

Statement of
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before the

Joint Economic Committee

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Mr. Chairman, Senator Bennett, Senator Reed and Members of the Committee:

I am delighted to have the opportunity to appear before you in my capacity as Chairman of the Council of Economic Advisers. The Council and I look forward to working with the Committee in its analysis of the economy and economic policy. Today, I welcome the opportunity to comment upon the outlook for the U. S. economy, and to present our view upon the policy challenges facing the Nation.

BACKDROP

The Long Boom

The current expansion is the most recent manifestation of accelerated long-term growth that began in the 1980s with the advent of a number of changes in the private economy and policy direction. These new policies include the pursuit of price stability through a steady monetary policy, an extensive process of deregulation in many sectors of the economy, and reductions in the tax burden facing American households and firms.

From 1982 onward, real GDP has grown at an average rate of 3.5 percent per year, as compared with 3.0 percent during the previous decade. Similarly, productivity in the nonfarm business sector has grown at an annual rate of 2.0 percent since 1982, as compared with 1.4 percent in the earlier period. From 1995, the acceleration in trend productivity was even more pronounced, with growth averaging 2.6 percent per year. These accomplishments have coincided with a period of low inflation. Inflation rates have declined from an average 8.8 percent during the 1972-81 period, to an average 3.3 percent from 1982 onward. Moreover, the volatility of inflation has also declined from 3.5 percent to 1.6 percent. These macroeconomic achievements are built upon a foundation of microeconomic initiatives such as: the deregulation of the airline and trucking industries, as well as the oil and natural gas producing sectors. Also very important, reductions in marginal tax rates (with the notable exception of the early 1990s

increases) have set the stage for increased labor force participation, as well as the entrepreneurial achievements that have made American prosperity and technological prowess objects of emulation

Recent Developments

Since late 2000, the economy's rate of growth has slowed substantially. Beginning in the fourth quarter of 2000, growth declined from the unsustainable rate of 4.2 percent recorded in the first three quarters. Real GDP growth slowed to 1 percent in the fourth quarter, and 2 percent in the first quarter of 2001. The Conference Board's index of coincident indicators peaked last September at 116.6, dipped to 116.3 in January, and at 116.5 in April, remains below the September peak.

Despite the recent deceleration in economic growth, it is unlikely that the U.S. economy is in a recession, as real growth has been and is anticipated to remain positive. The May Blue Chip consensus of economic forecasters foresees real GDP to grow 2.2 percent during the four quarters of 2001, and 3.4 percent during 2002. Nevertheless, there are some negative factors that threaten to delay a full recovery in growth.

Pressures on the Economy

Consumption. Consumption, which accounts for approximately two-thirds of aggregate demand, has held up relatively well during the recent growth slowdown. The resilience of consumption is especially remarkable given the reduction in wealth that has accompanied the decline in equity prices, as consumption (relative to income) tends to track wealth over the medium term. Estimates of the change in consumption for a dollar's change in wealth range from three to five cents, with the lag extending up to about two years after the shock. To the extent that these relationships hold, one should expect a period of slow consumption growth.

In line with the downturn in some asset prices and economic growth, indicators of consumer confidence have also posted warning signs. The University of Michigan index of consumer sentiment has been trending downward since November, but has recently retraced a fraction of that loss. The preliminary reading for May is 92.6, up from a final measure of 88.4 in April. Despite the decline over the past six months, the index remains above its historical average.

A key question in assessing consumption prospects is whether the rate of unemployment will continue to rise, and whether the associated income uncertainty will depress consumer spending. The payroll unemployment rate rose from 4.0 percent in December to 4.5 percent in April. Private payroll employment fell in March and April, with losses continuing in manufacturing and help-supply services. The recent level of initial claims for unemployment insurance suggests that the unemployment rate will likely continue to rise over the next several months, although last week's figures on unemployment insurance claims were somewhat more positive.

Investment. Business fixed investment spending overall has stagnated over the past two quarters. Equipment and software growth declined noticeably in the fourth and the first quarter and orders suggest a further decline in the second. In contrast, investment in non-residential construction is up sharply, with first-quarter real investment 10 percentage points above its level a year ago. This growth is being led by construction in energy extraction industries, and is likely to continue as more electricity generating plants are built.

Investment in information technology (IT) equipment has also decreased. Earlier increases in equity values in this sector may have encouraged a bit too much investment. The legacy of this possible over-investment may take a few quarters to re-equilibrate. Given the rapid technology gains and rapid depreciation, we expect IT investment to rebound by year-end.

There are basically two ways to calculate how adjustment to the equilibrium capital stock -- determined by output and the user cost of capital -- will be achieved. The first is to estimate a model wherein investment expenditures adjust in a manner to gradually work off the excess amount of capital. The second approach relies upon a cash flow model to determine the investment rate -- the greater the retained earnings, the greater the amount of investment.

Estimating the overhang is a challenging task because our knowledge of the economic rate of depreciation of IT equipment and software is limited. Assuming smooth adjustment to the desired capital stock, the overhang might be eliminated quite quickly. However, if investment is highly dependent upon corporate cash flow, the adjustment might be sharper.

Energy Prices. The rising cost of energy over the past two years has exerted a kind of tax on both consumers and those firms that are not energy producers. Although the share of the households' budgets devoted to energy needs are not at historical highs, the elevation of relative prices comes at a time when the economy is fragile. Similarly, firms face increased energy costs in a period of slackening demand.

Petroleum. From late 1998 through 2000, the prices of many energy products rose sharply from their low levels. Imported crude oil rose from as little as \$10 per barrel to over \$30 per barrels; as recently as 1997, it had cost \$20 per barrel.

In order to assess the economic consequences of higher oil prices, it is important to make the distinction between permanent and temporary energy price increases. To the extent it is unlikely that the oil prices in 1998 were long-term equilibrium prices, it may be more reasonable to use the \$20 price as a baseline. Evaluated from this perspective, the relevant price increase (that might be expected to persist for some years) was about \$10 a barrel or approximately 50 percent (the price of West Texas Intermediate currently is approximately \$28 per barrel).

A recent International Monetary Fund analysis* of oil price shocks on the U.S. economy determined that a price shock of this magnitude results in a 0.2 percentage point reduction in output below what it otherwise would have been in the first year after the shock, and a 0.4 percentage point reduction in the second year, with the effect diminishing thereafter. The shock adds 0.2, 0.7 and 0.5 percentage points, respectively, to core inflation in the years after the shock. Another macroeconomic model suggests that an increase of \$10 per barrel yields a 0.4 percent reduction in output relative to baseline in the first year. While the models differ in their exact predictions, they yield similar magnitudes of effects. Given relative stability in oil prices through the latter part of 2000 and indications from futures markets of a slight decline in prices, barring future negative shocks, we anticipate the effects of the oil price increase should dissipate over the next year.

Natural Gas. In assessing the impact of higher natural gas prices, it is important to recall virtually all of the 16 percent of natural gas consumption that is accounted for by imports originates in Canada, a large importer of U.S. goods. Thus the net "withdrawal" of spending from the U.S. economy is relatively small because a large proportion of the resulting Canadian spending returns as U.S. exports.

Compared with oil, the reduction of GDP due to natural gas spending leaking abroad is roughly one-sixth to one-seventh the impact experienced from higher oil prices.** Overall, the largest economic effects are domestic and redistributive in nature -- from natural gas consumers to natural gas producers.

Natural gas prices are higher relative to trend all over the country. However, they are highest in California. Even there, a recent study published by the Federal Reserve Bank of San Francisco notes that "...although rising natural gas prices have hurt some producers and consumers in the Twelfth [Federal Reserve] District, there is little evidence that rising costs have significantly slowed economic growth in the region." Further, the study observes that expenditures on natural gas in the Twelfth District amount to less than one percent of gross state product.***

It is also of interest that some firms have stopped production, not because they cannot afford to purchase natural gas, but because they have forward contracts for natural gas, and find it more profitable to resell the gas than to use it to produce their goods.

The differential prices for natural gas observed across the regions, and occasional interruptions in gas supply, buttress the Administration's argument that more resources need to be devoted to enhancing the Nation's natural gas delivery infrastructure. Accordingly, the National Energy Development Policy task force has highlighted this policy measure in its report.

*Benjamin Hunt, Peter Isard and Douglas Laxton, "The Macroeconomic Effects of Higher Oil Prices," *IMF Working Paper* WP/01/04, 2001.

**This calculation compares the change in import value due to higher prices, relative to GDP

***Mary Daly, "Economic Impact of Rising Natural Gas Prices," *Federal Reserve Bank of San Francisco Economic Letter* 2001-04 (February 9, 2001)

California and the Electricity Situation. Most analysts have concluded that the reductions in electricity consumption (due to rolling blackouts and voluntary outages) have thus far had only a small impact on gross California state product and hence national GDP. The likely impact of the outages during the upcoming summer months is much more difficult to determine given the vagaries of the weather and the uncertain quantitative impact on demand of the new rate structure implemented by the California Public Utilities Commission on May 15. The damage from summer blackouts is likely to be limited because firms with critical needs for uninterrupted power have installed backup generators. Assuming some reduction in demand due to higher retail prices, and a moderate summer, third-quarter GDP growth might not be reduced noticeably, while an unseasonably hot summer, combined with no additional action on the pricing front, would result in a clearly noticeable impact.

The major impact on California will be felt in the longer term, as firms make decisions regarding where to locate. Firms that rely upon a stable, uninterrupted supply of electricity, or use energy as a key component of their production process, are most likely to opt for locating outside of California, and perhaps even outside of the United States.

The Foreign Sector: Effects on the Rest of the World. Changes in economic conditions have not been restricted to the United States. The global economy has also experienced substantial reductions in growth and employment. These changes are not completely unrelated; rather they represent a complex set of interactions between the U.S. economy and its economic partners.

As the largest single economy and financial market in the world, trends in the United States have a substantial impact upon the rest of the world. Rapid growth in the United States during 1999 and 2000 sustained, through demand for their exports, the economic buoyancy of East Asia and (to a lesser extent) Europe. The slowdown in the U.S. economy, particularly in electronics and semiconductor products, has resulted in a substantial decline in growth prospects in those East Asian economies that specialized in these export markets.

The Euro area in particular is perhaps more susceptible to U.S. economic influences than many European policymakers have perceived. Most of the focus had been on the fact that trade flows between the United States and the Euro area are not particularly large. However, in this era of highly integrated product and financial markets, developments in asset markets can have ramifications far outside national borders.

The Foreign Sector: Rest-of-World Effects on the United States. While events outside of the United States can have an effect upon the U.S. economy, quantifying those effects is not straightforward. In general, it is our view that, aside from a systemic financial crisis, it is unlikely that events outside the United States will have a large impact upon domestic economic prospects, largely because trade accounts for a small share of the U.S. economy. As a proportion of GDP, exports are about 11 percent. Moreover, the United

States is not overly sensitive to developments in regions vulnerable to recession; for example, U.S. goods exports to the Japan only comprise 8.3 percent of total U.S. exports.

Furthermore, foreign financial markets are small compared to those in the United States. Even to the extent that the United States relies upon foreign savings, there does not appear to be cause for current alarm from recent trends. As U.S. economic growth has slowed, and equity markets experienced a correction, the willingness of foreign investors to purchase U.S. assets has not abated. Inflows of capital to purchase U.S. equities continued into the fourth quarter of 2000 (the last period for which data are available), despite declines in the major indices. As a further indication of this phenomenon, the value of the dollar has continued its upward trend in the first quarter, even as U.S. equity indices continued their decline and euro area growth rates exceeded that of the United States.

The current account deficit, which includes net payments such as interest, dividends and remittances, was \$435.4 billion in 2000, or 4.4 percent of GDP. This current account balance reflects the desire of global investors to invest in the U.S. economy.

Long-term Outlook

Over the longer term, the prospects for the U.S. economy remain bright. I say this because of the acceleration of trend productivity growth observed over the last few years, and the accompanying rise in the growth rate of potential output, making possible rising living standards and low inflation. Over the 1973 to 1994 period, the average annual growth rate of labor productivity in the nonfarm business sector was 1.3 percent. Since 1995, it has been 2.6 percent. Over the same period, manufacturing productivity has grown at 4.7 percent annum, versus the 2.5 percent per annum rate observed in the earlier period.

The latest release on productivity growth has given some observers pause for thought. Two cautionary points are in order. First, labor productivity is procyclical, so that some reduction in productivity growth is to be expected. Second, the surprisingly low productivity growth rate for the first quarter is likely to be downwardly biased because of the difficulty in measuring self-employed hours. Subsequent observations on productivity are likely to reaffirm a higher trend growth rate.

Rapid productivity growth, upon which our future prosperity rests, does not occur in a vacuum. It depends upon the appropriate policy framework. This framework should consist of policies that minimize interference with the accumulation of factors that contribute to growth.

IMPACTS OF THE PRESIDENT'S PROPOSALS

The President's tax plan is one example of such policies. Let me begin by reviewing the context in which the President's tax proposals were developed. The

President's plan was developed in the midst of a sustained period of rapid economic growth that had increased the overall tax burden (Federal tax revenues as a share of GDP) to over 20 percent – a post-war high. Over the course of that expansion the underlying fiscal position of the Federal government improved. Having taken steps to improve the sustainability of the Social Security system and reduce significantly the outstanding debt held by the public, the President's budget proposes to reduce the overall tax burden efficiently and fairly.

Now, since the inception of the President's proposals, immediate attention has swung from a rapidly growing economy to the need to ensure the continuation of steady growth. The tax cut was not initially designed to be a "stimulus package." The goal was to return a significant portion of the on-budget surplus to taxpayers in an economically efficient fashion. Fortunately, it can serve as both. Permanent cuts in marginal tax rates will have immediate and significant economic effects. Indeed, the evidence is that a purely temporary "stimulus" tax change would have much more modest impacts than the President's plan.

Still, the plan is primarily targeted toward long run objectives. Viewed from this perspective, an unfortunate feature of most of the debate has been its focus on "size." Some critics have argued that the economy somehow cannot afford to return \$1.6 trillion dollars to the citizens who earned it.

This concern is somewhat surprising. The President's budget outlines clearly how the tax cut co-exists with preserving Social Security and Medicare, and prudent increases in other necessary government programs. Moreover, when viewed in the context of the large U.S. economy, the cuts are quite modest. Over the budget window, the tax plan amounts to only 1.2 cents in each dollar of GDP. In comparison, the President's proposed tax cuts are less than one-half the size of the Kennedy tax cut, roughly one-fourth the size of tax cuts proposed by President Reagan, and takes place in an overall context of budgetary discipline.

Or, taking another perspective, the President's tax cut compensates for "real bracket creep." The idea of bracket creep is familiar. Taxpayers once were forced into higher tax brackets due to purely inflationary increase in their nominal incomes. Indexing tax brackets for inflation solved this kind of bracket creep. However, the tax system is not immune to *real* bracket creep. As the economy grows, the real incomes of households rise; pushing them into higher tax brackets. In the absence of a significant tax cut, real bracket creep will result in an increasing share of income being paid on taxes. The President's tax cut will simply reduce the share of individual income paid on taxes to levels that were in existence in the prior ten years.

A second unfortunate aspect of the public discussion has been some of the misleading assertions regarding the fairness of the tax cut. The President believes that everyone who pays income taxes should receive an income tax cut. However, consistent with his concerns for our least-well-off citizens, the largest percentage tax cuts are reserved for lower-income families.

The percentage reduction in income tax burdens under the President's proposal is the largest – a reduction of 136 percent – for the lowest income group (under \$30,000). The percentage reduction is smaller but above average for families with incomes between \$30,000 and \$100,000. The percentage reductions are below average – –9.5 percent – for families with incomes over \$100,000.

In addition, under the President's plan, the share of income taxes paid by upper-income households will rise. Families with incomes under \$100,000 will pay a smaller share of the total income tax burden under the President's proposal than they do under current law: 25.8 percent versus 30 percent. Conversely, families with incomes of \$100,000 or more will pay a larger share of the total income tax burden under the President's proposal than they do under current law: 74.2 percent versus 70 percent. By standard measures, the proposed tax cut is progressive.

However, from my perspective, the most dissatisfying aspect of much of the discussion has been that it fails to address the economic impacts of the President's proposals.

To begin, the key to the President's plan is its focus on reducing marginal tax rates. We are now quite familiar with the notion that accumulating physical capital, human capital – education, skills, and training – and new technologies is the heart of sustained economic growth and prosperity. There is now a large body of evidence that improving marginal incentives – the additional reward to effort, investment, innovation, and other activities – is the key to ensuring these investments in our economic future.

Almost all taxes interfere with the smooth functioning of a market economy, leading to reduced labor supply, investment, and GDP – economists have labeled these losses the “deadweight loss.” High marginal tax rates are especially damaging, so the gains to reducing high marginal rates are quite striking. Cutting marginal rates in half, for example, yields reductions in deadweight loss by more than a factor of two. By reducing marginal tax rates, the President's plan will enhance economic performance.

The visible benefits of lower marginal tax rates will be seen across the spectrum of economic activity. Economic research has established strongly the link between taxes and the decision to start or continue working: reductions in taxes bring low-wage and low-income individuals into the labor force, lower marginal tax rates – both explicit and implicit in our social insurance programs – permit the continued work effort of our most experienced and skilled workers: America's older workers. Lower marginal tax rates also have been shown to induce second-earners in two-earning families to work more frequently and longer.

Among the most damaging aspects of high marginal tax rates are their impact on the willingness to undertake economic risks. In particular, recent research has shown that tax rates have a profound influence on entry into entrepreneurship and entrepreneurial activity. Reducing marginal tax rates allows entrepreneurial businesses to grow faster,

enables greater purchases of capital, and allows small business to hire additional workers and increase payrolls. Marginal rate reductions also improve access to capital and the vitality of the entrepreneurial sector.

For example, recent research by economists Douglas Holtz-Eakin and Harvey Rosen indicates that reducing the top marginal tax rate from 39.6 percent to 33 percent will raise the fraction of high-income small businesses that undertake a capital expansion by 12.5 percent, and raises the average size of the capital outlays by 11.9 percent.

Cutting the top marginal tax rate raises the fraction of high-income small businesses whose prospects are good enough to afford outside help by 12.1 percent. For existing employers, cutting the top marginal tax rate from 39.6 percent to 33 percent permits payroll growth of 4 percent, taking the form of both higher wages and more workers. The effects on capitalization, employment, and incentives of lowering the top marginal tax rate from 39.6 percent to 33 percent causes the sales of high-income small businesses to rise by 8.2 percent.*

Finally, a commitment to lower marginal tax rates should be viewed as part of our continued efforts to encourage young people to acquire education and skills.

It is important to emphasize that the benefits of lower marginal rates and lower deadweight losses accrue to the economy as a whole. For example, when entrepreneurs expand, small businesses purchase more capital, benefiting their suppliers. They hire more workers and increase their payrolls. In addition, their growth and innovation provides consumers with a greater range of products and choices.

The incentives provided by lower marginal tax rates are especially important for the top marginal tax rate. A large body of economic research has examined the adjustments, seen and unseen, to improved incentives – more days and hours of work, greater effort on the job, increased risk-taking and entrepreneurial activity, reduced tax-based financial engineering, and so forth – are summarized by the increase in taxable income induced by a cut in marginal tax rates.

Cutting the top marginal tax rate leads to the greatest response in taxable income. Research by Martin Feldstein – a former Chairman of the Council of Economic Advisers – indicates that the response of taxable income to increases in the “tax price”—one minus the marginal tax rate-- may approach unity. However, even those who find the most modest impacts indicate that the response is at least one-half of this size.

It is easy to see the virtues of reducing the top marginal tax rate on the identifiable entrepreneurs who face tax-based costs of decisions to expand their facilities, hire new workers, reward their best employees, and push their businesses forward. The evidence on the response of taxable income reflects the benefits of lower marginal tax rates on all forms of economic activity.

*Computations based on Douglas Holtz-Eakin and Harvey S. Rosen, “Economic Policy and the Start-Up, Survival, and Growth of Entrepreneurial Ventures,” May 2001.

How does the President's plan measure up? First, the focus is on an across the board reduction in marginal tax rates – including reducing the top marginal income tax rate from 39.6 percent to 33 percent.

Second, the President's plan will encourage the saving and investment. By phasing out and eliminating the death tax, the plan reduces a tax on capital accumulation that has the highest marginal tax rates in the tax code. At the same time, by permitting non-itemizers a deduction for their charitable contributions, tax-free withdrawals from IRA for charity, and raising the cap on corporate charitable contributions, the President's plan will allow non-profits to compete more equally for the infrastructure to economic growth.

Third, the President's proposals will raise the accumulation of "human capital" at all stages of the life cycle. Expanding the generosity of the child tax credit will provide families additional resources to pay for education, childcare, and other costs associated with child rearing. At the same time, the President's proposals to reduce the marriage penalty will address both an issue of basic fairness, as well as lowering marginal tax rates on second earners. Finally, the proposed expansions of Education Savings Accounts will promote human capital investment in education.

Finally, the President's plan addresses as well the third component of sustained economic growth – increases in technology – by proposing to make permanent the Research and Experimentation tax credit.

Taken as a whole, the President's plan would have substantial beneficial effects on economic growth. Macroeconometric models focusing on the short run generally predict modest effects on aggregate demand growth of income tax reductions. Long-term equilibrium models that incorporate effects of tax reductions on incentives generally predict larger gains in output growth.

Thank you, Mr. Chairman, for providing me this opportunity to discuss the state of the economy and the President's proposals to enhance long-term economic growth and economic security. I would be happy to answer your questions.