



C H A P T E R 1

PROMOTING OPPORTUNITY AND SHARED, SUSTAINABLE GROWTH

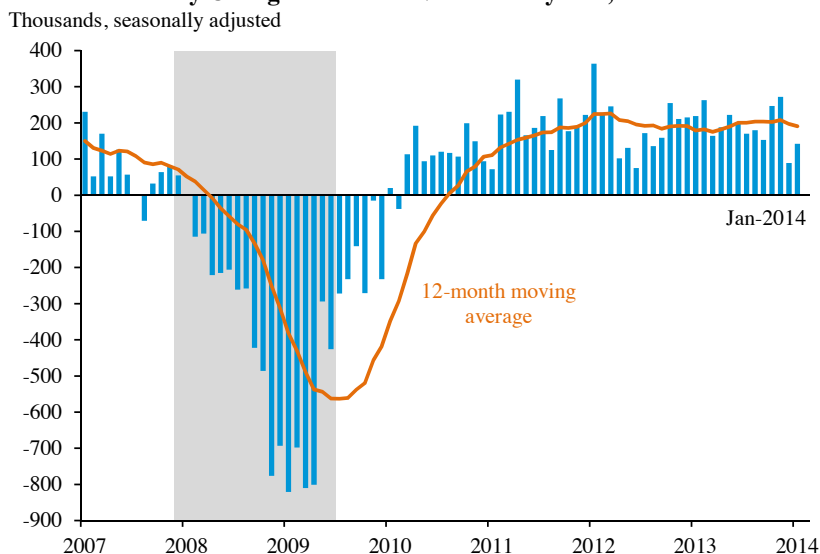
As the 2014 *Economic Report of the President* goes to press, the U.S. economy stands five years removed from one of the most tumultuous and challenging periods in its history. The state of acute crisis that emerged in the months just before President Obama took office was, in some respects, worse than the initial shock that touched off the Great Depression. The plunge in stock prices in late 2008 proved similar to what occurred in late 1929, but was compounded by sharper home price declines, ultimately leading to a drop in overall household wealth that was substantially greater than the loss in wealth at the outset of the Great Depression (Romer 2009; see also Greenspan 2013, Almunia et al. 2010). As the recession unfolded, the economy's total output contracted more sharply than at any other time since World War II, and the fallout ultimately cost the country a staggering 8.8 million private-sector jobs.

As of early 2014, however, the economic landscape looks vastly different: total output has grown for 11 consecutive quarters, businesses have added 8.5 million jobs since February 2010, and a range of analysts are optimistic that the economy will further strengthen in the years ahead. Yet despite this progress, many American families are still struggling to join the middle class or to stay there, as they face the lingering after-effects of the crisis on top of a long-standing trend of widening inequality that has caused the rungs on the economic ladder to grow further apart. This fundamental issue—making sure the economy provides opportunity for every American—is the President's central economic focus.

To move toward the President's goal of a broader, more solid foundation for future growth, three key imperatives must be addressed. The first and most immediate imperative is to continue to restore the economy to its full potential. Although the recovery from the Great Recession is well underway, it remains incomplete. The second imperative is to expand the economy's potential. In the decades after World War II, rapid productivity

Figure 1-1

Monthly Change in Private Nonfarm Payrolls, 2007–2014



Source: Bureau of Labor Statistics, Current Employment Statistics.

growth propelled the American economy forward and grew the middle class. The historic surge of women into the labor force further transformed America’s society and economic capacity. But in the last several decades, productivity growth has declined relative to the early postwar years, and looking ahead, America’s workforce is now expected to grow more slowly as members of the baby-boom generation move into retirement. As a result, efforts to enhance overall productivity and the skills of American workers, and to expand the labor force, will be as critical as ever. The third imperative is to ensure that the economy provides all Americans with greater opportunity to realize their full individual potential and to experience the prosperity they work to create. A typical family’s inflation-adjusted income barely budged in the years leading up to the crisis, which placed undue strain on millions of hardworking households, contributed to instability in the overall economy, and raised questions about how the American ideals of opportunity and mobility would manifest themselves in the 21st century.

These challenges are substantial, but so is America’s potential. As discussed in the remainder of this chapter and throughout this report, the President has set out an ambitious agenda to make progress on all three imperatives, both by working with Congress and by taking action on his own where possible. To return the economy to its full potential more quickly, the President has called for a range of measures including an

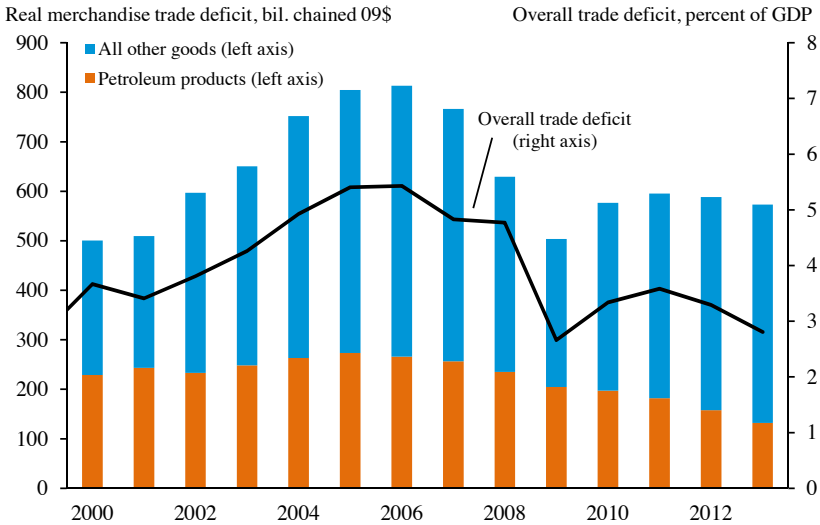
Opportunity, Growth, and Security initiative, along with steps to pair business tax reform with a major effort to upgrade our Nation's infrastructure. To expand the economy's potential, the President continues to urge the House of Representatives to follow the Senate's lead and pass commonsense immigration reform, which would help attract a new wave of inventors and entrepreneurs to American soil. The President also wants to build on the great strides that have already been made in the technology and energy sectors, which are laying the groundwork for a more productive economy in the years ahead. And to make sure that the economy provides opportunity for every American, the President's agenda includes improved job training programs and an increase in the minimum wage, because no one working full time should have to raise their family in poverty. In addition, the President has set a goal of preschool for all, since one of the best ways to ensure that all Americans have a chance to succeed is to invest in their early childhood development. Implementation of the Affordable Care Act is another critical step in this direction, because it is helping to provide financial security for more American families and to slow the growth in health care costs that cut into workers' take-home pay.

The President is calling for significant legislative measures in these areas, but will continue to pursue progress through executive authority by, for example, streamlining the infrastructure-permitting process, creating new products to improve retirement security, and raising wages for Federal contractors. The President is also using his influence to work with businesses, universities, and nonprofits to, for instance, help low-income students succeed in college and ensure that the long-term unemployed have a fair shot at a new job. These are just a few of the President's key efforts in what he has described as "a year of action," and the President remains ready to work with anyone offering constructive ideas to move forward.

THE ECONOMY FIVE YEARS AFTER THE CRISIS

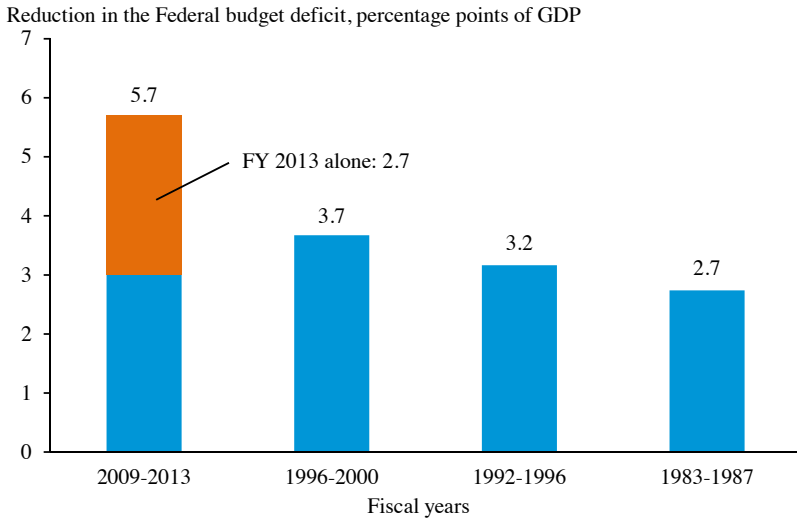
The recovery from the Great Recession took another major step forward in 2013, as detailed in Chapter 2. Businesses added 2.4 million jobs over the course of the year, or 197,000 a month, marking the third consecutive year that private employment increased by more than 2 million. From its trough in February 2010 through January 2014, private employment has risen in 47 consecutive months for a total of 8.5 million jobs added (Figure 1-1). The unemployment rate remains unacceptably high, primarily due to the continued elevation of long-term unemployment, but it has continued to recover, reaching a five-year low of 6.6 percent in January. The housing and automotive sectors—two areas that were especially hard-hit by the

Figure 1-2
U.S. Merchandise and Overall Trade Deficits, 2000–2013



Note: "All other goods" includes a residual due to chained-dollar price adjustment.
 Source: Census Bureau, U.S. International Trade in Goods and Services; Bureau of Economic Analysis, National Income and Product Accounts; CEA calculations.

Figure 1-3
Major Deficit Reduction Episodes Over a Four-Year Period Since the Demobilization from WWII



Source: Office of Management and Budget; Bureau of Economic Analysis, National Income and Product Accounts; CEA calculations.

crisis—continue to rebound and contribute to growth, as real (inflation-adjusted) residential investment rose more than 6 percent over the four quarters of the year, while motor vehicle production rose 9 percent. And in October 2013, the amount of crude oil produced domestically exceeded the amount imported for the first time since 1995, providing further evidence of a domestic energy boom that is supporting jobs and helping to sustain a markedly narrower trade deficit relative to the years leading up to the crisis (Figure 1-2).

The progress seen in 2013 is notable in part because the steep decline in the Federal budget deficit during the year was a major headwind on macroeconomic performance. Figure 1-3 shows the largest four-year reductions in the Federal budget deficit since the demobilization from World War II. Since the end of fiscal year 2009, the deficit has fallen by 5.7 percentage points of GDP, with nearly half of that reduction—2.7 percentage points of GDP—coming in FY 2013 alone. Some of the deficit reduction in 2013 was a natural consequence of the gradual improvement in the economy, and a large portion of it was due to policy decisions, like the spending caps agreed to in the Budget Control Act of 2011, the increase in tax rates for top earners at the beginning of 2013, as well as the end of the temporary payroll tax holiday. The fiscal contraction would, of course, have been much worse were it not for the permanent extension of tax cuts for middle-income households. While these factors reflected a balanced approach to making progress toward fiscal sustainability, they were unnecessarily compounded with the onset of budget sequestration in March, which the Congressional Budget Office (CBO 2013a) estimated slowed real GDP growth over the four quarters of the year by 0.6 percentage point and reduced employment by the equivalent of roughly 750,000 full-time jobs.

On top of the fiscal headwinds, the economy was also forced to contend with a disruptive government shutdown for 16 days in October, as well as dangerous brinksmanship over raising the Federal debt limit. The shutdown cost the government more than \$2 billion in lost productivity alone as Federal workers were furloughed for a combined 6.6 million days. In addition, families were unable to travel to national parks, oil and gas drilling permits were delayed, Small Business Administration loans were put on hold, and licenses to export high-tech products could not be granted, to name just a few effects. Consumer sentiment, as measured by the Reuters/University of Michigan Index, fell to its lowest point of the year in October, and fourth-quarter GDP growth was constrained by a large negative contribution from the Federal sector. Moreover, because Congress was slow to act to raise the debt ceiling, several large investment management firms announced that they had divested from Treasury securities maturing around the time of the

potential debt-ceiling breach. Ultimately, the episode provided yet another reminder of the need for policymakers to avoid self-inflicted wounds to the economy and to stay focused on constructive steps that support growth and job creation.

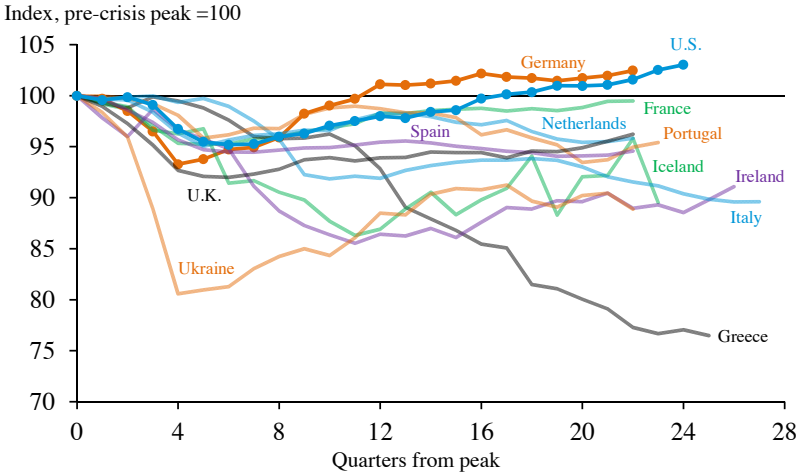
HOW WE GOT HERE: THE ADMINISTRATION'S RESPONSE TO THE CRISIS

In considering the recovery over the last five years and the sources of optimism for the years ahead, it is important not to lose sight of the critical policy decisions that averted a second Great Depression and made it possible for the economy to arrive at this point. Recoveries from financial crises tend to be slower than from recessions caused by other types of shocks because heavy household debt burdens and tight credit conditions can linger for an extended period of time. However, the U.S. economy has fared better than most other developed countries in recent years. As shown in Figure 1-4, among the 12 countries that experienced a systemic financial crisis in 2007 and 2008, the United States is one of just two in which output per working-age population has returned to pre-crisis levels. The fact that the United States has been one of the best performing economies in the wake of the crisis supports the view that the full set of policy interventions in the United States made a major difference in averting a substantially worse outcome.

Chapter 3 looks back at the American Recovery and Reinvestment Act of 2009 (the Recovery Act), along with more than a dozen subsequent jobs measures that the President signed into law, including the payroll tax cut, extensions of unemployment insurance, and tax cuts for business investment and hiring. At the macroeconomic level, CEA estimates that the Recovery Act, by itself, cumulatively saved or created about 6 million job-years, where a job-year is defined as one full-time job for one year (equivalent to an average of 1.6 million jobs a year for four years). Adding in the subsequent jobs measures, the cumulative gain in employment through the end of 2012 grows to 9 million job-years (Figure 1-5). This analysis is broadly similar to others provided by a variety of sources, including the Congressional Budget Office, and is generally consistent with a growing academic literature that is discussed in Chapter 3. In addition to the macroeconomic impact, Chapter 3 also reviews the Recovery Act's key investments in areas like education, clean energy, physical infrastructure, and technological infrastructure that will continue to pay dividends long after the Recovery Act has phased out.

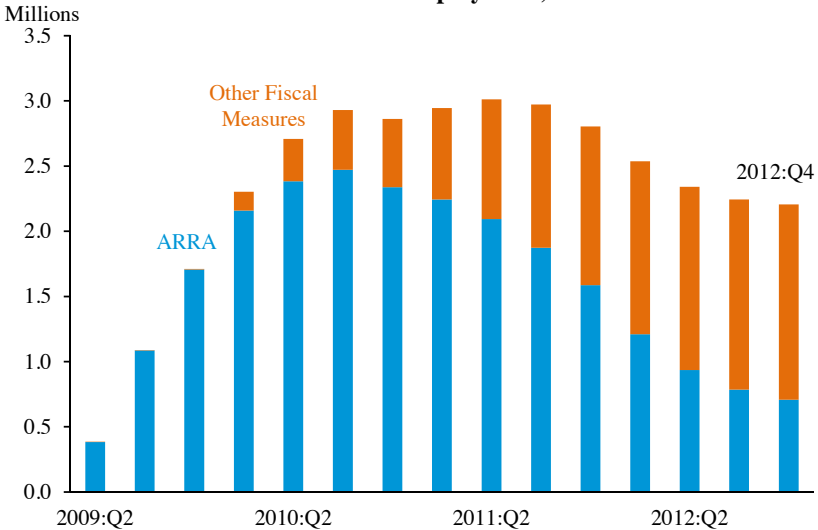
Fiscal measures were only part of the overall policy response. The President acted decisively to save the American auto industry and the suppliers and economic ecosystem that depend on it. The Administration also

Figure 1-4
Real GDP Per Working-Age Population
in 2007–2008 Banking Crisis Countries, 2007–2013



Note: U.S. as of 2013:Q4, all others as of 2013:Q3 except Iceland (Q2). Working-age population is 16-64 for U.S. and 15-64 for all others. Population for Ukraine is interpolated from annual estimates. Selection of countries based on Reinhart and Rogoff (forthcoming).
 Source: Statistical Office of the European Communities; national sources; CEA calculations.

Figure 1-5
Quarterly Effect of the Recovery Act and Subsequent
Fiscal Measures on Employment, 2009–2012



Source: Bureau of Economic Analysis, National Income and Product Accounts; Congressional Budget Office; CEA calculations.

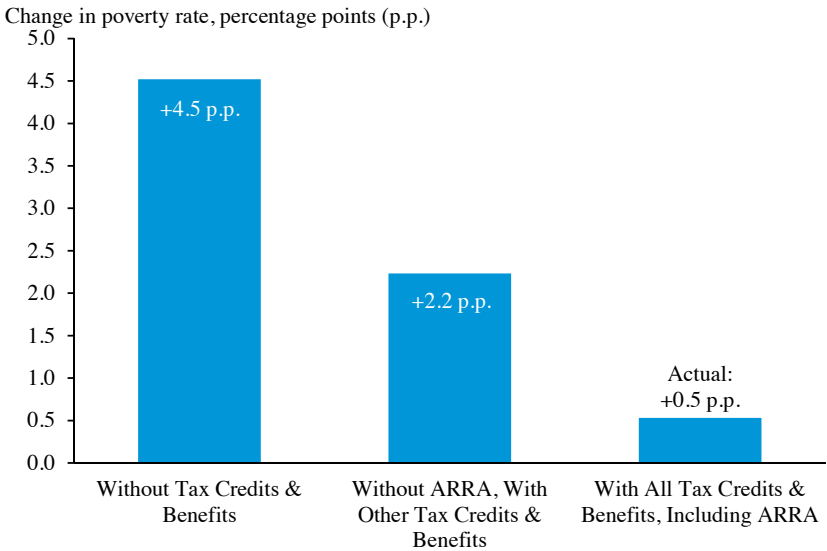
instituted a range of measures that helped families stay in their homes, facilitated refinancing into lower interest rates, and took steps toward alleviating the housing blight that can threaten neighborhoods and restrain home values. Furthermore, the Treasury Department promoted financial stability and instituted a range of programs to help restore the flow of credit for both large and small businesses. The Federal Reserve undertook important independent actions as well, which are more fully described in Bernanke (2012, 2014).

Another positive but less widely appreciated story from the recession and recovery is the performance of America's social safety net. Though employment and incomes declined sharply as the recession unfolded, millions of Americans were kept out of poverty by tax credits and programs like Social Security, nutrition assistance, and unemployment insurance. Excluding these measures, the poverty rate would have risen 4.5 percentage points from 2007 to 2010, but in fact it only rose half a percentage point (Figure 1-6). The direct effect of the Recovery Act on incomes, not even counting its impact on jobs and the broader economy, reduced the poverty rate in 2010 by 1.7 percentage points, equal to 5.3 million people kept out of poverty. As discussed in Chapter 6, these developments represent the continuation of a longer-running trend in which essentially all of the progress made in reducing poverty has come as a direct consequence of government programs. The poverty rate excluding tax credits and public programs actually rose from 1967 to 2012, but when tax credits and programs are included, the poverty rate was cut by 38 percent (Wimer et al. 2013). Nevertheless, with 49.7 million Americans still living in poverty as of 2012, far more work remains to be done. As the Nation recently marked the 50th anniversary of President Lyndon B. Johnson's declaration of a war on poverty, Chapter 6 details lessons that have been learned, ways that antipoverty programs can be strengthened, and other policies that can help take the next step forward by achieving meaningful reductions in poverty even before tax credits and government programs kick in.

SOURCES OF OPPORTUNITY IN 2014 AND BEYOND

The U.S. economy has made substantial gains over the last five years, and while many challenges remain, including recent weather-related disruptions and some turbulence in emerging markets, there are a number of reasons to be optimistic about the economy's prospects. Cyclical developments like diminished fiscal headwinds and an improvement in household finances are likely to contribute to a strengthening of the recovery in the near-term. At the same time, emerging structural trends like the decline in

Figure 1-6
**Change in Poverty Rate From 2007–2010,
 With and Without Tax Credits and Benefits**



Source: Wimer et al. (2013); CEA calculations.

the rate of health care cost growth, the surge in domestic energy production, and continued technological progress will support growth on a sustained basis into the future. As these developments unfold, it will be critical to take additional steps to ensure that the middle class and those striving to join it have opportunities to succeed. But these emerging trends will help create the framework for the sustainable, broad-based growth that the President is seeking to promote.

Cyclical Factors

Diminished fiscal headwinds. The most predictable reason for optimism about the U.S. economy in 2014 is the waning drag from fiscal policy and reduced fiscal uncertainty. In December, a bipartisan budget agreement averted a second round of discretionary sequester cuts that were scheduled to go into effect in January and also relieved a portion of the cuts that had already taken place during the preceding year. While Congress could do substantially more to support job growth and economic opportunity, the economy is unlikely to face anything like the fiscal consolidation seen at the Federal level in 2013, with deficit reduction continuing at a much more gradual pace going forward. As part of the budget deal, Congress also agreed on discretionary funding levels for the remainder of FY 2014 and all of FY 2015, offering a way to avoid another counterproductive shutdown. Earlier

this year, Congress passed appropriations bills for FY 2014 consistent with these spending levels and also extended the debt limit into 2015.

As fiscal headwinds ease at the Federal level, State and local governments are also showing encouraging signs. After shedding more than 700,000 jobs from 2009 to 2012, State and local governments added 32,000 jobs in 2013.

Improved household finances. American households saw trillions of dollars in wealth wiped out as a result of the recession, but recent data indicate that a large degree of progress has been made in the recovery. As of the third quarter of 2013, real per-capita household wealth had recouped over 80 percent of the large decline from its peak, reflecting gains in housing and stock prices, as well as the progress households have made in deleveraging. Moreover, the household debt service ratio—the estimated required payments on mortgage and consumer debt as a share of disposable income—was 9.9 percent in the third quarter of 2013, the lowest since the data began in 1980, and down from 13 percent in 2007. Further improvements in household finances and expanded access to credit will contribute to strengthening in consumer spending. Looking over the course of the recovery, real personal consumption expenditures have grown just 2.2 percent at an annual rate, compared with the 2.9 percent pace during the 2000s expansion period, a fact that partly reflects the lingering after-effects of the financial crisis. A noticeable pickup in consumer spending—which comprises more than two-thirds of the U.S. economy—would represent an important step toward turning the page on the crisis era.

While the aggregate statistics on household wealth paint a picture of improvement, too many families have not shared in the gains. For instance, middle-income households have on average a larger fraction of wealth in their homes relative to equities, and house prices—despite recent improvements—have not recovered as sharply as equities, which represent a larger fraction of the wealth held by upper-income households. The challenges of ensuring that more Americans share in the gains from economic growth are discussed in additional detail later in the chapter.

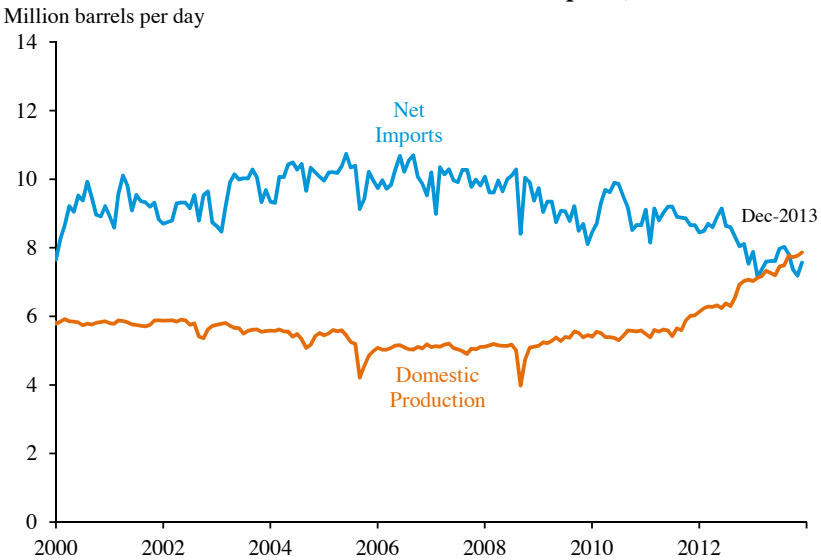
Structural Trends

Along with these positive near-term developments, this report also highlights three longer-term, structural trends that have emerged recently and will support growth on a sustained basis into the future.

Domestic energy boom and changes in energy use. The first major trend is the dramatic increase in domestic energy production combined with a shift in the use of energy that represents an important opportunity not just for the economy, but also for America's security and climate. Current

Figure 1-7

Domestic Crude Oil Production and Net Imports, 2000–2013



Note: Not seasonally adjusted.

Source: Energy Information Administration, Petroleum Supply Monthly.

projections indicate that the United States became the world’s largest producer of oil and gas in 2013, exceeding both Russia and Saudi Arabia. As noted earlier, domestic production of crude oil rose above imports in October for the first time since 1995 (Figure 1-7), and further increases in domestic production and reduced oil imports are expected in the coming years. Moreover, natural gas production continued to rise in 2013 from the 2012 record high and is up more than 20 percent over the past five years. The power sector has undertaken a shift from coal to natural gas, which was responsible for 27 percent of our overall energy consumption in 2012, up from 24 percent in 2008. But the progress is not limited to oil and gas—consistent with the President’s “all of the above” energy strategy, great strides have also been made in renewables and energy efficiency. Wind and solar power generation have each more than doubled since the President took office, while oil consumption has fallen over this time, as stronger fuel economy standards and investments in cutting-edge technologies have led to the most fuel-efficient light vehicle fleet ever. This broad-based energy boom supports jobs directly in production and distribution, and also indirectly, by making the United States more attractive as a location for multi-national firms in energy-intensive industries like manufacturing.

The President recently announced new steps to further capitalize on these exciting developments in the energy sector and reduce our dependence

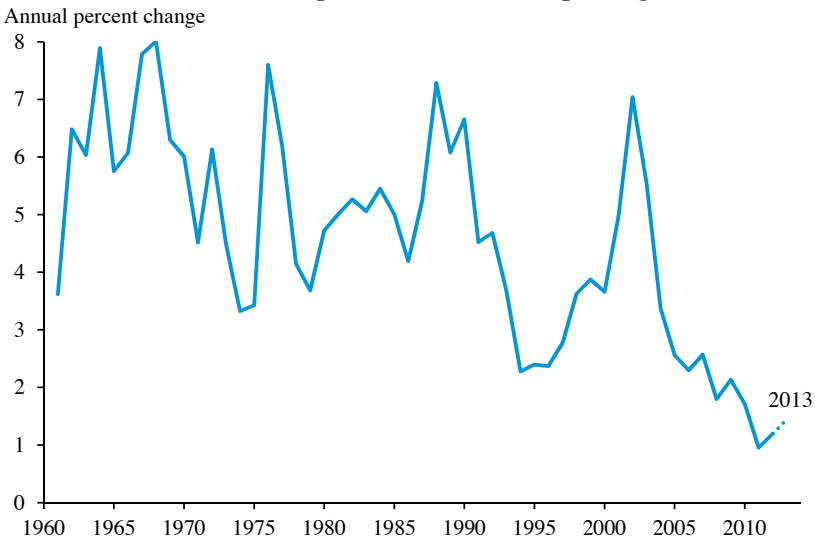
on foreign energy sources while creating new jobs. In the 2014 State of the Union address, the President announced his intention to forge ahead with new executive actions that will improve the fuel efficiency of the nation's trucking fleet and help states and localities attract investment in new factories powered by natural gas.

Although many of the recent trends in the energy sector are positive, looking ahead over the coming decades, climate change continues to pose considerable threats to America's environment, economy, and national security. The combined effects of shifting electricity production from coal to cleaner-burning natural gas, large increases in wind and solar power generation, and ongoing progress in energy efficiency have made a large contribution to reducing national energy-related carbon dioxide emissions by more than 10 percent since 2005. In his Climate Action Plan, the President set out the concrete steps that the Administration is taking to address the costs of climate change through new actions to reduce greenhouse gas emissions and prepare for the future climate changes that are an inevitable consequence of past emissions. The President has also recently directed his Administration to continue working with states, utilities, and other stakeholders to set new standards on carbon pollution from power plants.

Health care cost slowdown. The second structural trend is the slowdown in the growth of health care costs. The growth rate of real per-capita health care expenditures from 2010 to 2012 was the lowest since the Center for Medicare and Medicaid Services data began in the 1960s (Figure 1-8), and preliminary data and projections indicate that slow growth continued into 2013. As detailed in Chapter 4, this historic slowdown in health care cost growth does not appear to be merely an after-effect of the recession. The slowdown has persisted even as the economic recovery has unfolded, and it is evident in areas like Medicare as well as in the gap between health care price inflation and overall inflation, neither of which should be sensitive to cyclical fluctuations. Chapter 4 also presents evidence that some already-implemented features of the Affordable Care Act, including reductions in overpayments to Medicare providers and private insurers as well as payment reforms that incentivize better patient outcomes, are contributing to this trend. Primarily as a consequence of slower health care cost growth, the Congressional Budget Office has marked down its forecast of spending on Medicare and Medicaid in the year 2020 by about 13 percent relative to the projection it issued in August 2010. Employers and families are also likely to see significant benefits as health care places less pressure on employers' compensation costs, and the resulting savings are passed on to workers in the form of higher wages.

Figure 1-8

Growth in Real Per Capita National Health Spending, 1961–2013



Note: Data for 2013 is a projection.

Source: Centers for Medicare and Medicaid Services, National Health Expenditure Accounts; Bureau of Economic Analysis, National Income and Product Accounts; CEA calculations.

Expansion of innovation. The third emerging trend that presents a major opportunity for long-term growth is the rapid advance in telecommunications technology, particularly in fast and widely available wired and wireless broadband networks, and in their capacity to allow mobile devices to take advantage of cloud computing. The economic potential of these technologies and the broader context of U.S. productivity growth are discussed in greater detail in Chapter 5. From 2009 to 2012, annual investment in U.S. wireless networks grew more than 40 percent from \$21 billion to \$30 billion, and the United States now leads the world in the availability of advanced 4G wireless broadband Internet services. This infrastructure is at the center of a vibrant ecosystem that includes smartphone design, mobile app development, and the deployment of these technologies in sectors like business, health care, education, public safety, entertainment, and more. All told, the expansion of advanced telecommunications technology—along with the slowdown in health care cost growth and the rise in domestic energy production—are major reasons to be upbeat about the U.S. economy’s growth prospects in the coming years.

Long-Term Fiscal Sustainability

To the extent these structural trends continue to unfold and support stronger-than-projected economic growth in the years ahead, they will

help move the Federal government closer to fiscal sustainability over the medium- and long-run. The steep decline in the Federal deficit over the last several years discussed earlier has been accompanied by similar improvement in the long-term fiscal outlook. One key gauge of the long-term fiscal outlook is the fiscal gap, which represents the amount of tax increases or spending cuts as a share of GDP required in the present to stabilize the debt-to-GDP ratio over the next 75 years. While long-run fiscal projections are always subject to a wide margin of error, recent estimates of the fiscal gap are smaller than those issued just a few years ago. These improvements are thanks in large part to the aforementioned slowdown in health care cost growth, including the cost-saving measures in the Affordable Care Act together with other spending restraint and the restoration of higher tax rates on high-income households.

THE CHALLENGES THAT REMAIN AND THE PRESIDENT'S PLANS TO ADDRESS THEM

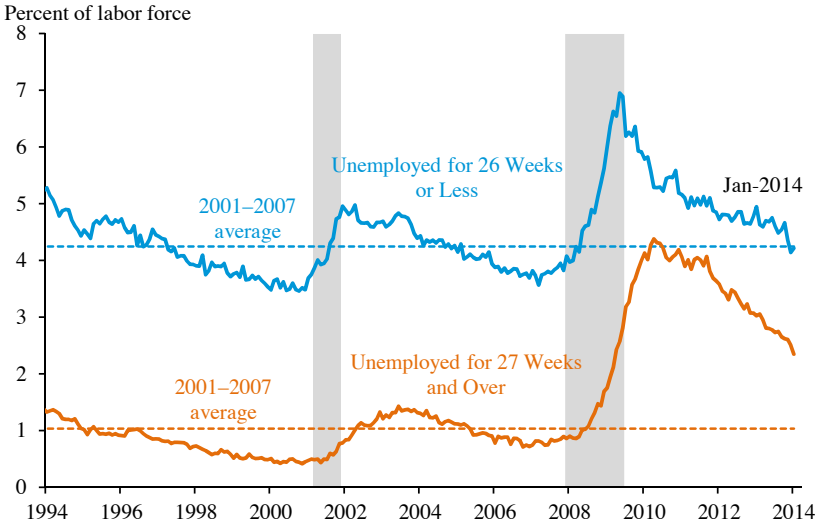
In the five years since the depths of the Great Recession, the U.S. economy has strengthened considerably. Nevertheless, many of the challenges left in the wake of the recession linger, as do other challenges that built up in the decades before the recession. Presently, the first and most immediate imperative is to support the recovery and continue to restore the economy to its full potential. But going forward, it will also be critical to find ways to expand the economy's potential and to ensure that all Americans have the opportunity to experience the prosperity that they help create.

Continuing to Restore the Economy to its Full Potential

Despite the 8.5 million private-sector jobs added over the last 47 months and the decline in the unemployment rate to a five-year low, the economy has not fully healed from the massive blow of the Great Recession, and helping restore the economy to its full potential is the most immediate challenge policymakers face. This imperative can in large part be understood through the prism of the U.S. labor market, which is currently subject to multiple distinct but closely related challenges. First, given the magnitude of the job losses stemming from the Great Recession and the need to add jobs to support a growing working-age population, the economy continues to exhibit an absolute shortfall in the number of jobs.

Moreover, while the long-term unemployment rate has trended down, it still remains markedly elevated. As shown in Figure 1-9, the prevalence of persons unemployed for 26 weeks or less has returned to its pre-recession average (4.2 percent of the labor force in January 2014, same as the average

Figure 1-9
Unemployment Rate by Duration, 1994–2014



Note: Dotted lines represent average during the December 2001 to December 2007 expansion period as defined by the National Bureau of Economic Research. Shading denotes recession.
 Source: Bureau of Labor Statistics, Current Population Survey; CEA calculations.

from 2001 to 2007), but the long-term unemployment rate is more than twice what it was during the pre-crisis years (2.3 percent in January 2014 compared with 1.0 percent on average from 2001 to 2007). Reducing long-term unemployment presents a major challenge because these individuals may face stigmatization from employers or experience skill deterioration.

Even as the economy continues to add jobs, it will also be important to see a concurrent recovery in the volume of job-to-job mobility. The flow of workers across firms plays a critical role in the economy because job mobility enables rising productivity and wages as individuals switch to jobs for which they are better suited. However, in recent months there have been fewer than 9 million combined hires and separations a month, compared with more than 10 million a month on average from 2005 to 2007. The rate of voluntary separations—a measure of workers’ confidence in labor market conditions—also remains below pre-recession levels.

As the unemployment rate trends down and worker mobility picks up, real wages should grow more quickly; but currently, the sluggish real wage growth seen in recent years represents another serious outstanding challenge in the labor market. Real wage growth remained positive for most of 2013, a key sign of the progress being made (Figure 1-10). However, as discussed in greater depth below, substantially faster real wage increases will

Figure 1-10
**Growth in Real Average Hourly Earnings for
 Production and Nonsupervisory Workers, 2007–2014**

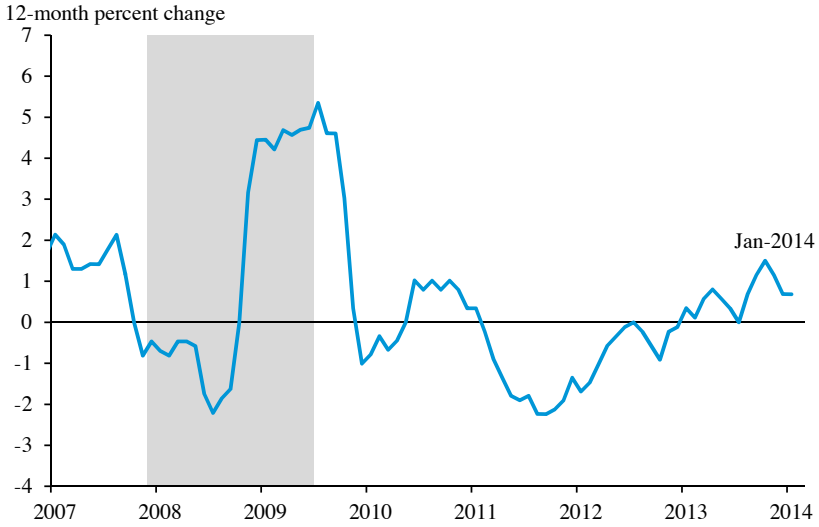
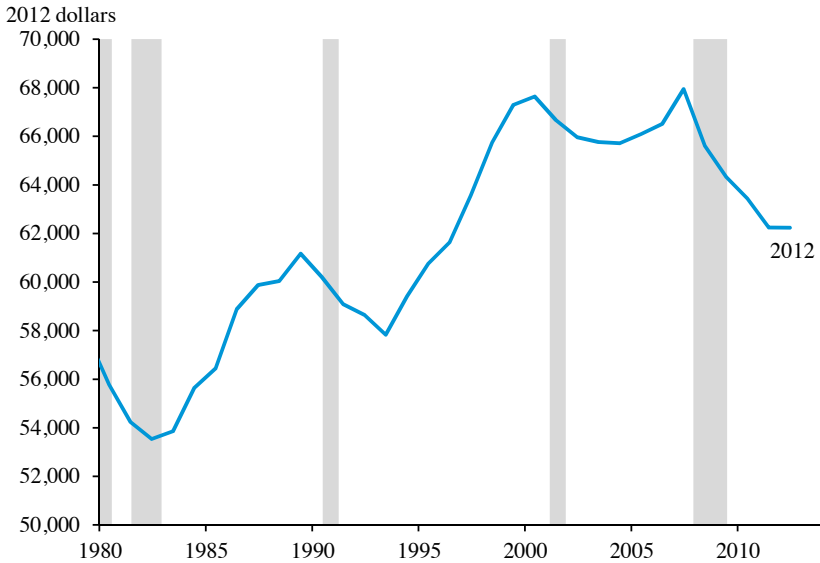


Figure 1-11
Real Median Family Income, 1980–2012



be needed to make up for a decades-long trend of average wages failing to keep pace with productivity gains.

The typical family's inflation-adjusted income has also been slow to recover. The Census Bureau reported in September that the median family earned \$62,241 during 2012, little changed in real terms from the preceding year (Figure 1-11). After increasing cumulatively less than half a percent in the seven years leading up to the recession, real median family income fell markedly during the recession and its aftermath and, as of 2012, was still 8 percent below its previous peak. Going forward, this is an important indicator of the way in which the recovery makes progress for the middle class.

To speed the recovery, boost job creation, and tighten labor markets so as to put upward pressure on median wages, the President has repeatedly called for investment in America's infrastructure. This type of investment would not only help address the 11 percent average unemployment rate in the construction sector during 2013, but would also foster stronger long-run growth. In the 2014 State of the Union, the President renewed his call for using the one-time revenue associated with the transition to a reformed business tax system to finance a major modernization of U.S. transportation infrastructure. But in the absence of the necessary Congressional action on this proposal, the President will press ahead in other ways by speeding up the permitting process for new construction projects.

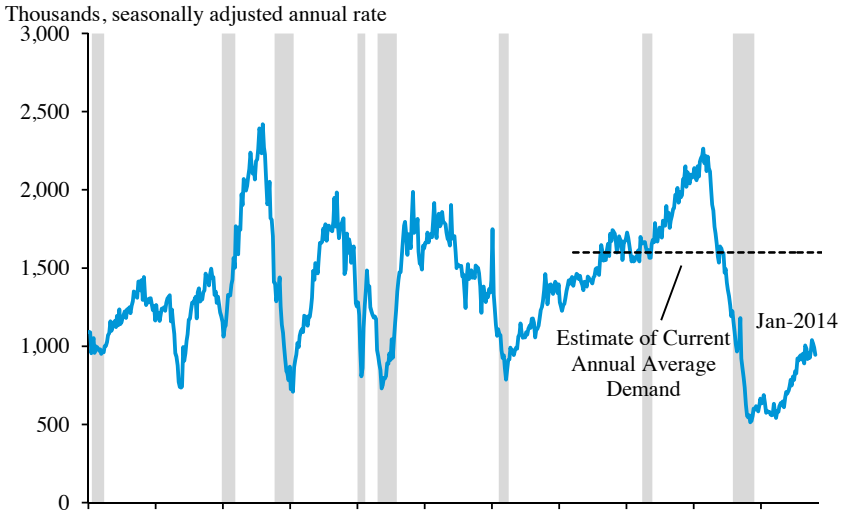
In addition, the President's budget includes an Opportunity, Growth, and Security initiative, which will finance additional discretionary investments in areas such as education, research, infrastructure, and national security. The \$56 billion initiative is evenly split between defense and non-defense and is fully paid for with mandatory spending reforms and tax loophole closers—and would both speed the return of the economy to its full potential and also expand that potential.

In addition to the challenges in the areas of jobs and income, the housing sector represents another key area with scope for further improvement. As shown in Figure 1-12, construction activity fell so far in the wake of the recession that, despite notable gains in recent years, the rate of permitting for new residential sites still remains well below the level suggested by demographic trends and home depreciation. To help unlock this potential, steps must be taken to bring certainty to the mortgage finance system, and also to support communities that were particularly hard hit when the housing bubble burst and are still coping with a legacy of foreclosures and blight.

Expanding the Economy's Potential

In addition to taking steps that speed the economy's return to full potential, the Administration continues to push simultaneously for

Figure 1-12
Building Permits for New Residential Units, 1960–2014

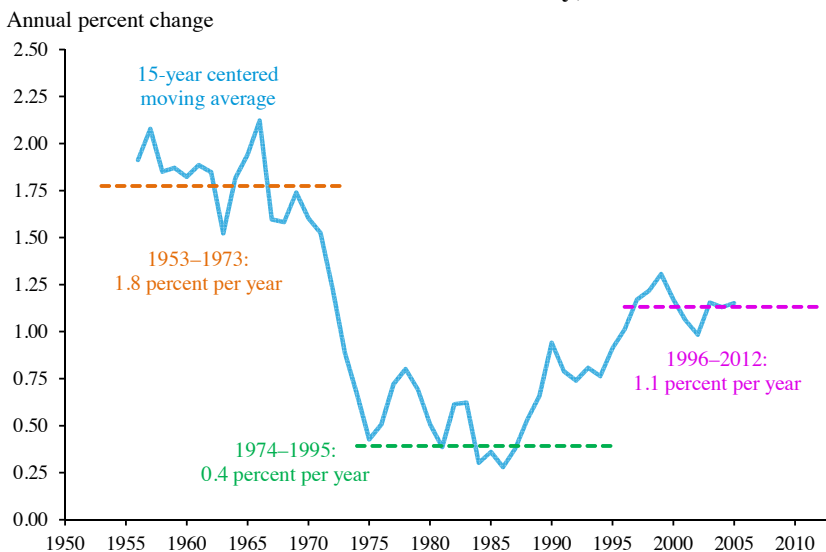


Note: CEA estimates that approximately 1.6 million new units per year are needed to keep pace with household formation and home depreciation. Shading denotes recession.
 Source: Census Bureau, New Residential Construction; CEA calculations.

measures that will expand that potential. To understand the importance of this goal, consider that an American worker in 2012 could produce more than four times as much per hour as his or her counterpart in 1948. About 10 percent of the increase is due to improvements in the composition of labor, mostly because of greater education, and 38 percent is due to increases in the amounts of capital that workers have at their disposal. Fully 52 percent is due to increases in total factor productivity, or what the Bureau of Labor Statistics calls multifactor productivity, which reflects technological change as well as the scale of markets and organization of production processes.

The growth of total factor productivity can vary widely year-to-year, but the longer-term trends can be broadly illustrated by splitting the last 60 years into three periods, as shown in Figure 1-13. First, from the 1950s through the early 1970s, total factor productivity grew at a relatively rapid 1.8 percent annual rate, fueled in part by public investments like the interstate highway system and the commercialization of innovations from World War II like the jet engine and synthetic rubber. Then, from the mid 1970s to the mid 1990s, the rate of total factor productivity growth slowed substantially, to just 0.4 percent a year. The causes of this slowdown have been the subject of extensive academic debate, with some evidence pointing to the disruptive effect of higher and volatile oil prices. Finally, from the mid 1990s through the latest available data for 2012, total factor productivity growth

Figure 1-13
Growth in Total Factor Productivity, 1953–2012



Note: The dotted lines divide the last 60 years into three periods that broadly reflect three "episodes" in productivity growth. For the nonfarm business sector.

Source: Bureau of Labor Statistics, Multifactor Productivity; CEA calculations.

picked up to a 1.1 percent-a-year rate, in part reflecting vast improvements in computer technology and software during this time. Although differences across these episodes may seem small, over time they compound to enormous differences in output and living standards.

While the growth rate of total factor productivity is always critical to an economy's long-run potential, the projected slowdown in the growth of America's workforce due to the aging of the population places even greater emphasis on productivity going forward. Since an economy's potential output depends fundamentally on the number of workers and the average output per worker, slower productivity growth can in theory be offset by rapid population growth. And during the aforementioned 1974 to 1995 period marked by slower total factor productivity growth, the working-age (16 to 64) population continued to expand at a solid rate of more than 1 percent a year. However, the Census Bureau projects that over the 20 years from 2012 to 2032, the working-age population will grow only 0.3 percent a year, largely a consequence of the aging of the baby boomers into retirement. Thus, looking ahead, productivity-enhancing investments are likely to be as critical as ever.

The President has several key proposals that will expand the U.S. economy's long-run potential. Comprehensive immigration reform would counteract the slower growth of America's workforce by attracting highly

skilled inventors and entrepreneurs to create jobs in the United States. The Congressional Budget Office (2013b) has affirmed that the bipartisan bill passed by the Senate would raise the economy's productivity and total output.

In addition, while the Opportunity, Growth and Security initiative, infrastructure investments, and business tax reform proposals discussed earlier will speed the recovery in the near term, these steps will also help make the economy more productive over the long run. Specifically, the President's framework for business tax reform would expand the economy's potential by reducing the distortions in the current system that skew investment decisions. By developing a system that is more neutral, corporate decision makers can act for business reasons, not tax reasons, creating an environment in which capital will flow to the most efficient purposes.

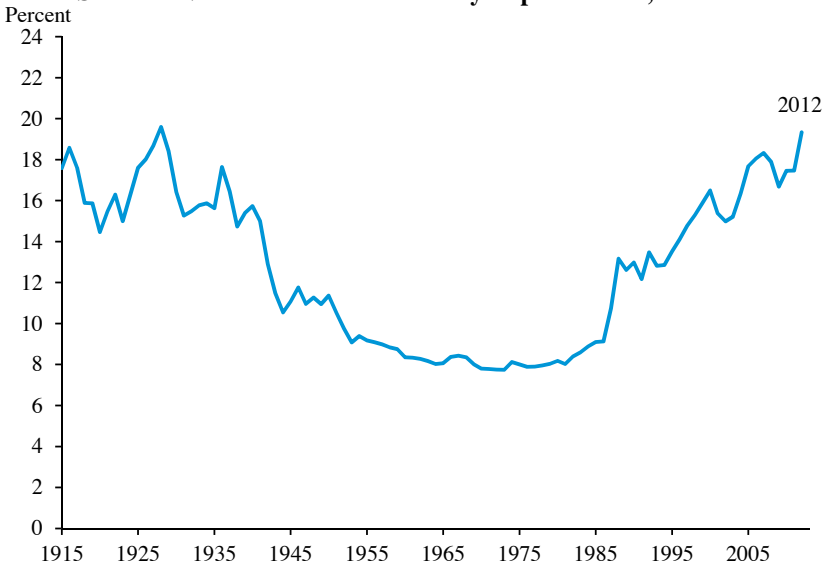
Expanding the economy's potential also means ensuring that the Federal budget is fiscally sustainable over the medium- and long-run. Fiscal sustainability frees up resources for productive investment and reduces borrowing from abroad that would ultimately require commensurate reductions in future national income. For these reasons, the President's budget proposals have repeatedly included additional steps toward long-run fiscal sustainability, including proposals to promote additional efficiencies in the health care system and limit tax benefits and loopholes for the highest earners. The Administration has also placed substantial emphasis on using evidence and evaluation in the budgeting process, as discussed in Chapter 7. These practices will help make the Federal Government more efficient and save taxpayer money for years to come.

Executive actions—including establishing new, innovative manufacturing institutes and expanding the SelectUSA initiative to attract foreign investment—will also help improve productivity and create well-paying jobs in the United States. Further, the Administration continues to negotiate new trade and investment partnerships with Europe and Asia, to help American consumers, the American businesses that sell their products overseas, and the workers they employ. The President is asking Congress for the Trade Promotion Authority he will need to make these agreements a reality.

Promoting Economic Opportunity

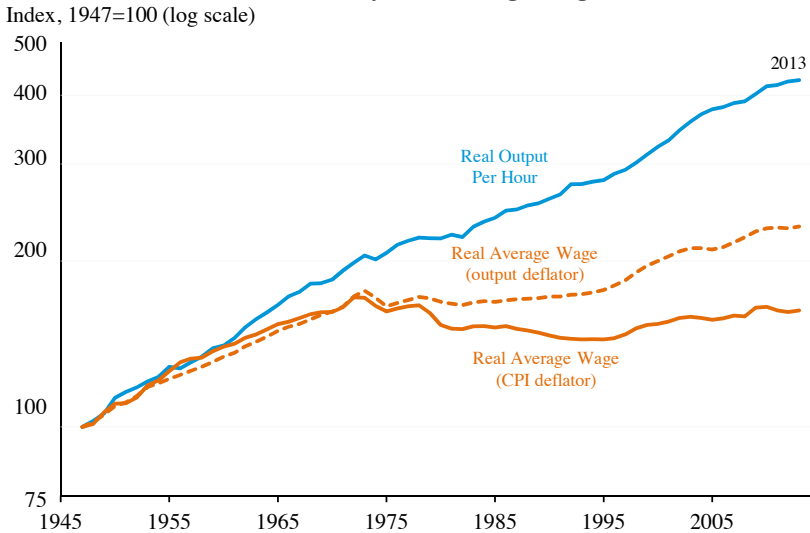
The third major challenge the economy faces is the need to ensure that every American has an opportunity to realize their full potential and partake in the prosperity they help create. Since the late 1970s, the United States has seen a major increase in income inequality due to a combination of technological change, globalization, changes in social norms, and institutional shifts like the erosion of the inflation-adjusted minimum wage and

Figure 1-14
Share of National Income Earned by Top 1 Percent, 1915–2012



Note: Excludes capital gains.
 Source: September 2013 update to Piketty and Saez (2003).

Figure 1-15
Growth in Productivity and Average Wage, 1947–2013



Note: Real output per hour is for all workers in the nonfarm business sector. Average wage is for private production and nonsupervisory workers. Output deflator is the price index for nonfarm business output. CPI deflator is the CPI-W. Data on wages before 1964 reflect SIC-based industry classifications.
 Source: Bureau of Labor Statistics, Productivity and Costs, Current Employment Statistics; CEA calculations.

the decline in union membership. As shown earlier, in 2012, the median U.S. family's inflation-adjusted income was less than it was in 1997. In contrast, separate data derived from administrative tax records show that the top 1 percent of tax units—who earned an average of more than \$1 million in 2012—received 19.3 percent of total income (excluding income from capital gains, which can be highly volatile year-to-year), the largest share since 1928 (Figure 1-14).

These statistics are symptomatic of a troubling disconnect between the economy's productivity and ordinary workers' wages that has emerged over the last 40 years. As shown in Figure 1-15, real average hourly earnings for production and nonsupervisory employees roughly kept pace with productivity growth in the nonfarm business sector during the early postwar years. But starting around the 1970s, a large gap emerged between overall productivity and an ordinary worker's take-home pay. Several factors may be contributing to this gap, including the relatively rapid increase in non-wage compensation like employer-sponsored health insurance, as well as the likelihood that productivity gains may translate into higher pay differently across occupations. Moreover, the gap is substantial regardless of whether one adjusts for inflation using the Consumer Price Index, which is more indicative of the typical household's purchasing power, or using the price index for total nonfarm business output, which allows for a more direct comparison with the productivity data. Ultimately, the Figure illustrates the growing concern that too many ordinary workers are being left behind, and helps explain why the President has said that the basic bargain in America—that those who work hard will have the chance to get ahead—has frayed.

To address this issue and to restore a greater measure of fairness and opportunity to the economy, the President has proposed a number of important measures. In the near term, the most direct step is to raise the minimum wage, which, after adjusting for inflation, has declined by more than one-third from its peak in the 1960s and is now worth less than it was when President Ronald Reagan first took office in 1981. Along with a minimum wage increase, the President has also called for other measures that would help those striving to join the middle class, including an expansion of the Earned Income Tax Credit for workers without children. In addition to these immediate steps, the President has set out a range of ideas to invest in education and equip workers with the skills they will need to compete in the global economy for years to come. For instance, the ConnectEd program continues to move forward, putting high-speed Internet in classrooms across America, and the Administration has also secured over 150 new commitments from universities, businesses, and nonprofits to improve college opportunity and outcomes for students from low-income families.

Along with steps that create jobs, boost incomes, and invest in educational opportunities, the President is pursuing measures to ensure that families can experience a greater degree of financial security. Three million young adults under age 26 have gained coverage through their parents' plans because of the Affordable Care Act, another 4 million people enrolled in insurance plans through State and Federal marketplaces as of late February, and millions more have been determined eligible for State Medicaid programs. Additionally, in the 2014 State of the Union, the President announced the creation of MyRA, a new safe and easy-to-use savings vehicle that can help millions Americans start saving for retirement.

CONCLUSION

The challenges discussed above are substantial, but the President believes that it is well within our capacity as a Nation to address these issues and to move toward shared and sustainable growth. The President has set out an ambitious agenda to support the recovery in the near term, while building on emerging strengths to expand the economy's potential over the long term. In this context, the President also remains focused on restoring greater measures of fairness and opportunity to our economy, to strengthen the middle class and give a boost to those striving to join it. This agenda includes measures to create new well-paying jobs, continue to reduce dependence on foreign energy sources, equip workers with skills to compete in the global economy, support those hardest hit by economic change, and provide families with a greater sense of financial security. These steps, and the rationale underlying them, are the focus of the pages that follow.

