The 2018 Economic Report of the President
Testimony before the Joint Economic Committee
By the Council of Economic Advisers Chairman Kevin Hassett
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Chairman Paulsen, Ranking Member Heinrich, Vice Chairman Lee, and Members of the committee, thank you for inviting me to discuss the 2018 *Economic Report of the President* with you today. In the testimony that follows, I will discuss the contents of the *Report*, and I will highlight some of the observations that I believe should be of greatest interest to policymakers.

As I am sure you know, President Harry S. Truman transmitted the first *Economic Report of the President* in 1947, fulfilling the mandate of the newly enacted Employment Act of 1946. The Employment Act created both the Council of Economic Advisers and the Joint Economic Committee along with the mandate for an annual report. All were codified into law in response to the particular economic concerns of Truman's era: employment, the standard of living, the postwar transformation, and so on. Similarly, *Reports* prepared in landmark years by Presidents Ronald Reagan and John F. Kennedy each distinguish themselves today as a vision and roadmap for navigating the economic problems that defined those eras—they are, unmistakably, documents of and for their time. We hope that our 2018 report is as well.

The *Report* is intended to help policymakers make sense of our precise moment in history. To fulfill its purpose, it must be responsive to its era. To this end, our *Report* focuses on explaining our present economic conditions by analyzing the recent history of policies and circumstances that have affected them; we identify areas of vulnerability that are or will become pressing areas of concern; and we assess a variety of policy options.

In brief, our *Report* outlines the economics of an agenda intended chiefly to improve growth and end the so-called "secular stagnation" of low growth that has plagued our nation since the Great Recession. This Administration has worked to boost growth by cutting taxes and reforming the tax code and by eliminating unnecessary regulations, thereby encouraging higher wages. This Administration also stands poised to modernize infrastructure, address healthcare issues, and fight malicious cyberattacks.

Growth in 2017 exceeded expectations, and we remain optimistic that growth will continue to surprise to the upside even as data may have some noise in the short-run. Plenty of work remains to be done to get economic growth up to the rate that this Administration believes the American people deserve, and the 2018 *Report* contains a great deal of analysis on that topic. Growth in the economy can be a somewhat abstract concept, with discussions of tenths of a point converting to billions of dollars. Thus, in the abstract, it often has little meaning to average Americans. But fundamentally, greater economic growth enables Americans to find and pursue greater opportunities.

Because growth strengthens our nation through prosperity and opportunity, we are focused on creating and implementing policies that history suggests can lead to 3 percent growth each year.

The United States has done it before and we aspire to do it again. In the 2018 *Economic Report of the President*, we write transparently about the policies that can help achieve this goal.

The *Report* is comprised of the following chapters: Taxes and Growth, Deregulation that Frees the Economy, Labor Market Policies to Help the Middle Class, Infrastructure to Boost Productivity and Growth, Enhancing U.S. trade in a Global Economy, Innovative Policies to Improve All Americans' Health, and Fighting Cybersecurity Threats to the Growing Economy. It then closes with The Year in Review and the Years Ahead. I will provide a brief synopsis of each chapter and then I look forward to your questions.

Taxes

The 2018 Report begins by examining recent changes to United States tax policy and how this will benefit the economy.

For years, other developed countries have been attracting business from outside their shores, and enjoying higher wages by lowering their tax rates to levels below our own. As Chapter 1 of the 2018 Report shows, since the year 2000, the OECD average tax rate trended downward while the rate in the United States remained the same as it had been. Given this reality, we simply couldn't compete—our corporate taxes were the highest among the community of economically developed nations, and this incentivized our companies to move jobs and factories to lower-taxed countries. For a long time, lowering the corporate rate was seen by both parties as something that needed to be done. The Tax Cuts and Jobs Act (TCJA) has definitively made America more competitive.

Our analysis in the *Report* of taxes and growth includes the modelling done previously by our staff to identify the effect of the corporate component of the TCJA on American economic growth and wages, finding that a household could get a $4,000 wage increase from the new law once the law's full effects get absorbed by the macro economy in their entirety. While this is detailed in the 2018 *Report*, CEA generated its $4,000 estimate in a paper released in October 2017.[1]

We include a new estimate of the effect of the TCJA's changes to the individual tax code on growth, which we had waited to model until we knew the parameters: the changes could increase GDP by 1.3 to 1.6 percent after 10 years, according to the analysis presented in Chapter 1 of the Report. This will increase spending power for families. If the tax cuts are made permanent, the Report's analysis shows, the boost to GDP will add another $4.7 trillion to $7.4 trillion to the economy in the next decade. As Chapter 1 shows, the TCJA has already delivered benefits to America's workers and businesses. Almost 4.6 million workers received raises, bonuses, or improved benefits as of last week, by our calculations. Companies have already announced investments of over $190 billion, investments likely to increase growth and wages.

I would also add that that a variety of misconceptions have been stubbornly perpetuated by opponents of the tax bill. One misconception that has been the focus of recent debate is that share buybacks attributable to the TCJA undermine the claim that the majority of the TCJA's corporate tax reforms benefits will accrue to workers. The buybacks are happening because monies that were

[1] "Corporate Tax Reform and Wages: Theory and Evidence," White House Council of Economic Advisers, October 2017. https://www.whitehouse.gov/sites/whitehouse.gov/files/documents/Tax%20Reform%20and%20Wages.pdf

previously offshore are being sent back to work here in the U.S. This is a one-time adjustment of the stock of trillions of dollars of "old profits" that were locked in foreign subsidiaries by our misguided former tax law. One would expect firms to invest this money back home in capital and even bank accounts, use it for wage increases, and use it for dividends and buybacks. No economist would make the case that the American economy would be better off if these monies were still locked offshore, which makes this line of criticism spurious. Share buybacks today are not mutually exclusive to long-run wage gains that accompany American capital formation that will accumulate this year and in the future.

Deregulation

Tackling both tax reform and regulatory reform was central to the Administration's economic agenda in the first year. Just as a backward tax code harms economic growth, overregulation drags down the economy. Chapter 2 of the Report documents the ways in which regulations stifle productivity and prevent the creation of new businesses. Regulations also give older, more established businesses an unfair advantage against upstart competitors and may be one of the reasons business dynamism has suffered a decline since the recession. The year 2009 marked the first time that more firms died than were born in the United States since the Census Bureau began compiling its Business Dynamics Statistics in 1978.[2] Recent research shows that fewer younger Americans are becoming entrepreneurs, an ominous development.[3] The previous Administration's tendency to regulate the economy excessively likely slowed overall growth for a number of reasons documented widely in the economic literature on the subject. In this chapter, we review the explanations that emerge from the literature. As the Trump Administration has reversed this trend in regulation, the depressed growth rate has turned itself around, too.

Of course, not all regulations are bad, and the type of changes envisioned by this administration will not threaten the environment or worker safety. To put our overregulation into perspective, CEA finds that if the U.S. regulatory environment were such that the U.S. had the same OECD Product Market Regulation value as Germany, we would increase annual growth by 0.1 percent per year. If we deregulate further, to the level of the Netherlands according to the OECD Product Market Regulation index, we could get growth at twice that rate: 0.2 percent per year. In spite of what you may think about European countries having a heavier regulatory hand, many in fact recognize, as this administration does, that the key to a healthy economy is to let the private sector create jobs with less red tape.

The Middle Class

One of the most definitive problems of our era is the stagnation of America's middle-class. The third chapter in the *Report* lays this out in detail.

[2] Hathaway, Ian and Robert E. Litan. "Declining Business Dynamism in the United States: A Look at States and Metros." 2014. Brookings Institution. https://www.brookings.edu/wp-content/uploads/2016/06/declining_business_dynamism_hathaway_litan.pdf
[3] Economic Innovation Group. "Millennials & Entrepreneurship." 2016. http://eig.org/wp-content/uploads/2016/09/Millennials-Entrepreneurship.pdf

Government policy under the previous Administration bears some responsibility, but not all of it. The labor income of the typical household at the middle of the income distribution is still below what it was at the start of the 21st century, and one explanation for this historical slowdown, the Report's analysis shows, is that the Obama Administration's tax and transfer policies worsened the wound through their effect on the labor market. Based on CEA estimations using Census Bureau data, the median American's inflation-adjusted household income from working took 9 years to recover to its pre-recession level after the Great Recession – the longest this type of recovery has taken since at least 1979.

Although these tax and transfer policies softened the blow of the recession by partially making up for lost income, they also had the unfortunate effect of decreasing the incentive to work, contributing to the historic decline in Americans participating in the workforce and the continued stagnation of wages. In the end, these policies hampered the economic success of the very middle-class households they were intended to help.

Although much has been written about the retirement of the Baby Boomers as one of the main causes of the reduction in labor force participation, that explanation is only one piece of the puzzle. Demography is not destiny when it comes to economic growth, and the *Report* explains why the Administration believes that reducing work disincentives and rising wages, which we are finally starting to see, will bring people off the sidelines. A combination of policies and economic conditions that return the prime-age participation rate to the level in 2007 (still well below the rate apparent in 2000) would return about 1.7 million U.S. workers to the labor force over 10 years and raise the overall participation rate by 0.065 percentage point per year, resulting in a 0.1-percentage-point increase per year in the rate of GDP growth over the next 10 years, according to CEA's estimates.

Related to workforce participation, I would like to add a note about the President's immigration policies, which focus on a merit- or skills-based approach. There has been a discussion about immigration being a headcount exercise. But the economics of human capital tells us that bringing in immigrants who are highly productive and skilled as opposed to those who simply arrive through a family relation and who may have low or no skills shows why a headcount is not the way to think about the impact of immigration on growth. For instance, a predecessor of mine at the Council of Economic Advisers, Edward P. Lazear, has written about the importance of understanding the relationship between the education levels of prospective immigrants and the economic effects their admission could rationally be expected to have.[4] It does not simply boil down to the number of people who arrive on our shores.

Infrastructure

Investing in infrastructure via the stimulus and its shovel-ready projects was expected to be a major factor in our recovery to the Great Recession, but – as Chapter 4 of the *Report* shows –this type of investment ended up as only a fraction of what was promised, with only 3.5 percent of the over-$800 billion plan going to highway transportation infrastructure. Improving infrastructure should have wide bipartisan agreement, and polls show it is highly popular among the American

[4] Lazear, Edward. "Why Are Some Immigrant Groups More Successful Than Others?" October 2017. NBER Working Paper No. 23458. http://www.nber.org/papers/w23548

people, with 84 percent in support and 76 percent believing it should be funded as the president has suggested: a combination of public funds, bonds, and public-private partnerships. As the *Report* notes, sources indicate that in 2014 total congestion costs peaked at $160 billion, wasting 6.9 billion hours in delays and 3.1 billion gallons of fuel.

Bureaucracy has built up over decades, creating years-long obstruction on many projects. The President's infrastructure plan focuses on streamlining the permitting process and eliminating red tape that has stymied infrastructure projects from being efficiently developed and managed to enable projects to get off the ground faster. The plan also calls for a $1.5 trillion investment in infrastructure, which we find could add 0.1 to 0.2 percentage points to economic growth over the next decade, saving Americans precious time by alleviating traffic congestion and enabling them to connect to opportunities that create more prosperity.

Our report lays out additional steps such as enacting targeted user fees, facilitating public-private partnerships, and ensuring that infrastructure funding goes towards the most-valuable infrastructure projects.

Trade

Another defining problem of our era is the need to improve trade deals that are nonreciprocal and asymmetric. CEA, in Chapter 4 of the *Report*, documents that American firms face higher barriers to selling their products abroad and fewer barriers to selling their own products here in the United States than their peer firms in the group of high-income G20 countries. This holds true when looking at tariffs or non-tariff barriers, which have grown in importance as tariff rates have trended down.

CEA also notes that in recent decades, trade has left some American communities worse off. When you look at the data, it is not hard to see why this Administration is seeking to improve America's position with respect to international trade. Additionally, the global trade system has come under strain due to the influence of countries, such as China, that violate market principles and distort the functioning of global markets. When America's businesses and workers can compete in the global economy on a level playing field, our underlying dynamism will allow our economy to flourish. A priority of the Administration is to create the conditions that would maximize the free trade benefits accruing to the United States—and produce gains for our trading partners as well.

Health

To continue our assessment of economic issues that define our era, we turn in Chapter 6 to examining the status of Americans' health and the options available to them to live longer, healthier lives.

The Administration is focused on policies that would improve healthcare outcomes and lower healthcare costs for all Americans. CEA's analysis calls attention to several factors that affect health and healthcare costs, such as smoking, obesity, and opioid abuse, which have contributed to the decline of American life expectancy for the second year in a row.[5]

CEA highlights how competition and choice could improve health insurance as well as lower American drug prices—without undermining American pharmaceutical innovation. Our government can also pursue policies that lead to other countries paying their fair share for innovations. CEA estimates that, among members of the OECD, Americans pay more than 70 percent of patented biopharmaceutical profits that fund drug innovation.

Cyber

Another definitive problem of our time, and one poised only to grow in importance over time, is the issue of cybercrime and its impact on our economy.

CEA finds that malicious cyber actors inflicted over $100 billion of damage on our economy in 2016, on top of the threat this poses to our national security. The economic risks of cyber vulnerabilities have grown as information technology has increased in its importance to the U.S. economy. CEA finds evidence suggesting that there is a market failure that leads private firms, many of which face risks correlated with one another, to invest less in cybersecurity than would be economically optimal. Cybersecurity matters for the economy now more than ever. The Administration is advocating for better cooperation between the public and private sectors, which is vital to managing these risks going forward.

Outlook

We conclude our 2018 *Report* by examining the year in review and offering our projections for the years ahead.

CEA documents that the U.S. economy experienced a strong and notable acceleration in 2017, with growth in real gross domestic product exceeding expectations and increasing to 2.5 percent, up from 1.8 percent during the four quarters of 2016, and the unemployment rate falling 0.6 percentage point to 4.1 percent, the lowest since 2000. Economic growth is important because it allows Americans more spending power, more take-home pay and a better quality of life. The Administration's baseline forecast for the longer term is for output to grow by an overall average annual rate of 2.2 percent through 2028, excluding the effects of the December 2017 Tax Cuts and Jobs Act. The policy-inclusive forecast, which assumes implementation of the Administration's agenda —tax reform, deregulation, infrastructure and addressing disincentives to work—is for real GDP to grow by 3.0 percent a year, on average, through 2028.

The current Administration's long-run, policy-inclusive forecast is conservative relative to previous administrations, and is in fact slightly below their median of 3.1 percent. The baseline forecast is exactly in line with the long-run outlook given in the Obama administration's last *Economic Report of the President* (2017), reflecting our view that not implementing the Administration's policy

[5] "Mortality in the United States, 2016." December 2017. National Center for Health Statistics Data Brief No. 293, Center for Disease Control." https://www.cdc.gov/nchs/data/databriefs/db293.pdf

objectives would simply result in a reversion to the lower growth expectations of the Obama years. In this chapter, we seek to provide greater transparency about our methods for forecasting growth than many have in the past. We feel this is important knowledge to provide to policymakers, and we hope it will inspire a trend of greater transparency in the future.

I hope that you find this *Report* to be a document that identifies and responds to the most pressing economic issues of our time, just as was intended when CEA was given this charge during Harry Truman's presidency. I appreciate your time today, and I look forward to taking your questions.

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