2010, "Technical Support Document:

- **Global Economy and International Trade:** Readers of this section of the ERP should be greatly encouraged by the Administration's expression of commitment to growing markets and its recognition that "growth abroad is good for the United States – the global economy is not a zero sum game."[5] The question remains whether the White House will follow through with meaningful action.

  Unfortunately, the ERP ignores a major cause of persistent global imbalances—massive foreign exchange interventions by China and certain other developing countries to support export-led growth strategies. By buying U.S. dollars, China and certain other developing countries with trade surpluses have minimized the appreciation of the foreign exchange value of their currencies relative to the U.S. dollar that would have otherwise occurred. Absent such massive and sustained interventions, the resulting increase in the foreign exchange value of the Chinese renminbi and the currencies of certain other developing countries would have slowed their export growth (as their exports become more expensive), would have boosted their imports (as imports become relatively cheaper to their domestic firms and households), and would have redirected some domestic production away from exportation and toward their now wealthier domestic consumers. Thus, current account surpluses in China and certain other developing countries would have declined as a percentage of GDP. Simultaneously, the opposite process would have occurred in the United States, reducing our current account deficit as a percentage of GDP.

  China and certain other developing countries invested most of the U.S. dollars that they accumulated in U.S. debt securities, especially Treasuries. This action reinforced the Federal Reserve's overly loose monetary policy from 2002 through early 2006, helping to inflate an unsustainable housing bubble.

- **Healthcare:** The ERP incorrectly claims that the recent enactment of the *Patient Protection and Affordable Care Act* (PPACA) will bring about significant improvements in our nation's health care system. Specifically, the Administration claims that PPACA will expand and improve health insurance coverage, increase the quality of care, and reduce costs through delivery system reforms and competitive insurance markets.[6]

  However, such claims are based on unrealistic assumptions and flawed economics. PPACA is merely the latest addition to our nation's unsustainable medical entitlement system. PPACA not only expands Medicare and Medicaid coverage but also creates refundable tax credits to subsidize the purchase of health insurance.

  PPACA will be financed through a combination of tax increases and Medicare cuts. But the available budget estimates do not include the negative impact of higher taxes on economic growth. The new 3.8% surtax on interest, dividends, and capital gains for those earning over $200,000 (single) and $250,000 (married) will substantially reduce businesses investment and employment.[7]

  Also, available budget estimates fail to include the effects of increased demand and new healthcare taxes on the price of health care.[8] PPACA would increase coverage for the insured and expand coverage to many of the uninsured, resulting in greater demand for health care services. But various supply constraints—such as certificates of need for new facilities, physician education and training, testing and patents for drugs and devices—restrict the availability of more health care services. As a result of these constraints, much of the increased demand will generate higher prices, not more services. The Medicare Office of the Actuary has noted that increased demand would likely increase prices or decrease access relative to its initial budget estimate.[9]

- **Housing:** While acknowledging some volatility in home prices over the past year, the ERP claims that home prices have generally stabilized since March 2009.[10] However, the ERP ignored more woeful signs—such as the S&P/Case-Shiller 20-City Home Price Index, which has posted six straight months of declines (from July 2010 to December 2010)—and the likelihood that home prices may continue to fall because of expired tax credits,

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Social Cost of Carbon for Regulatory Impact Analysis under Executive Order 12866," February 2010. (www.epa.gov/oms/climate/regulations/scc-tsd.pdf).

[5] ERP, 102

[6] ERP, 111

[7] PPACA as amended by the *Health Care and Education Reconciliation Act of 2010* (P.L. 111-152)

[8] http://www.cbo.gov/ftpdocs/107xx/doc10781/11-30-Premiums.pdf

[9] http://www.cms.gov/ActuarialStudies/Downloads/PPACA_2010-04-22.pdf

[10] ERP, 34

distressed sales, and the substantial "shadow inventory" of foreclosed homes off the market, all of which create headwinds to price appreciation.

While the ERP touts that the "Administration's housing programs, including the Home Affordable Refinance Program (HARP), the Housing Affordable Modification Program (HAMP), and funds allocated to … the hardest-hit areas, have helped many borrowers achieve more affordable mortgages,"[11] the consensus among economists and other commentators is that these mortgage modification programs have faced implementation problems and been generally ineffective. For example, the Administration estimated that it would achieve 3-4 million permanent loan modifications using the $75 billion initially allocated to the HAMP program; however, according to the Special Inspector General of TARP, there were fewer than 522,000 ongoing permanent modifications and nearly 792,000 cancelled modifications as of December 31, 2010.[12]

- **Labor:** The ERP provides a relatively accurate analysis of the current labor situation, but its claim that job growth is occurring relatively quickly after the recent recession compared to the two previous recessions is quite weak. While the Administration recognizes that payroll employment remains well below its pre-recession peak, the emphasis of the ERP appears to be on the few months between the end of the recession and the month in which positive payroll job growth resumed. As of January 2011, the unemployment rate is little changed at 9.0%—less than one percentage point below its 9.9% level in December 2009. Since the recession ended in June 2009, more than 1.5 million people have exited the labor force.

- **Monetary Policy:** The ERP is largely silent on monetary policy and the prospects for higher price inflation. During the financial crisis in the fall of 2008, the Federal Reserve acted in its proper capacity as the lender of last resort by injecting a tremendous amount of liquidity into the economy.[13] As a result, the Fed's balance sheet more than doubled from $985 billion on September 17, 2008 to $2.29 trillion on December 10, 2008.[14] Banks kept most of the additional reserves created by the Fed on deposit with the Fed as "excess reserves" rather than lend them out. Excess reserves, which were $2 billion prior to the crisis, swelled to $798 billion by year-end 2008.

As the credit shock receded, financial institutions reduced their use of these temporary credit programs and the size of the Fed's balance sheet began to decrease in early 2009. Rather than allow its balance sheet to contract further, the Fed initiated large purchases of longer-term Treasuries, government-sponsored enterprise (GSE) debt securities, and GSE mortgage-backed securities in what was dubbed quantitative easing one (QE1).[15] As a result, the Fed maintained its balance sheet at between $2.05 and $2.28 trillion for the remainder of 2009. However, banks remained reluctant to lend. Thus, excess reserves climbed to $1.19 trillion by February 3, 2010.

In the summer of 2010, real GDP growth decelerated, the unemployment rate remained stubbornly elevated, and the housing market continued to struggle. On November 3, 2010, excess reserves were $969 billion. On that date, the Fed initiated a second round of purchases of up to $600 billion of longer-term Treasuries through the second quarter of 2011, in what was dubbed QE2. Subsequently, excess reserves rose to $1.22 trillion on February 23, 2011.

Many economists are concerned that the additional liquidity being added during QE2 may be driving commodity prices, especially food and energy, higher. There is also a risk that the Fed's current monetary policy will spark a higher rate of general price inflation in the near future.

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[11] ERP, 36

[12] SIGTARP, Quarterly Report to Congress, January 26, 2011, 11

[13] During the financial crisis, the Fed utilized several new programs—including the Term Auction Facility (TAF), the Primary Dealer Credit Facility (PDCF), the Term Securities Lending Facility (TSLF), the Money Market Investor Funding Facility, the Commercial Paper Funding Facility (CPFF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), and the Term Asset-Backed Securities Loan Facility (TALF)—to provide short-term liquidity to banks and other depository institutions and other financial institutions (TAF, PDCF, TSLF) and to provide liquidity directly to borrowers and investors in key credit markets (CPFF, AMLF, MMIFF, TALF).

[14] Monetary data are the average for the week ending on the specified date.

[15] QE1 consisted of the purchase of $300 billion in longer-term Treasuries, approximately $200 billion in government-sponsored enterprise (GSE) debt securities, and $1.25 trillion in GSE residential mortgage-backed securities (RMBS).

- **Small Business:** The ERP claims that the Administration is on the side of small businesses by touting a laundry list of initiatives. However, the Administration has taken positions that are, in fact, extremely hostile to small business. The Administration has consistently pushed for higher taxes, healthcare mandates, and increased regulation, all issues that the ERP ironically documents as the top policy concerns of small business owners.

- **Transportation & Infrastructure:** The ERP affirms that the Administration does not just want to repair and improve the existing government-provided infrastructure but wants to strike out aggressively in new directions by providing high speed rail service to 80% of the population as well as expanding government-funded broadband service. While investment in infrastructure can generate economic benefits, that does not mean the federal government has to fund it, or that whatever the federal government decides to invest in will have a net positive payoff.

  1. Federal investment, however beneficial, adds to federal debt, which is a growing burden on our economy.
  2. In other countries, private firms are now providing much of the transportation infrastructure that government agencies have traditionally provided in the United States (e.g., airports, port facilities, expressways). The United States lags behind other countries in infrastructure privatization.
  3. Decisions about federal investments are inherently political. The Administration's proposals for "high speed" passenger rail outside of the Boston-to-Washington corridor is an example of the political allocation of capital in which federal funds can be misdirected toward projects that are extremely costly but provide relatively few benefits.
  4. Governments often mismanage otherwise beneficial projects, resulting in large cost overruns.