The Economic Outlook
Testimony before the Joint Economic Committee
By Council of Economic Advisers Chairman Kevin Hassett
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Chairman Tiberi, Ranking Member Heinrich, Vice Chairman Lee, and Members of the Committee, thank you for inviting me to discuss the state of the economy with you today. In the testimony that follows, I will provide an overview and discuss the status of a number of sectors. I will emphasize some areas that need attention, as well as recommend policy changes that will improve our citizens' economic well-being.

Overview: the economy, which is buoyed by heightened expectations, is now growing at a solid and sustainable pace with low unemployment and low inflation. Financial markets appear to recognize the likelihood of continued growth with low inflation, with the major stock price indexes up substantially over the past year, and with expected inflation (from the market for Treasury's inflation-protected securities) remaining low.

That said, the Trump Administration is not satisfied with business as usual nor with the pace of real output and income growth during the past several years. As a result, we have put forward a program designed to boost the rate of real GDP growth. That program includes tax cuts designed to boost the rate of investment, raise productivity, and boost real wages. The Administration also plans to improve the regulatory landscape, and thereby to keep the flow of new regulations from further reducing the pace of economic growth. We recently put out a report that looked specifically at the burden of regulation on our economy, and there is no doubt that overly burdensome regulation hurts GDP growth.

I am happy to report that the economy is doing well so far in 2017. Real GDP growth during the first two quarters of the year averaged 2.1 percent at an annual rate, and the range currently being estimated for third-quarter growth (2-to-3½ percent) despite the negative effects of Hurricanes Harvey and Irma. As a result, some snap-back can be expected in the fourth quarter, especially in the petroleum-producing sectors whose Texas operations were shut down by Hurricane Harvey. Since January, the unemployment rate fell 0.6 percentage points to 4.2 percent in September, the lowest rate since 2001, and overall growth is poised to average about 3 percent over the second half of the year.

Financial Markets: Since the election, stock market values have climbed steeply, with a value of large companies in the Standard and Poor's 500 index increasing [20] percent and the values of the small companies in the Russell 2000 climbing even more, [26] percent. The joint Administration-Congressional tax proposal, the "Unified Framework for Fixing our Broken Tax

Code," likely boosted the overall stock market, which has priced in an increased chance of a major tax cut. Also, the President's program to stabilize the regulatory environment may be partly responsible for the relatively strong performance of small company stocks because regulation is an approximately fixed cost and is therefore more of an impediment for small firms than for large firms. The rise in the stock market—together with the increase in home prices—has generally positive implications for the rest of the economy, such as its role in supporting consumer spending.

Real consumer spending grew 2.6 percent at an annual rate during the first two quarters of 2017, only slightly below the 2.9 percent rate of growth during the preceding two years. Consumer spending has outpaced disposable income growth during the past four quarters (1.2 percent). As a result the saving rate fell to 3.8 percent in the second quarter from a 2016 average of 4.9 percent. High levels of consumer sentiment and the recent gains in housing values and stock-market wealth have supported growth in consumer spending and the accompanying decline in the saving rate.

Business investment grew at a 7 percent annual rate during the first half of 2017, a notable acceleration from an essentially flat pace during the preceding two years. The acceleration was in the equipment and structures components while the intellectual property component continued to grow at a healthy (5 percent annual) rate. Looking back over the whole of this past business-cycle, business investment fell more during 2008-09 than during any previous recession, but then recovered in line with a normal recovery—at least through about 2014. During the past two years (2015-16), however, it plateaued. Because of the deep dive during the recession, however, the level of investment did not rebound to the level of the previous (2007) peak until four years into the recovery.

After translating this pattern of investment into the flow of capital services, it is apparent that capital deepening—the flow of capital services per hour worked—has made essentially no contribution to the growth of labor productivity in contrast to a post-WWII average of 0.8 percentage point per year. As I will discuss in a moment, this Administration thinks that tax policy could play a role in reviving the contribution of capital services to labor productivity growth, and through that channel to the growth of real wages.

Real residential investment grew at a slow (1.5 percent) annual rate in the first half of 2017. Growth was also slow during the four quarters of 2016, after five years of rapid growth. We have reason to expect somewhat faster growth during the next year in view of tight housing-market conditions, rising home prices, and a shortage of existing homes for sale. Building permits have exceeded housing starts for the past [7] months and the level of permits authorized but not yet started is near its business-cycle high, suggesting solid near-term prospects for an increase in housing starts.

Consistent with tight supply, nominal national home prices increased 6.3 percent during the 12-months ended in July (according to the FHFA Purchase-Only Index). Nominal national home prices were 10 percent above their 2007 peak. However, after adjusting for inflation with the

Consumer Price Index, real home prices in July were still 8 percent below their peak. The changes in home prices varied considerably across states. Over the four quarters that ended in 2017:Q2, home prices rose in 48 states and the District of Columbia. West Virginia experienced the largest decrease (-1.2 percent), while Washington State experienced the largest increase (12.4 percent). A consensus of housing-price experts expects that home prices will continue to increase, albeit at a moderating rate over time. The median forecast from Zillow's survey of house price experts is for home prices to increase 5.0 percent in 2017 and 4.0 percent in 2018.

The low-and-steady rate of core inflation is notable. Core CPI inflation (that is, excluding food and energy prices) was only 1.7 percent for the 12 months through September, down from 2.2 percent during the year-earlier period. Low prices on goods imported from our trading partners have been one force holding down domestic inflation. The low and roughly-stable rate of core inflation suggests that the U.S. economy has not yet bumped up against a capacity constraint and that it still has room to grow.

Looking back at the past few years, it appears that real potential GDP appears to be growing at about only a 2 percent annual rate, or perhaps less. After all, the unemployment rate has fallen 0.5 percentage points per year during the past two second-quarter to second-quarter intervals with only 1.7 percent per year real GDP growth. Looking back at this recent history, I can understand why the Congressional Budget Office projects growth of potential GDP of 1.8 percent during the next 10 years in their current-law forecast, although I am not endorsing that CBO forecast. If economic policy can do anything to elevate this growth rate, it should…because of the importance of potential growth for the soundness of our Budget and the welfare of our nation. This recent disappointing growth is the key motivation behind this Administration's growth agenda.

Real wage growth in America has stagnated. Over the past eight years, the real median household income in the United States rose by an average of six-tenths of a percent per year. But even as Americans' real wages stagnated, real corporate profits soared, increasing by an average of 11 percent per year. The relationship between corporate profits and worker compensation broke down in the late 1980s. Prior to 1990, labor compensation rose by more than 1 percent for every 1 percent increase in corporate profits. From 1990-2016, the pass-through from corporate profits to labor compensation was only 0.6 percent, and looking most recently, from 2008-2016, only 0.3 percent.[1] The profits of U.S. multinationals are still American profits, but, increasingly, the benefits of those profits do not accrue to U.S. workers.

The deteriorating relationship between the wages of American workers and U.S. corporate profits reflects the state of international tax competition. Countries around the world have responded to the international outflow of capital by cutting their corporate tax rates to attract

[1] Results from a regression of total labor compensation in the U.S. on corporate profits from BEA data covering 1966-2016. A Wald test supremum trend break occurs in Q4 1989.

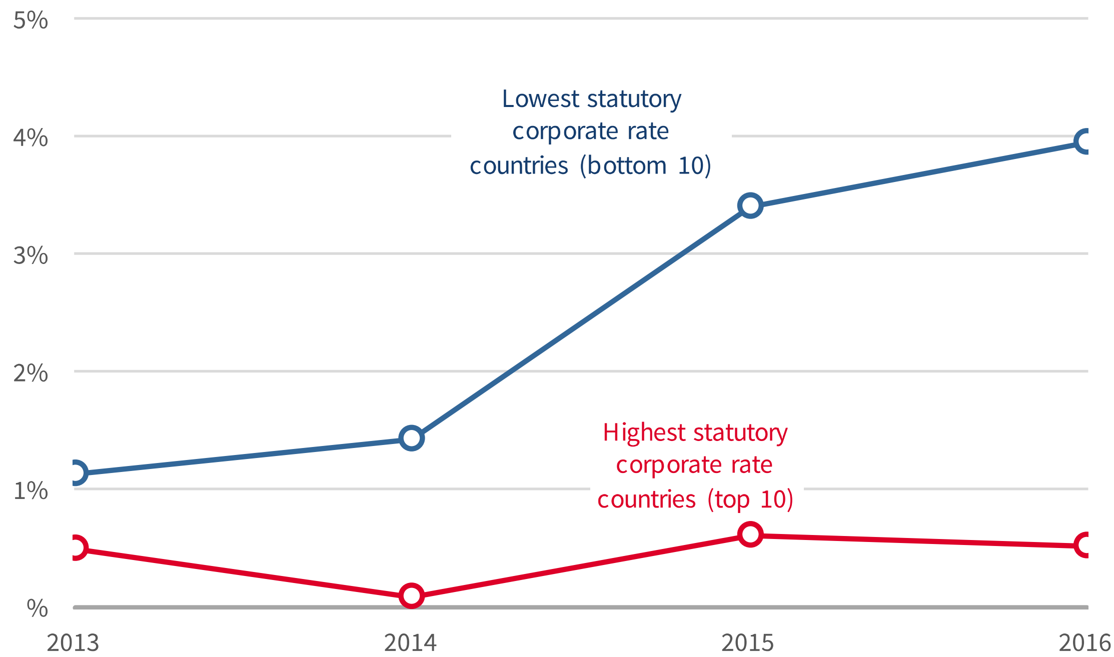
capital back. They have doubled down on such policies as they have seen business-friendly policies benefit workers.

A key feature of the joint proposal for taxes of this Administration together with Congressional leadership is the proposed reduction of the statutory federal corporate tax rate from 35 to 20 percent. An analysis by the Council of Economic Advisers suggests that this tax-rate-cut would increase the level of average household income (relative to a no-tax cut baseline) in the United States by, conservatively, $4,000 annually after the effects have taken hold.

It may sound counter-intuitive to some that a cut in the tax on profits might boost wages, but the chain of causality is straightforward. Real wages reflect output per hour (labor productivity) of American workers. The productivity of workers in an economy depends, in part, on tools and machinery in the hands of the workers. The services of these tools, known technically as the flow of capital services—in the right hands—enables production. Even in an economy without international capital flows, reductions in the corporate tax rates and the associated capital deepening may imply a higher marginal product of labor and higher wages. The issue becomes more dramatic when the international dimensions are considered. The ability of domestic U.S. firms to invest foreign profits overseas magnifies the implications of corporate tax policy for domestic workers because an uncompetitive domestic corporate tax rate reduces the demand for U.S. workers by encouraging capital formation abroad. Indeed, when viewed in this way, the incidence of the corporate tax could theoretically fall entirely on U.S. workers, so long as workers are immobile and capital moves freely across borders. And wage changes of the scale we have modeled happen in just a few years simply if capital deepening returns to normal.

This conclusion—that the incidence of the corporate tax—falls partly but importantly on workers is driven by empirical patterns that are highly visible, in addition to extensive peer-reviewed research, not to mention a number of follow-up studies to ours that have appeared during the past 10 days or so. For example, the covariation between real wage growth and statutory corporate tax rates between the most-taxed and least-taxed developed countries (OECD) over recent years, visible in Figure 1 (attached), is indicative of this larger literature. Between 2012 and 2016, the 10 lowest corporate tax countries of the OECD had corporate tax rates 13.9 percentage points lower than the 10 highest corporate tax countries, about the same scale as the reduction currently under consideration in the United States. The average real wage growth in the low tax countries has been dramatically higher, as would have been predicted by a consumer of the recent academic literature, which looks at much longer time periods and explores the relationship with modern econometric techniques.

Figure 1. Wage Growth in Developed Countries: Lowest vs. Highest Corporate Tax Countries
(Year-over-year change)



The U.S. economy has made great progress during the past years in reducing the jobless rate, but the rate of productivity growth and therefore real wage growth has been slow. It is time to turn our attention to building a plan for boosting the rate of growth in the long-run. As I have discussed, the Administration's plan for tax reform will have an important role in improving the rate of productivity growth, in combination with its plan to stabilize the regulatory environment, and we look forward to working with you to reach these goals.

I will be happy to respond to any questions the committee may have. Thank you.