Testimony
of
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before the
Joint Economic Committee, U.S. Congress

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Chairman Saxton, Vice Chairman Reed, and members of the Committee, it is a pleasure to appear before you today to discuss the economic outlook and policies that will advance the recovery and promote economic growth.

The Economic Outlook

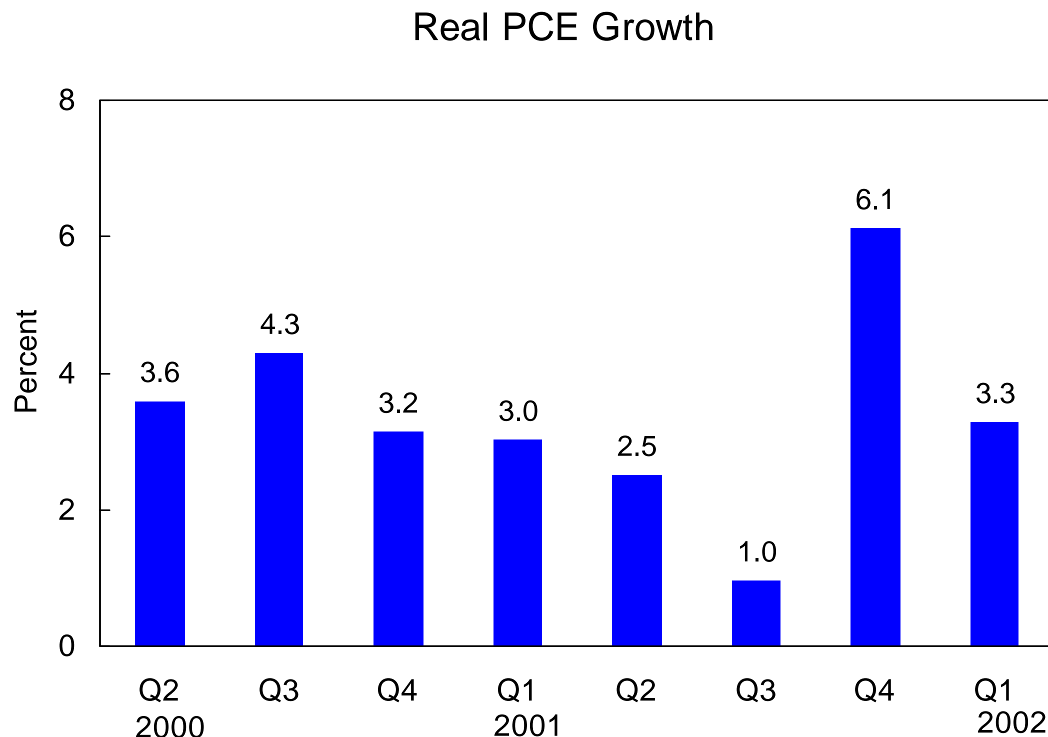
The Administration's economic outlook is contained in detail in the recently released *Mid-Session Review of the Budget*. In these remarks, I will focus only on the main features of that *Review*. The economic assumptions were revised from those used in the Administration's 2003 Budget to incorporate the unanticipated strength and timing of the recovery, as well as the passage of the Job Creation and Worker Assistance Act (JCWAA). Real GDP growth this year is now expected to be considerably higher than anticipated in the Budget, a revision that reflects broad consensus among private sector forecasters. The rates of GDP growth and unemployment during the second half of the projection period are the same as in the Budget; inflation and interest rate projections are nearly identical to those in the Budget. Specifically, year-over-year GDP growth in 2002 is projected to be 2.6 percent, compared with 0.7 percent in the Budget. Growth during 2002-12 is projected to average 3.2 percent per year – the same rate as in the most recent Blue Chip consensus long-run forecast. During the latter years of the forecast (2008-2012), growth is projected to proceed at the potential rate of 3.1 percent per year.

Consistent with the FY2003 Budget assumptions, the unemployment rate is projected to decline during the next few years to 4.9 percent in 2007 and then remain at that low level. That rate is the Administration's estimate (and matches the Blue Chip consensus long-run estimate) of the long-run unemployment rate that is consistent with stable inflation. With regard to inflation,

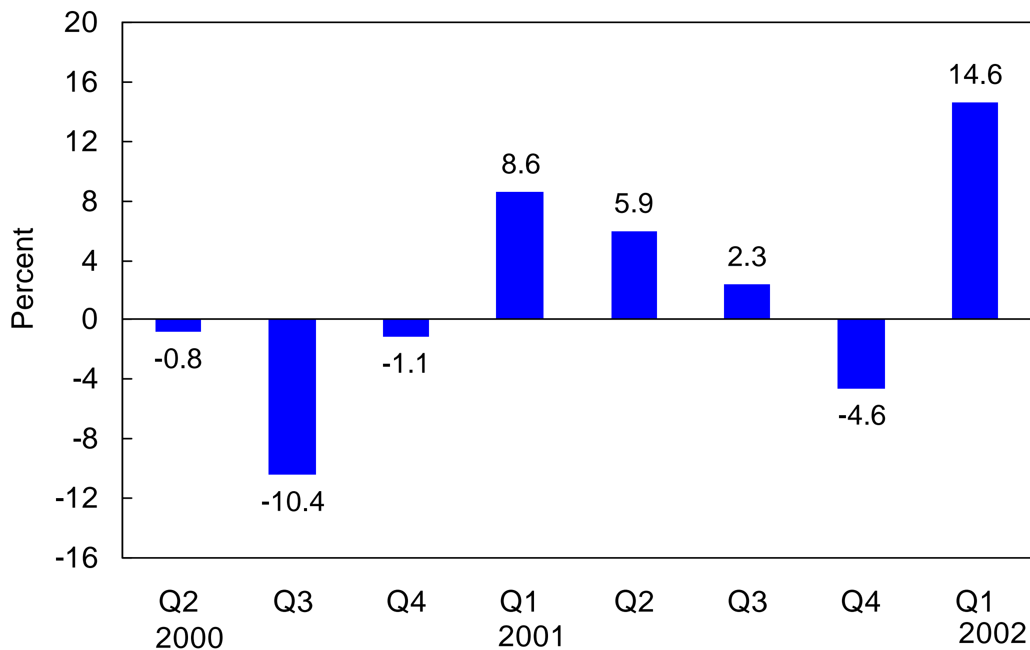
in the near term, the CPI measure of inflation is projected to be 1.7 percent, slightly below the budget projection, while over 2003-2012 the inflation projection is slightly less than 2.5 percent.

The Mechanics of Economic Recovery

The basic mechanics of the present economic recovery are familiar. Solid consumption growth forms the foundation of continued strength in the growth of final demand. Indeed, as is well known, the household sector has been a source of strength in final demand over the course of the recession and recovery. In addition to enhancing long-term economic efficiency, the tax cut proposed by the President and passed by Congress last spring provided valuable support for disposable incomes. Substantial cuts in the target federal funds rate by the Federal Reserve have translated into lower mortgage interest rates, supporting housing starts and mortgage refinancing. The upshot has been solid growth in personal consumption expenditures and residential investment that will support the recovery.



Source: Bureau of Economic Analysis, Department of Commerce



Source: Bureau of Economic Analysis, Department of Commerce

In addition, growth in GDP has benefited from government purchases associated with enhanced homeland security and short-run inventory dynamics; the latter are estimated to have contributed 3.4 percentage points to GDP growth during the first quarter. These factors are likely to continue to contribute a bit in the near term, while there is little basis for expectation of aggregate demand growth stemming from the international sector.

Inventory investment contributed to the economic slowdown, but by early in 2002, the pace of inventory decline slowed, and business efforts to reduce further decline provided a significant fillip to production. In some sectors of the economy, evidence suggests that inventory restocking is underway. Over the next several quarters, as inventory and sales growth come together, inventory investment's role in real GDP growth should provide momentum. Attention on fixed investment decisions is therefore important.

The key to transforming recovery into robust growth is the pace of business fixed investment. Only with robust business investment will labor markets firm and the economy return to robust job creation. The recently passed “Job Creation and Worker Assistance Act of 2002” (more widely known as the “stimulus package”) reduces disincentives to investment – technically 30 percent expensing. Businesses are permitted to deduct immediately 30 percent of the cost of new qualifying business investments undertaken in the three years starting on September 11, 2001.

These provisions provide valuable policy support for an investment recovery. In addition, the interest rate environment remains favorable and the corporate profitability appear to be improving. As reported in the National Income and Product Accounts, profits from domestic operations have increased 26 percent (not annualized) during the past two quarters. The gain in profits is partly accounted for by very modest growth of unit labor costs. Productivity grew 4.2 percent during the past four quarters (a period that includes recession and recovery) – and quite rapidly during the first quarter. The Employment Cost Index measure of hourly compensation growth was stable at about 4 percent, allowing profit margins to expand. Given the stronger fundamentals, one would expect investment to recover.

Indeed, most private forecasters envision a rebound this year. In its May 2002 *Economic Outlook*, Macroeconomic Advisers reported that it expects a recovery in investment in 2002, with nonresidential business fixed investment forecast to rise 0.8 percent this year and 12.1 percent in 2003.

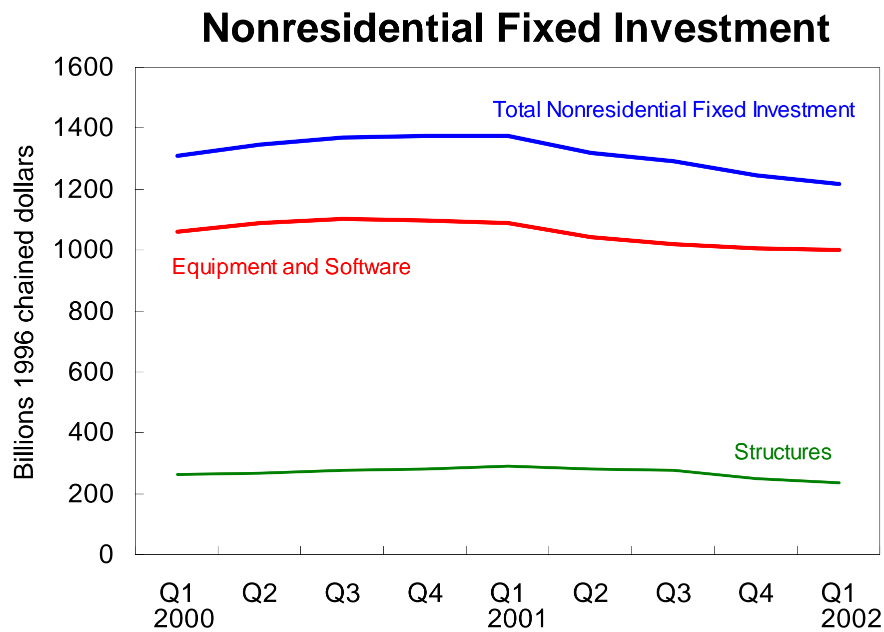
Macroeconomic Advisers June 2002 Investment Forecast
(Q4/Q4 Real Growth)

	2002	2003
Nonresidential Fixed Investment	**0.8%**	**12.1%**
➢ Structures	-8.7%	1.9%
➢ Equipment and Software	4.1%	15.3%
-- Computers and Software	8.5%	25.5%
-- Other Equipment	2.2%	11.0%

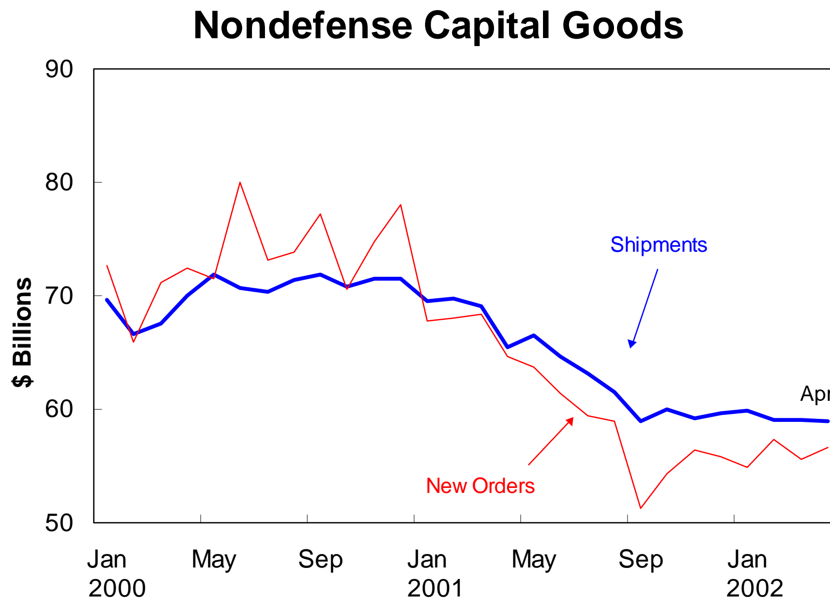
Source: Macroeconomic Advisers June 2002 Economic Outlook

In building its forecast, Macroeconomic Advisers argues that there is little cause to worry about investment drag related to a high-tech overhang, as any capital overhang in the economy has been largely eliminated. These conclusions mirror analysis done at the Council of Economic Advisers.

For the economy as a whole business investment slowed its decline during the first quarter. Investment in nonresidential structures continues to decline, but purchases of equipment and software have shown some signs of firming.



The most recent data are consistent with flat to modest growth in investment during the second quarter thus far. For example, the Commerce Department announced that new orders for manufactured durable goods excluding semiconductors increased 0.7 percent in May, after rising the same amount in April. New orders for nondefense capital goods (which give an indication of future investment spending) grew 4.3 percent in May, following a 1.1 percent increase in April. In contrast, shipments of nondefense capital goods (which give an indication of current business investment) rose a more modest 1.2 percent in May, compared with 0.1 percent in April.



On balance, then, while forecasts and surveys are promising, we await firm evidence of a rebound in business investment strong enough to sustain rapid rates of job growth. Such evidence is likely in the coming months, as firms respond to improved sales and profits, investment tax incentives, and enhancements in productivity made possible by advances in technology. Toward this end the most recent data on industrial production – which rose by 0.8 percent in June – are heartening, as they showed stronger growth in industrial production in a broad cross-section of industries.

Of course, there are risks to this outlook. For example, the stock market has declined about 13 percent since the end of May, reflecting shifts in the equity risk premium and concerns over among other things, profitability and financial data, with the result that household equity wealth has fallen about $1.3 trillion. While this represents a clear loss to households through direct holdings and 401(k) and retirement plans, it has also raised concerns over the durability of the recovery. To get a sense for the potential magnitudes involved, however, begin by noting that consumption tends to fall three to five cents for every dollar of lost equity wealth. In addition, investment also falls because of the higher cost of capital. Combining these effects, a *permanent* loss of 13 percent in stock-market value – together with other macroeconomic interactions in a standard model, including any offsetting action by the Federal Reserve – would reduce the level of real GDP by roughly 0.4 to 0.7 percentage point after one year. While this is a

significant impact, but it would not overwhelm the upward path of the recovery. Moreover, the reduction in GDP would be a transitory event, with GDP returning to its former path after three years or so.

Moreover, such an effect would require a substantial (and, as I noted, permanent) loss in wealth and investment incentives. In this respect, it is useful to note that declines in equity values have been offset in part – though certainly not entirely – by increases in housing wealth, lessening the impact on consumption. These recent increases in home prices reflect effects on the demand for housing of low interest rates and demographic factors and have bolstered household balance sheets or, through mortgage refinancing, provided extra funds to finance consumption and debt service. In part due to refinancing, some measures of household debt service burdens have risen; excluding mortgage interest reveals no significant rise in the fraction of household income devoted to interest costs.

On the investment side, it is interesting to note that there has been a modest rise in risk spreads recently – a factor that could contribute to lower equity valuations – but these have been offset by a shrinkage in the yield spread between long-term and short-term Treasury securities. Also, in the past month, the rise in risk premia appears concentrated in Baa corporate bonds, as these yields have risen relative to high-grade corporate bonds.

Data Sharing Initiative

The intense focus on monthly – or even weekly – data releases during the recovery thus far has focused attention on the importance of improving our economic data. Last week, the Council of Economic Advisers unveiled the President's initiative to raise further the quality of economic statistics. This initiative would remove statutory barriers to the sharing of business data among the Bureau of the Census, the Bureau of Economic Analysis, and the Bureau of Labor Statistics. In addition, it would strengthen the safeguards that protect the confidentiality of the public's statistical information through a clear and consistent set of minimum statutory safeguards and stiff penalties for violators. Enhanced data sharing would improve the reliability and accuracy of key business statistics such as GDP, employment, productivity, and industrial production and would permit the statistical agencies to resolve existing and growing data

anomalies that raise questions about the accuracy of economic statistics. For example, GDP has experienced an historically high measurement error approaching $200 billion. At the same time, nearly 30 percent of single-establishment businesses had inconsistent four-digit standardized industry classification codes in the separate business lists maintained at the Census Bureau and at the Bureau of Labor Statistics. This seemingly minor classification issue brings into question the ability to track accurately industry output, employment, and productivity trends.

Improving the quality of these data is central to maintaining the foundation for our understanding of the economy and economic policies. The President looks forward to working with Congress so that the American people can benefit from higher-quality economic statistics for public and private decisionmaking.

Enhancing Economic Growth

Focusing on the "real economy" my reading of the basic mechanics of recovery and the data thus far indicate a recovery that is roughly on track, with the possible exception of business investment. Of course, it is subject to the standard economic uncertainty regarding fundamentals. However, as you are doubtless aware, there are many news reports focusing on an uncertain state of economic recovery. To some degree this is surprising in light of my reading of the fundamentals of the economic recovery. Although there are always questions about "when" a particular phase of recovery will transpire, or how strongly a particular component of aggregate purchases may grow, the uncertainty evinced in the public discourse is seemingly far deeper.

To the extent that additional uncertainty stems from the outlook for economic policies that support growth, it is unfortunate. Two of the key lessons of the past two decades at home and abroad is the centrality of private firms and markets in generating superior economic performance through their ability to drive innovation and growth, and the importance of maintaining vigilance against impaired market incentives.

The deregulation of our economy beginning in the 1970s and 1980s was and is a tremendous source of economic flexibility and success in generating resources for our economy. Deregulation of several key sectors of our economy brought substantial benefits to consumers

and workers. One study estimates the combined economic benefit of deregulating airlines, motor carriers, and railroads to be about 0.5 percent of GDP per year.

Deregulation, reductions in marginal tax rates, and victory in the Cold War fueled a long boom in the United States that was interrupted only briefly during the early 1990s. The post-1995 boom in productivity growth in the United States stands out from other industrial economies. Productivity growth does not arrive from the heavens, and businesses around the world can all buy the same technology – the U.S. advantage must be elsewhere. New technologies, process innovations, and other aspects of entrepreneurial, private-sector productivity gains are the result of investment and risk-taking.

Despite the economy's success during the long boom, during the 1990s, a new orthodoxy took root in Washington. While ostensibly adherent to market principles, this view placed the government at the center of good economic performance. A recent manifestation of this orientation has been the focus on accumulating government budget surpluses as the key. Despite essentially no evidence that surpluses are related to long-term interest rates, proponents of this view argue that increasing the budget surplus is the key to faster growth through its effects on long-term interest rates. In reality, these concepts are linked. However, the prevailing orthodoxy has the tail wagging the dog – a stronger economy produces higher revenue and larger surpluses, not the other way around.

It is remarkable that some suggest that growth-oriented tax policy might be making matters worse, and some urge its repeal. Economic growth is a direct consequence of millions of individual decisions to produce, save, invest, innovate, create, and bear risks. Any added tax burden today would be a step in the wrong direction. Entrepreneurs are at the heart of this equation. Recent research shows that cutting marginal tax rates allows entrepreneurial businesses to grow faster, invest more, and hire faster.

Marginal rate reductions also improve access to capital and the vitality of the entrepreneurial sector. These impacts are not confined to the income tax. The estate tax acts as a brake on entrepreneurial activity. While entrepreneurs constitute a minority of people, they are

three times more likely to be subject to the estate tax, making the tax a drag on asset accumulation and risk-taking in the economy.

Thus one source of uncertainty facing the economy is the specter of failing to make the tax cut permanent, and facing the diminished growth opportunities that would follow. Of course, it is not just an issue of the level of taxes. It is the potential loss of a pro-growth tax policy. Princeton University economist Harvey Rosen has estimated that the marginal tax rate reductions passed in 2001 will lower the efficiency cost – the "deadweight loss" or pure drag on the economy – by roughly $40 billion in 2010. To put this figure in perspective, note that it is about the same size as last year's tax rebate of $36 billion – and it would happen every year. A manifestation of returning to a less efficient tax system is reduced growth. Professor Rosen's results suggest that doing a U-turn on taxes would reduce growth by 0.15 percent annually. The basic message is straightforward: Placing the future of pro-growth tax policy at risk raises the level of uncertainty and mitigates against rapid recovery and growth.

Another perspective on the threat to pro-growth tax policies comes from examining the recent, rapid growth in Federal spending. Over the long term, increased growth in Federal spending will necessarily be financed by higher levels of taxation. Thus one threat to lower tax rates and rapid retirement of Federal debt is an absence of fiscal discipline. Moreover, to the extent that debt service burdens and retirement are ultimately linked to tax revenues, the failure to control the growth of Federal spending places upward pressure on distortionary taxes.

A second feature of the new orthodoxy revolves around an economy of guarantees. Even when pursing one of the fundamental policies central to better growth – expanding global free markets – proponents of this view demand "guarantees" to insulate the economy from the very source of its dynamics and growth. The recent debate over an ever-widening Trade Adjustment Assistance Program and its threat to Trade Promotion Authority is a second troubling source of uncertainty over the outlook for growth.

In short, the clash between policies to provide an environment for faster sustained growth and the new orthodoxy has given rise to uncertainty over the future course of policy. Sadly, this

clash translates immediately into reduced incentives for growth. In each case, simple action by the Senate – passing TPA or making the tax cut permanent – would remove the lingering uncertainty and raise incentives for growth.

At some level, however, it is "normal" for the private sector to face conflicting messages on economic policy. However, there are special features raising uncertainty as well. Terrorism has raised the need to harden the economy against the risk of terrorist events. In the aftermath of the events of September 11, the President immediately began a campaign to strike at terrorism's roots, and to secure the United States against the risk of terrorist events. These efforts have beneficial economic effects, raising consumer confidence and reducing the need for private-sector security expenditures.

An important part of the President's response was a proposal to provide a catastrophic backstop for terrorism risk insurance. The terrorist attacks indicated that the probability of catastrophic property and casualty losses was higher than anticipated. This situation called for a new policy to encourage private market incentives so that insurers would expand their capacity to absorb and diversify risk—an approach that the Administration proposed.

A part of the debate over terrorism risk insurance has been proposals for litigation procedures for mass tort terrorism cases. Another possible source of uncertainty hanging over the growth outlook is the tort system as a whole. While business concerns over the impacts of frivolous lawsuits are not new, it may be the case that the events of September 11 have produced heightened awareness of the potential for a substantial "tort tax" in the future, impeding growth.

The final "new" element of uncertainty in the economic environment is the increased concern over corporate governance that has emerged in the aftermath of accounting failures and related events. The corporate governance question has raised concerns over investor protection and has impeded the efficient functioning of capital markets. A key underpinning of productivity growth is the flexibility with which capital is allocated in the United States. This efficacy is made possible by timely and accurate judgments in the marketplace, which in turn

reflect timely and accurate information in a complex web of relationships among corporate leaders, boards, auditors, analysts, institutional investors, and ultimately investors.

The President recognizes that the quality of our economic performance would be enhanced by prompt improvements in corporate disclosure, greater accountability of corporate leaders, and the strengthening of audit systems. On March 7, he announced a ten-point plan to strengthen the quality of the information underlying investment decisions. The President's plan focused on the key issues of financial transparency and corporate accountability. It began with proposals to improve the timeliness and quantity of crucial information disseminated to investors, turned to incentives for CEOs to provide high-quality information, and then addressed steps to strengthen the auditing function. This approach focused attention on the underlying sources of information shortcomings in financial accounting, and rapid implementation of its recommendations will serve to reduce the uncertainty stemming from issues of corporate governance.

In the weeks following the President's diagnosis, the Securities and Exchange Commission has initiated rulemakings regarding the content of quarterly informational reports and ensured that CEOs and other officers will not profit from financial misstatements. It has initiated a rulemaking to ensure that corporate leaders provide prompt disclosure of trades in their companies' stock.

The SEC efforts continued by requiring CEOs and CFOs to certify the contents of the company's quarterly and annual reports, meeting the President's directive that corporate leaders should personally vouch for the veracity, timeliness, and fairness of their companies' public disclosures, including financial statements. In addition, the SEC proposed amendments to disclosure rules – Form 8-K rules to be precise – regarding extraordinary corporate events. The proposals would add eleven new disclosure items, move two items from annual and quarterly reports to Form 8-K, shorten the Form 8-K filing deadline to two business days, and make other changes.

More recently, the President called for a new ethic of responsibility in America's corporate community. He signed an Executive Order creating a Corporate Fraud Task Force to provide direction for investigations and prosecutions of criminal activity, requested the funds necessary to beef up SEC enforcement, and proposed toughening criminal sanctions for corporate financial fraud. The Administration looks forward to working with Congress on these important issues.

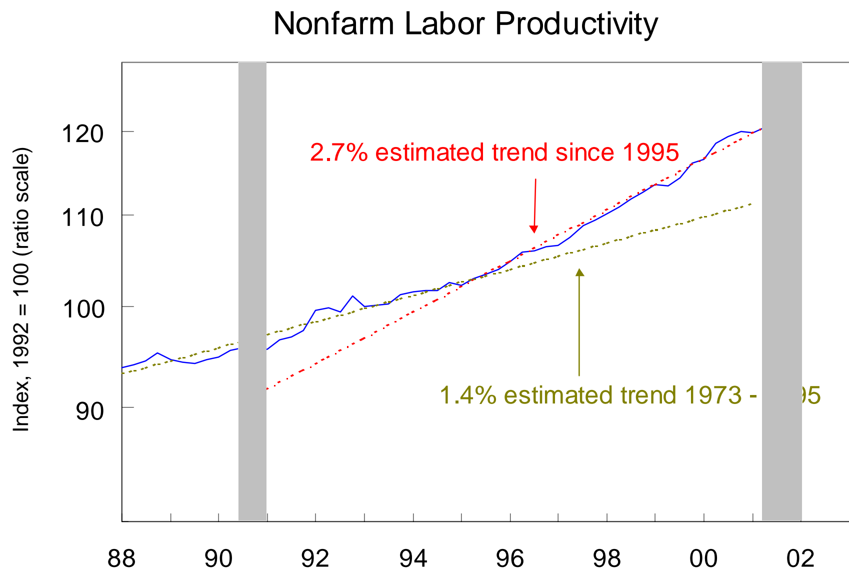
The private sector has also been active. As noted by Federal Reserve Board Chairman Alan Greenspan, "Corporate governance has doubtless already measurably improved as a result of this greater market discipline in the wake of recent events." One piece of evidence in this regard is the recent corporate governance rule changes announced by the NASDAQ. Likewise, a committee of the New York Stock Exchange has emphasized the need for reforms of corporate governance.

Given the inherent informational advantage of corporate insiders over outside investors, private sector and regulatory reform will hopefully lead to progress, in the spirit of the President's plan, in improving transparency and accountability. As an example, in their proposals on corporate governance reform, both the NASDAQ and the NYSE include provisions to ensure that shareholders approve all stock options plans. While the final resolution remains a matter of study and debate, initiatives of this type aim to improve the accountability within our existing system. This could be paired with matching provisions to improve transparency.

Regardless of the specifics, there will be an advantage to a rapid resolution of the future path of corporate governance reforms. The SEC has done an excellent job of turning the President's ten-point plan into better disclosure. The rulemaking process includes necessary deliberation and time for public comment. Nevertheless, the actions to date represent a swift response to the revelation of the need to enhance the information available to investors.

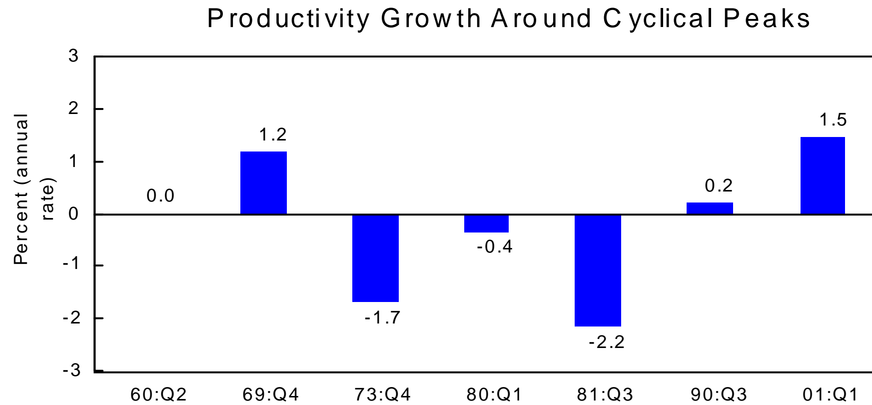
Innovation and Long-Term Productivity Growth

Thus far, I have focused primarily on the near-term recovery and the degree to which uncertainty has impeded the pace of acceleration. Before finishing, let me turn to an area without any uncertainty: Over the long term, the increase in the United States' standard of living is determined by productivity growth. Put differently, the underlying rate of productivity growth is the single most important indicator of long-term economic success, international competitiveness, and our ability to meet myriad future demands in both the private and public sectors. As is by now widely recognized, the United States experienced an acceleration of productivity in the years following 1995.



Source: CEA calculations.

The economic downturn has raised the specter of less robust productivity growth. Thus, the strength of productivity growth on the recent business cycle turning point is important evidence in support of the idea that U.S. structural productivity growth rate remains robust.



Source: CEA calculations

Productivity growth depends heavily on the policy environment for innovation. The United States must foster incentives to ensure continued growth in innovation and new technologies. We must invest in basic research, ensure that the intellectual property of innovators is secure at home and abroad, as well as invest in the skills and abilities of all our people. In part to support the private sector in these areas, the President signed into law an economic security package that will accelerate investment. Deploying advanced technologies can be capital intensive. Faster capital cost recovery is both good tax policy and makes companies more likely to make important investments.

The Administration has a commitment to promote basic research and development. The President signed into law the largest federal R&D budget in history and proposed broadening and making permanent the Research and Experimentation Tax Credit. The Administration has proposed broadening access to the research and experimentation tax credit to make it easier for companies to deduct many costs associated with developing new technologies and drugs.

Conclusion

Mr. Chairman, I am delighted to have had the opportunity to discuss the pace of the economic recovery and the long-term economic outlook. I look forward to our discussion and would be happy to answer your questions.