

Overview

The U.S. economy has proven itself remarkably resilient over the past 8 years, having withstood a number of major shocks throughout the period. During the last few months of 2008, however, the economy encountered major shocks in the financial sector that it could not shake off. Those financial shocks combined with other factors—record high commodity prices earlier in the year, natural disasters, and continued weakness in the housing market—to cause the economy to contract modestly in the third quarter and what appears to be a sharp decline in the fourth quarter (see Chapters 1 and 2). The contraction will likely last into early- or mid-2009. Despite rapid fiscal and monetary policy action in response to weakening economic conditions, the economy entered into recession at the end of 2007, ending 6 years of expansion and a record 52 months of uninterrupted job growth. Several factors contributed over many years to create the credit difficulties that reached crisis proportions late in the year. The magnitude of the crisis required unprecedented policy responses to reduce the extent of the damage to the economy. These policy actions have laid a foundation for a strong economic recovery early in the term of the next Administration. Most market forecasts suggest the weakness will continue in the first half of 2009, followed by a recovery beginning in the second half of 2009 that will gain momentum in 2010 and beyond.

Despite the risk that recent events may overshadow the many positive developments of the past 8 years, there have been major policy advances that have improved the long-term prospects of our economy and strengthened its foundation. Much of this *Report* examines the effects of pro-growth economic policies and market-based reforms adopted during the Administration, as well as policy considerations that will further improve the long-term position of our economy and allow more Americans to realize the benefits of economic expansion in the future.

Record-high energy prices in 2008 highlighted our economy's dependence on fossil fuels and underscored the need to diversify our national energy portfolio. Although it will take time and major technological breakthroughs to substantially reduce our dependence on fossil fuels, the Administration has invested unprecedented levels of Federal resources and adopted a number of policies that have helped advance the economy's transition to new sources of energy while reducing local and regional pollutants in responsible ways that do not threaten our economic well-being (see Chapter 3).

Export performance was one of the bright spots in the economy over the past several years, and played an important role in offsetting other areas of weakness in the economy. The United States's continued commitment to open trade and investment policies will be an important factor in maintaining the international competitiveness and the dynamic nature of our economy (see Chapter 4). Lower tax rates have also contributed to economic performance by easing the burden on labor and capital and enabling firms, investors, and consumers to allocate resources more efficiently (see Chapter 5). These policies, which contribute to the increased flexibility of the economy, will be important in facilitating the economic recovery going forward. There remains considerable opportunity to strengthen our economic position by eliminating the uncertainty surrounding tax relief that is scheduled to expire. In addition, rising health care costs and spending on entitlement programs are ongoing areas of concern, and the Administration has offered reforms that could substantially lower costs and improve our fiscal position (see Chapters 6 and 7). Education is essential to future prosperity, and the Administration has taken several steps to improve kindergarten through twelfth-grade education and to make college more affordable (see Chapter 8). Finally, as highlighted by the recent financial crisis, there are several areas in which regulatory reforms are necessary and appropriate to address market failures. The Administration has pursued market-oriented regulatory reforms that favor individual choice over Government decision making wherever appropriate, and this approach has proven effective in addressing market failures without imposing excessive costs on society or the economy (see Chapter 9).

Chapter 1: The Year in Review and the Years Ahead

Following 6 consecutive years of expansion of the U.S. economy, the pace of real GDP expansion slowed in the first half of 2008 and turned negative in the second half. The Business Cycle Dating Committee of the National Bureau of Economic Research declared that the economy peaked in December of 2007, then began a recession that continued throughout 2008. Falling house prices initiated a cascade of problems that threatened the solvency of several major financial institutions and resulted in a major decline in the stock market. To respond to these problems, policymakers undertook a wide range of fiscal and monetary policy actions. Chapter 1 reviews the economic developments of 2008 and discusses the Administration's forecast for the years ahead. The key points of Chapter 1 are:

- Real GDP likely declined over the four quarters of 2008, ending a 6-year run of positive growth, as the slow growth in the first half of the year was eclipsed by what appears to be a sharp decline in the fourth quarter.
- Financial distress, which first became evident in mid-2007 in the market for mortgage-backed securities (MBS), continued through 2008 and affected a variety of markets. In the wake of the failure and near-failure of several major financial institutions in September 2008, financial stresses increased sharply to levels not seen during the post–World War II era.
- Payroll jobs declined during 2008, having peaked in December of 2007. Employment losses averaged 82,000-per-month during the first 8 months of 2008, before accelerating to a 420,000-per-month pace during the next 3 months. The unemployment rate was at 5 percent through April—a low rate by historical standards—but increased to 6.7 percent in November. Initial and continued claims for unemployment insurance moved up sharply over the course of the year.
- Energy prices dominated the movement of overall inflation in the consumer price index (CPI), with large increases through July, followed by a sharp decline during the latter part of the year. Core consumer inflation (which excludes food and energy inflation) edged down from 2.4 percent during the 12 months of 2007 to a 1.9 percent annual rate during the first 11 months of 2008. Food prices rose appreciably faster than core prices.
- Nominal hourly compensation increased 2.8 percent during the 12 months through September 2008 (according to the employment cost index), a gain that was undermined by the rise in food and energy prices, so that real hourly compensation fell 2 percent. In the long run, real hourly compensation tends to increase with labor productivity, although the correlation can be very loose over shorter intervals. Nonfarm business productivity has grown at an average annual rate of 2.6 percent since the business cycle peak in 2001.
- An economic stimulus was proposed by the President in January and passed by Congress in February, authorizing about \$113 billion in tax rebate checks to low- and middle-income taxpayers and allowing 50 percent expensing for business equipment investment. The stimulus likely boosted GDP growth in the second and third quarters above what it might have been otherwise, but its influence faded by the end of the year.
- The Administration’s forecast calls for real GDP to continue to fall in the first half of 2009, with the major declines projected to be concentrated in the fourth quarter of 2008 and the first quarter of 2009. An active monetary policy and the Treasury’s injection of assets into financial institutions are expected to ease financial stress and to lead to a

rebound in the interest-sensitive sectors of the economy in the second half of 2009. Also supporting growth during 2009 is the substantial recent drop in petroleum prices, which offsets some of the effects of the recent decline in household wealth. The unemployment rate is expected to increase to an average of 7.7 percent for 2009. The expansion in 2010–11 is projected to be vigorous, bringing the unemployment rate down to 5 percent by 2012.

Chapter 2: Housing and Financial Markets

In the summer of 2008, the disruptions in credit markets that began in 2007 worsened to the point that the global financial system was in crisis. The magnitude of the crisis required an unprecedented response on the part of the Government to limit the extent of damage to the economy and restore stability to the financial system. Chapter 2 reviews the origins of the crisis, its consequences, the Government’s response, and discusses several policy challenges going forward. The key points of Chapter 2 are:

- The roots of the current global financial crisis began in the late 1990s. A rapid increase in saving by developing countries (sometimes called the “global saving glut”) resulted in a large influx of capital to the United States and other industrialized countries, driving down the return on safe assets. The relatively low yield on safe assets likely encouraged investors to look for higher yields from riskier assets, whose yields also went down. What turned out to be an underpricing of risk across a number of markets (housing, commercial real estate, and leveraged buyouts, among others) in the United States and abroad, and an uncertainty about how this risk was distributed throughout the global financial system, set the stage for subsequent financial distress.
- The influx of inexpensive capital helped finance a housing boom. House prices appreciated rapidly earlier in this decade, and building increased to well-above historic levels. Eventually, house prices began to decline with this glut in housing supply.
- Considerable innovations in housing finance—the growth of subprime mortgages and the expansion of the market for assets backed by mortgages—helped fuel the housing boom. Those innovations were often beneficial, helping to make home ownership more affordable and accessible, but excesses set the stage for later losses.
- The declining value of mortgage-related assets has had a disproportionate effect on the financial sector because a large fraction of mortgage-related assets are held by banks, investment banks, and other highly levered financial institutions. The combination of leverage (the use of borrowed

funds) and, in particular, a reliance on short-term funding made these institutions (both in the United States and abroad) vulnerable to large mortgage losses.

- Vulnerable institutions failed, and others nearly failed. The remaining institutions pulled back from extending credit to each other, and inter-bank lending rates increased to unprecedented levels. The effects of the crisis were most visible in the financial sector, but the impact and consequences of the crisis are being felt by households, businesses, and governments throughout the world.
- The U.S. Government has undertaken a historic effort to address the underlying problems behind the freeze in the credit markets. These problems, the subject of much of this chapter, are a sudden increase in the desire for liquidity, a massive reassessment of risk, and a solvency crisis for many systemically important institutions. The Government has worked to preserve the stability of the overall financial system by preventing the disorderly failures of important financial institutions; taken unprecedented action to boost liquidity in short-term funding markets; provided substantial new protections for consumers, businesses, and investors; and cooperated closely with its international partners.
- Looking forward, the global financial crisis presents several additional challenges for the U.S. Government. Among them are the need to modernize financial regulation, unwind temporary programs in an orderly fashion, and develop long-term solutions for the government-sponsored enterprises (privately-owned, publicly-chartered entities) Fannie Mae and Freddie Mac.

Chapter 3: Energy and the Environment

Although fossil fuels will continue to constitute a large share of the Nation's energy portfolio for some time, the Administration has taken major steps to increase and diversify the Nation's energy supply and to improve the environment. Since 2001, significant investments have been made to develop cleaner and more reliable energy sources, and several regulatory changes are expected to deliver dramatic improvements in air quality nationwide. Chapter 3 reviews recent advances in energy and environmental policy and discusses several challenges associated with efforts to diversify the Nation's energy portfolio, to increase energy security, and to reduce emissions related to fossil-fuel based energy use. The key points of Chapter 3 are:

- Because of innovative regulations promulgated under this Administration, there should be substantial improvements in air quality over the next few decades. Two rules that implemented cap-and-trade programs in the electricity sector represent a significant step in using cost-effective, market-oriented policy instruments to dramatically reduce power plants' emissions of sulfur dioxide, nitrogen oxide, and mercury.
- Despite widespread support for using market-based approaches to achieve our environmental and energy policy goals going forward, challenges remain in realizing the full potential of these approaches.
- There is an increasing need to reassess how well existing laws can address the environmental problems associated with fossil fuel use in more cost-effective ways. For example, it may become increasingly costly to make additional reductions in traditional air pollutants, and existing statutes that focus on local or regional pollutants were not designed to address global problems such as greenhouse gas (GHG) emissions.
- Substantial reductions in global GHG emissions will require participation by all large emitters (countries and sectors within countries).

Chapter 4: The Benefits of Open Trade and Investment Policies

The United States has one of the most open economies in the world, ranking very high in common measures of openness to trade and investment. In the long run, the benefits that open economic policies generate far outweigh the narrow, short-run perceived benefits of protectionist or isolationist policies. The more diffuse but larger benefits of open trade and investment policies to the general economy are often difficult to discern, especially in the short run, and are sometimes obscured by the more visible effects of protectionist policies on favored groups. This chapter discusses several key facts about trade and investment in the United States, the benefits of free trade and open investment, and the policies that the United States has taken to enhance both. The key points of Chapter 4 are:

- Openness to trade and investment has boosted U.S. economic growth. Openness can also reduce the impact of shocks and increase the resilience of the U.S. economy.
- The number of U.S. free trade agreements has increased greatly during this Administration, and these agreements have contributed to the growth in U.S. exports.

- Portfolio and direct investments into the United States reached historic levels over the past decade, in part due to the depth, diversity, and openness of U.S. financial markets and the competitiveness of U.S. firms.
- The United States has maintained an open investment policy, facilitating foreign direct investment flows between the United States and the world while addressing legitimate national security concerns.
- U.S. development and trade initiatives, as well as U.S. engagement in multilateral institutions such as the World Trade Organization and the World Bank, have helped increase growth and foster political and economic stability in developing countries throughout the world.
- Continued commitment to open economic policies throughout the world will help ensure continued economic gains for the United States and the rest of the world.

Chapter 5: Tax Policy

Several policy changes over the past 8 years have resulted in lower tax rates for both individuals and businesses, and specific incentives have been established to reduce the adverse tax consequences of certain desirable activities, such as running a small business or buying an alternative-fuel vehicle. Lower tax rates have increased the benefit of working and investing; in particular, lower tax rates on dividends and capital gains helped business investment expand, thereby helping firms increase worker productivity. Tax relief has contributed to the solid economic growth and job creation that prevailed over most of the past several years. The expiration of these tax reductions would have serious consequences for the U.S. economy. An additional challenge is to further reduce business tax burdens to encourage business investment in the United States in order to develop new jobs for U.S. workers and to continue improving our standard of living. The key points of Chapter 5 are:

- Taxes alter individual and business incentives and thus have the potential to distort their behavior. This Administration consistently fought to reduce tax burdens on individuals and businesses; tax rates are now much lower than they were just 8 years ago.
- Tax reductions over the past 8 years have improved incentives to work, save, and invest.
- Globally, nations compete for businesses and the associated jobs; the United States may need to reduce tax rates on businesses to remain competitive in today's world.

- Future goals should include permanently extending the tax relief of the past 8 years and reforming the Alternative Minimum Tax.

Chapter 6: The Long-Run Challenges of Entitlement Spending

Federal spending on entitlement programs is expected to increase dramatically in the coming decades, particularly for Social Security, Medicare, and Medicaid. Taken together, these programs currently constitute 45 percent of Federal non-interest spending, and assuming no major changes to these programs, this share is projected to rise dramatically in coming decades. An aging population and rising health care spending per person are major reasons for these projected increases. The primary objective of this chapter is to highlight the budgetary challenges facing each of the three major entitlement programs and to outline possible strategies for addressing these challenges. The key points of Chapter 6 are:

- Federal entitlement spending is on an unsustainable path. Spending on the three major entitlement programs—Social Security, Medicare, and Medicaid—is projected to increase much faster than tax revenues or than the overall economy over the coming decades. Paying all scheduled benefits would eventually require substantial reductions in other Government spending, or major tax increases, or both.
- The aging population is a major cause of the expected increase, especially for Social Security, representing a permanent, as opposed to temporary, shift in the entitlement landscape. Currently, one out of six adults is age 65 or older; by 2020, one out of five adults will be 65 or older; and, by 2030, one out of four adults will be age 65 or older.
- The pay-as-you-go financing structure of Social Security, coupled with the aging population, creates a sizeable structural imbalance that will cause current and future generations of workers to bear increasing costs or receive smaller benefits than now scheduled, or both.
- Over the past 30 years, real per capita health care spending has grown considerably faster than real gross domestic product (GDP) per capita. Real growth in Medicare spending is being driven by increasing enrollment, greater utilization of more expensive high-technology medical treatments, and expansion of the goods and services covered by the program.
- Long-term care expenditures for low-income elderly and disabled persons represent a large and growing share of total Medicaid spending. The demand for long-term care is expected to grow in the United States

as a result of the aging population. In turn, this will place even greater financial strain on Federal and State budgets.

Chapter 7: Balancing Private and Public Roles in Health Care

Health care is one of the largest and fastest-growing sectors of the U.S. economy. While modern health care provides substantial benefits, there are growing concerns that its rising cost poses a threat to Americans' access to health insurance and medical care. The Administration has pursued several initiatives to encourage the efficient provision of health care through private markets and to improve access to affordable health care for individuals in the United States. This chapter provides an overview of U.S. performance with respect to the population's health status and spending on health care and discusses key efforts by the Administration to address issues of health care quality, cost, and access. The key points of Chapter 7 are:

- Health care spending is expected to grow rapidly over the next several decades, a trend that is driven by the increased use of high-technology medical procedures, comprehensive health insurance that decreases consumer incentives to shop for cost-effective care, rising rates of chronic disease, and the aging of the population in the United States.
- Markets for health care services can function more efficiently when payers, providers, and consumers have more complete information as well as incentives to use medical care that is clinically effective and of high value.
- Health insurance improves individuals' well-being by providing financial protection against uncertain medical costs and by improving access to care. Market-based approaches and innovative benefit designs can enable people to select coverage that best fits their preferences and to more actively participate in their own health care decision making.
- The Federal Government has an important role in investing in public health infrastructure, particularly with respect to improving the availability of community-based health care for the underserved, preparing for possible public health crises, supporting health-related research and development, and promoting global health improvement.

Chapter 8: Education and Labor

Long-term economic growth requires a productive workforce with the skills necessary to compete in a global labor market. The Administration's commitment to maintaining the high productivity of American workers is evident in successful education and training policies. A continued commitment to broader access to quality education and training will be required to meet the increasing worldwide demand for highly skilled labor. A workforce with better and more widely dispersed skills will ensure that workers enjoy higher incomes and will be a force in reducing income inequality in the United States. The United States also needs comprehensive reform of its immigration policies. The key points of this chapter are:

- Education benefits individuals through higher earnings, and it benefits society as a whole. Administration initiatives to improve kindergarten through twelfth-grade education, most notably the No Child Left Behind Act, are demonstrating clear, measureable results.
- Access to higher education was maintained through an expanded Pell Grant program and proactive efforts that helped protect Federally subsidized student loans from recent credit issues faced elsewhere in the economy.
- Despite a small decline in real median household income, which had begun prior to the Administration taking office, hourly earnings of workers outpaced inflation, and real per capita disposable income rose substantially during the past 8 years. Median household income increased steadily after the recovery began in earnest in 2004. Also, pension reforms were enacted to help protect retirement income.
- Income inequality and immigration reform must still be addressed. Strong support for education and a focus on workers' skills can help close income gaps. Reform of immigration policies must provide border security while allowing the economic benefits that immigrant labor provides to the economy.

Chapter 9: Economic Regulation

The private enterprise system, supported by consistent enforcement of laws protecting property and contracts, has been at the heart of the American economy's tremendous prosperity and growth. Although free markets produce the most efficient outcome in most cases, there are instances where government intervention can increase economic efficiency. Government regulation can improve economic outcomes where there are specific market failures that, for example, create negative externalities that impose costs on society or create harm from natural monopolies. At the same time, the Government's ability to create efficient regulation is limited and may create significant costs, which must be weighed against the potential benefits of addressing market failures. This chapter reviews several areas in which markets have been affected by Government policy in the past 8 years. The key points of this chapter are:

- Regulation is appropriate when, and only when, there is an important market failure that can be effectively addressed by the Government. For example, the Administration has taken steps to reduce restrictive regulation of broadband markets, preserving an environment conducive to innovation and new investment. Conversely, the Administration supported new rules for financial reporting when it became clear that existing laws did not adequately reduce information asymmetries between investors and management.
- When the Government intervenes to address market failures, it should attempt to take advantage of market-based incentives whenever possible. The Administration has helped ensure that scarce spectrum licenses are allocated more efficiently by increasing the amount of bandwidth allocated through auctions rather than through arbitrary allotments. In transportation, the Administration has supported market-based approaches to financing infrastructure such as roads and the air traffic control system.
- The Administration has endeavored to ensure that, when the government does intervene in markets, it does so in a way that supports the operation of competitive markets. When the market for terrorism insurance was disrupted following the attacks of 9/11, the Administration supported a temporary program of Federal support for terrorism insurance, and the Administration has insisted that subsidies be phased out as private insurers adapt and return to the market. By supporting tort reform, the Administration has helped reduce the scope for class action lawsuits that create costs that outweigh their social benefits.