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# THE ECONOMIC OUTLOOK

## HEARING

before the

## JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

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# THE ECONOMIC OUTLOOK

**Wednesday, November 28, 2001**

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
*WASHINGTON, D.C.*

The Committee met, pursuant to notice, at 10:00 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

**Present:** Representatives Saxton, Ryan, Smith, Dunn, Putnam, and Maloney. Senators Bennett, Reed, Sarbanes, and Corzine.

**Staff Present:** Chris Frenze, Bob Keleher, Darryl Evans, Colleen J. Healy, Brian Higginbotham, Patricia Ruggles, Matthew Salomon, Daphne Clones-Federing, and Diane Rogers.

## OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

**Representative Saxton.**. We are going to begin right on time despite the fact that not all our Members are here yet. Let me just say at the outset that the House will have a series of votes at 10 o'clock, which will last approximately a half hour, and so we will unfortunately need to have a brief recess at that time.

So we will get started here this morning, and let me just begin by saying it is a pleasure to welcome Chairman Hubbard before the Joint Economic Committee (JEC) to testify on the economic outlook of our country. We appreciate your appearance here today, Dr. Hubbard, and look forward to hearing your testimony.

According to the National Bureau of Economic Research (NBER), data following the terrorist attacks indicate that the weak economy had slipped into a recession earlier this year. Even before the events of September 11, the available economic data indicate that the economic slowdown that began in the middle of 2000 continued in 2001. The rate of real gross domestic product (GDP) growth has slowed quite sharply since the second quarter of 2000, actually falling in the third quarter of this year. The manufacturing sector has been hit hard, losing over a million jobs since July of 2000. Investment growth has fallen over the last several quarters and corporate profits are quite weak.

On the other hand, housing and consumer spending have held up fairly well. In addition, since last January, the Fed has reduced interest rates 10 times. Congress has lowered the tax drag on the economy with some tax reductions, and energy prices are declining. Many economists had expected these factors to lead to an economic rebound in the last half of 2001, but the attacks have led them to forecast a delay in the recovery.

Financial markets and the economy have been disrupted by terrorist attacks. The attacks have increased uncertainty and caused a widespread revaluation of risk and security. Delays and higher shipping costs in air and ground transport, additional inventory and insurance costs, higher expenses for security personnel and equipment, fortification of buildings and facilities and other measures will have the effect of imposing something like a "security tax" on an already vulnerable economy. I note that we will hear more about the "security tax," which is also called a terrorist tax, later from several of our witnesses. This burden will undermine the economy in the short run and could tend to adversely affect both productivity growth and the economy's potential growth rate.

Although the precise amount of the extra burden imposed by these security costs is not known, it appears to be large, and, unfortunately, growing by the day. Over the last several months, private sector economists have begun to consider this cost issue and its potential impact on an already weak economy. A logical policy response would be to offset these costs by relieving some of the tax burden on the private sector. Measures to reduce the cost of capital and address the sharp declines in business investment are particularly needed.

Monetary policy has addressed the economic situation with an easing that began last January. The Fed's policy moves so far this year have certainly provided economic stimulus, but the lags in monetary policy are long and variable. Given the lack of inflation pressures, prudent action by the Federal Reserve could also contribute to an improving economic outlook. However, measures to offset the security tax and improve incentives for work and investment are urgently needed to boost the economy.

Thank you, and at this point I will turn to Senator Reed for his opening statement.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 48.]

## PREPARED STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

**Senator Reed.** Thank you very much, Mr. Chairman. Welcome, Chairman Hubbard.. Thank you, Chairman Saxton, for this opportunity to discuss and debate our economic outlook and to examine which policies are appropriate for dealing with our current economic situation. I also want to thank Chairman Hubbard and the distinguished economists who will follow him for coming to testify before us today.

Two days ago, the National Bureau of Economic Research declared that this Country's longest economic expansion on record came to an end back in March and that we have been in a recession since then. Of course, it was pretty clear before the NBER made it official that we had entered a period of slow economic growth, which was aggravated by the terrorist attacks on September 11.

The task before us as policymakers is to make the right decisions to get the economy out of this recession quickly and put us back on the path of strong and sustainable growth. Monetary policy is already doing its part, and we took some steps immediately after the attacks to increase funding for fighting terrorism, address the needs of the areas most affected by the attacks, and maintain a viable airline industry. Yet most economists say that the economy could use a further fiscal boost, provided – and this is very important – provided it is quick and effective.

A poorly designed fiscal policy could be a waste of valuable resources or it could even be counterproductive. As I urged in our October hearing with Federal Reserve Chairman Greenspan, a fiscal stimulus package is only a good idea to the extent that it has a maximum impact in the short run and does not undermine long-term fiscal discipline.

We must not let the recession be an excuse to promote changes in taxes and spending that erode budget surpluses for years to come. Such an outcome would very likely produce higher interest rates that would discourage investment. This would not only limit the amount of stimulus in the short run, it would also weaken our long-term growth prospects.

I also doubt that tax cuts are the most effective way to stimulate the economy. To be effective in stimulating new investment, business tax cuts must be sharply focused on the investment decision and must be limited to only a short amount of time. This hardly seems to be the case with the corporate alternative minimum tax (AMT), especially the proposal by the House to provide rebates on past corporate AMT payments. Only about a quarter of taxpayers would benefit from accelerating income tax rate cuts, and these are upper income taxpayers who are less likely than others to spend most of their tax savings.

Permanent tax cuts also represent a permanent commitment of federal budget resources at a time when the tremendous budgetary pressures associated with the retirement of the baby boomers are less than a decade away.

I am puzzled by the claim that tax cuts are stimulative but government spending is not. There are many worthy public investments that would contribute directly to GDP while addressing needs that would go unfulfilled if left to the private sector; for example, strengthening our public health system, our transportation systems and our security systems. And the primary effect of getting money into the hands of lower income households either through tax rebates or expanded unemployment benefits would be to boost consumption spending. People who have lost their jobs and have trouble making ends meet are the ones to target if the goal is to get the most bang for the buck out of our stimulus policies.

Mr. Chairman, I am looking forward to the testimony and discussion with Chairman Hubbard and the other distinguished economists at this hearing. I hope we can clarify some of these issues and contribute to the development of a stimulus package that gets the economy back on track as quickly and effectively as possible. Thank you, Mr. Chairman.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 50.]

**Representative Saxton.** Senator Reed, thank you very much.

Chairman Hubbard, we are anxious to hear your testimony this morning, and if you would like to take whatever time you need to share your perspective with us on the economy, we would appreciate it. The floor is yours, Mr. Chairman.

## OPENING STATEMENT OF DR. R. GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

**Dr. Hubbard.** Thank you very much, Mr. Chairman and Senator Reed. You have my prepared testimony. What I would like to do is spend a few moments with you talking about the outlook for the economy really in three parts: first, the outlook for the near term, which I think both of you emphasized in your opening statements; second, a discussion you both again teed up very well on the outlook for public policy and so-called stimulus package; and third to return to the long-term and ask what the outlook is for the long-term in the U.S. and how public policy might affect that outlook.

As an economist, I always go back to supply and demand. When looking at the current state of the economy, it is useful to organize our thinking and discussion around supply conditions – that is, the capacity of the economy to produce goods and services – and demand conditions, the ability and the willingness of households and businesses and governments to purchase those services.

The supply shock consequences, if you will, of the attacks of September 11 certainly had significant negative effects on growth rates in the third quarter and also quite significant effects on the fourth quarter of this year. On the demand side, the attacks and their potential repercussions had effects which are perhaps longer-lasting and more uncertain; that is, effects on household and business confidence about the future, and translate that into household and business willingness to spend and invest. To the extent that those confidence effects prove substantial, the attacks shift our focus somewhat away from simply thinking about transfers toward buttressing confidence of households to make purchases out of dollars they might receive.

To begin with the outlook: the most recent Blue Chip consensus forecast for the private sector indicate a GDP growth rebound in 2002 with a very modest beginning in the year, with growth about a half of a percent in the first quarter, 2.6 percent in the second quarter, and then 3.9 percent about the likely potential growth for the economy by the second half of 2002.

I should note that even with that sort of recovery, the unemployment rate is likely to continue to rise throughout 2002. If one peels back, if you will, the assumptions behind forecasts that are in the private sector, some of which you will hear more about later in your hearing, I think there is an implicit current decline in confidence that is followed by a pretty rapid rebound in confidence.

Much of the recent attention, as you noted, Mr. Chairman, has focused on the United States having entered a recession, at least as defined in the November 26 announcement by the National Bureau of Economic Research, identifying March of this year as the cyclical peak for the economy. As an economist sitting before you also in a policy capacity, I would argue with you that this announcement is less important as an historical record than it is in stressing the need to look forward and anticipate the past for economic policy that is best able to facilitate the economy's return to potential growth.

Let me spend a moment on the mechanics of how such a recovery might take place. I think the key factors are growth in business investment and the strength of personal consumption expenditures. Even if we change no other aspect of economic performance, simply having investment decline at a slower rate would yield substantially higher GDP growth. That is the first component of mechanics of what will bring about a recovery.

Second, a return of consumption growth to levels more familiar in 2000 would be the piece that cements the recovery. Even that kind of mechanical observation I think places the emphasis where we need it for policy on business investment and on consumer spending. It is not necessary to have an immediate robust rebound in investment to have more rapid growth. Simply slowing the decline or even stopping it would contribute greatly, and I offer in the testimony for you, and won't bore you with them here, some numerical calculations in that regard.

I did, however, I want to emphasize one point that I think has surfaced and to my mind is overplayed, and that is the notion that there is a significant capital overhang that both serves as a barrier to the recovery and the barrier to public policies towards business investment. I think that is unduly pessimistic. I think there are sectors in the economy for which that is true – telecommunications comes to mind – but in general I don't think an overhang persists.

Why am I suspicious of this alleged barrier to the recovery and to investment incentives? First, it is important to ask ourselves what exactly is this capital overhang that economists discuss. It is really just a difference between the capital stock that the economy has actually at a point in time and the capital stock the businesspeople feel is desirable given what they see in terms of demand conditions now and in the future in the economy.

Suppose for example that rapid economic growth in the late 1990s implied that at the close of the decade, say in 1999, we had it just about right, as businesspeople were holding the right amount of capital stock, but suddenly we saw a growth slowdown commencing in 2000. For example, the capital stock in 2000 grew at a rate of about 4.2 percent. We knew there had been a slowdown, ex post, there had been a slowdown in growth and we might have had a capital overhang of $100 billion at that point. Given the pace of events and the performance of investment we have seen thus far, I think it is fair to say the capital stock overhang has been virtually if not entirely eradicated.

So I think the best path of economic recovery again points up to the need for bolstering consumption and on focusing on the need to stop the decline in investment.

Now this baseline forecast that I have offered to you corresponds roughly to the consensus of private forecasters. However, I would note an important point that is a good segue to discussing the stimulus package. Those forecasts, like all these economists offer you (at least when economists are being honest with you) are associated with considerable ranges of uncertainty, and the uncertainty in the range of the Blue Chip forecast we are seeing right now are indeed quite striking, and that range suggests the need to think very seriously about downside risks and policies that would address the source of the economy's vulnerability in the quarters ahead, again the path of business investment and the path of personal consumption.

So how should we think about public policies to promote economic security? The key element of this discussion – and it has been the key element both from the administration side and the discussions here in the Congress – is on efforts regarding economic growth insurance. As I mentioned in referring to the private sector forecasts, I think it is important to focus on the potential for downside risks at the present time and develop policies as insurance against a slower or more sluggish upturn in economic growth than that which is expected by many private sector forecasts. The reason to do this, of course, is to guard against a sustained downturn in business and household competence, which would materialize in increased unemployment and slower investment growth. Of course, insurance has to be purchased ahead of time to have any value. So the first implication of this "growth insurance" view of what we need to do is that we need to put in place the correct package of measures.

In response to the President's leadership, the House of Representatives has acted quickly on the stimulus front. It is time for the Senate to follow suit. There has clearly been substantial debate on what should be included in a stimulus package. Mr. Chairman, Senator Reed, both of you introduced that very important question in your remarks. I think the metaphor, if you will, of growth insurance provides considerable guidance to you as you deliberate this.

First, whatever package that you consider should be pro-growth; that is, it should enhance incentives to work, to invest, to take risks, to expand the productive capacity of the economy. It should also be cognizant of short-term needs. The President indeed recognized this early on, incorporating tax relief for low-income families and targeting extensions of assistance for displaced workers that addresses both the short-term needs and provides demand side insurance for businesses.

As a general matter, simply throwing money at a problem does not provide meaningful growth insurance. Indeed, because some of the spending increases that have been discussed are likely to become more permanent, they are prone to replace private sector expansion by creating future fiscal problems and the possibility of higher taxes in the future, and that is at odds with enhancing growth. None of that vitiates the important need to talk about homeland security and defense spending, but I think there is a great deal of caution in other areas of spending.

Over the past year the household sector has sustained economic growth in the face of quite weak business investment. Because personal consumption spending is about two-thirds of aggregate purchases, again negative growth in consumption would be an important downside risk against which we should try to insure. In part due to the tax cut proposed by the President and passed by the Congress last spring, disposable income has held up very well through the third quarter. Indeed, if one were to look at previous downturns relative to what we are now experiencing, we see an uncommonly good holding up of disposable income. Instead, the slowdown in household spending is tracking in no small part to declines in consumer confidence, making confidence a key issue for your consideration.

How do we address confidence? Well, one part, of course, is beyond the matters we are discussing today. It is attention to security and progress against terrorism. That of course is very important. On the economic front, the survey data that we have on consumer sentiment suggest that individuals become less optimistic in the face of job losses and in the face of prospects of future softening in the labor market. To address confidence we need to focus on job creation. The key there is helping businesses overcome uncertainty and restarting business demand.

Some critics again have suggested that investment incentives in this regard will not work because of the capital overhang. As I argued previously, I think that is not accurate, and I think investment incentives will do what they have done in the past, which is lower the expected cost of capital, raise the amount of capital firms wish to hold and increase investment. The administration's proposal is a growth insurance package that contains both demand side support for purchases and incentives to expand investments and jobs. We believe that timely adoption of the package the President outlined in the Rose Garden when he kicked off the debate would raise GDP growth by about half of a percentage point in 2002; also because the President's plan is focused on households and firms, it uses the private sector to crowd in private activity that will not harm the longer outlook.

Now there is a particular crowding out notion about which I would like to urge caution that has surfaced in another area of debate over the macroeconomic responses to terrorist attacks, and that has affected policies that you might consider on long-term interest rates. The right policy at the right time is not likely to cause long-term interest rates to rise. Indeed, recent research here by Doug Elmendorf at the Federal Reserve Board and Greg Mankiw of Harvard indicates that reduced surpluses for the sorts of packages that the President put forth would raise long-term interest rates at most by about three to five basis points.

There is, of course, in the stimulus debate considerable discussion, as there should be, on displaced workers and expansions of social insurance. The administration has proposed tax relief for lower-income families and extension of unemployment insurance benefits in areas experiencing a marked increase in unemployment and flexible national emergency grants to provide funds for relocation, retraining, health insurance and other needs that are flexible at the state level.

We believe in the administration the sort of approach that the President outlined is timely, flexible, and likely to have a significant payoff. The public policy response that you considered on terrorist attacks rightly includes a carefully constructive set of measures designed to address risks of shocks to business confidence and household confidence. Again, at a philosophical level, we believe that those risks are most effectively addressed using the private sector. Tax cuts crowd in the private sector by supporting its job creation, providing support to demand, enhancing incentives and doing these things in a timely fashion. Spending oriented alternatives are both less timely and fail to exploit the creativity, flexibility and innovation of the private sector.

In my prepared testimony, I also offered you a set of economic arguments on the overall economy and the importance of terrorism risk insurance. I will omit those in my oral remarks, but I will be happy to talk to you about it. Suffice it to say it is our concern in the administration that a failure to enact a prompt and wise terrorism risk insurance package would have macroeconomic dislocations.

Coming to the longer-term outlook, I would like to raise a few brief issues with you. The first and most important is despite the terrible human and economic tragedy that we have seen since September 11, the long-term fundamentals of the economy remain sound. Even during the recent slowdown productivity growth, for example, remained strong. Over the long term, there will be a need to address a generalized concern about security. The example or metaphor that has been used is hardening the U.S. economy against the threat of terrorism. In so doing, it is important to consider measures in such a way that they minimize impact on underlying productivity growth. To date, I think the impact of meeting these needs appears to have at best a modest impact on productivity growth.

One calculation I offered you in the testimony is that doubling private security spending over the next 10 years will lower the rate of productivity growth by no more than about a tenth of a percentage point. Even that is likely to be an overestimate because it does not take into account the private sector's ability to innovate and to respond.

It may be the case that the nation determines that adequately addressing security needs actually requires devoting substantial resources. If so, I would leave you with another thought that it is sensible and important for all of us to re-prioritize and not just augment budget resources to address those needs. As with any other aspect of the addressing of terrorism risks, we should not forget the historical lesson that private markets are resilient, efficient and flexible in meeting the challenges.

To conclude, I have every reason to believe given what we see in the data and with the expectation of a timely stimulus package from the Congress that we will see the recovery of economic growth along the timetable the private sector forecasters tell us and of course a continuation of the economy's long-term progress.

So with that as an introduction, thank you again, Mr. Chairman for the opportunity, and I am happy to answer any questions you or the Members of the Committee might have.

[The prepared statement of Chairman Hubbard appears in the Submissions for the Record on page 52.]

**Representative Saxton.** Dr. Hubbard, thank you very much for articulating your views of the current economy. Dr. Hubbard, I always think it is helpful in understanding where we are with this very complicated subject to look at where we have been recently, and to that end I have brought some charts with me that tend to demonstrate where we have been over the last 18 months or so.

If we could look at the first one, we have a chart here which shows what has happened with GDP. We were cooking along pretty well there until the middle of 2000, and all of a sudden we saw a very significant decrease in GDP, which is no surprise to you, of course, but I think it is notable to point out that that trend has been in place through the last two quarters of 2000 as well as in this year, and I point this out because the National Bureau of Economic Research, as has already been mentioned here today, has indicated that this recession actually officially began in March of this year but in fact this process, this trend precedes March of this year by at least two quarters.

[The chart entitled, "Gross Domestic Product" appears in the Submissions for the Record on page 111.]

If we could go to the next chart. It is also apparent by looking at fixed private nonresidential investment, that we see – going all the way back to the second quarter of 2000 that we begin to see a trend in problems relating to investment. And so this aspect – this element of economic growth also is reflective of a longer term trend than would be indicated by pointing the finger at March of 2001.

[The chart entitled, "Fixed Private Nonresidential Investment" appears in the Submissions for the Record on page 112.]

Go to the next chart, please. Here the health and the manufacturing sector, as indicated by employees gainfully employed in the manufacturing sector, have fallen likewise since early 2000. And so we have got almost two years of decline in employment in the manufacturing sector. Likewise, a trend in terms of employment in nonfarm payrolls, again starting back in early 2000.

[The charts entitled, "All Employees: Manufacturing" and "Employees on Nonfarm Payrolls" appear in the Submissions for the Record on pages 113 and 114, respectively.]

Next chart, please. And finally, a chart which is related but perhaps in a more subtle way, that is the long-term interest rates we will get into later.

[The chart entitled, "10 year Treasury Bond Yield at Constant Maturity" appears in the Submissions for the Record on page 115.]

Now you also mentioned, Dr. Hubbard, that the National Bureau of Economic Research has now officially indicated that we are in a recession, and I have here with me a summary of the logic that they used in coming to that position, and they looked at basically four elements of the economic structure. They looked at industrial production, they looked at employment, they looked at real sales, and they looked at income growth, real income growth. And even in their analysis, they go back into 2000. They say that we started to see this trend in industrial production go down rather remarkably in July of 2000. We started to see real sales run into problems in June of 2000. And it was employment that began to be reflected in the figures in a negative way in March. And that is looking back from November. They look back to March and said that we began the recession in March because of trends of employment.

My question, I guess, based on all of this is very simply this. We hear a lot about the various cost factors which promote or inhibit economic growth, and looking back actually to the middle of 1999, we saw interest rates – short-term interest rates start to creep up. Looking back into 2000, we saw energy prices begin to creep up. And so as energy prices began to creep up, the cost of production started to creep up and nonfarm payroll started to be hurt and economic growth started to soften and then eventually turned down in the middle of 2000. So we see these cost factors in production begin to increase as the economy begins to soften, and I guess I would make the point that we need to perhaps look at these increased costs and try to figure out how to offset them. And of course the events of September 11, as you have correctly pointed out, have increased the costs of production even further with something I refer to as a "security tax" and other people refer to it in perhaps another way. So we continue to see the increased costs of production which the House economic stimulus package at least begins to try to offset by reducing taxes.

Would you comment and try to give us your perspective, your point of view on these factors in the economy and what we ought to do? Are we on the right track or is there something we haven't seen yet from your point of view we ought to be doing?

**Dr. Hubbard.** Well, your question puts the finger on very important cost shocks that business felt in 1999 and in 2000, and I think that we are seeing more favorable developments in some of those cost shocks actually in the recent period. It is important that public policy take measures to try to minimize the effects on the transactions costs that businesses face as a result of September 11. This comes up in the terrorism risk insurance issue that I mentioned for you. It comes up in a variety of regulatory issues and of course in the tax issues. Yes, I would think that is something that you in your deliberations would use as a thread in considering policies.

**Representative Saxton.** The trends that we are seeing today in terms of these costs are quite different than they were in 1999 and 2000, I believe. If we look at energy and interest rates specifically, do we look at those now as perhaps forming the basis of beginning or the basis upon which a recovery could occur? Is this helpful in terms of the decreases that we have seen in short-term interest rates as well as energy costs?

**Dr. Hubbard.** Well, it is certainly the case. As you noted in your introduction, monetary policy works with the lag, and we will be beginning to see the substantial positive effects of Federal Reserve actions that had begun early in 2001. We have seen softening in some energy prices and that in large part reflects weak demand. It will still pose a cost reduction for many firms. So I agree with your question.

**Representative Saxton.** Thank you. Let me turn to a slightly different, but very closely related subject. Some months ago, I introduced a bill, which is known now as *H.R. 168*, that would provide partial deferral on capital gains distributions made by mutual fund shareholders. This bill, I believe, would benefit tens of millions of middle income mutual fund owners. How do you view this proposal?

**Dr. Hubbard.** It is first important to step back, and I commend you for your work and thought in this area. The way in which we tax capital income generally in the country has a number of important complexity issues as well as the efficiency costs that economists generally discuss. It is important to focus on capital gains and the tax treatment of capital income. In the context of this stimulus package or growth insurance package, it was the President's wish to try to restrict areas toward policies that would have the shorter macroeconomic benefit. But I think a variety of capital gains and other tax policy issues remain important issues for the country to discuss, and I commend your work in this area.

**Representative Saxton.** I think this is an especially important concept understanding that mutual funds are today used as a savings instrument, if you will, or savings mechanism for many middle-income wage earners, and when we look at the distribution of who use mutual funds, it is very often, in fact most often, those folks who don't have the time to evaluate individual stocks. Those are middle-income people, and so this effort could lead to a middle class tax cut. And what effect would that kind of tax cut have on the economy?

**Dr. Hubbard.** Certainly it would have positive effects on people's ability to spend. It would also have potentially favorable effects on asset prices. I think this is something to be considered and importantly considered in a discussion of tax simplification proposals, and I can assure you the administration will be bringing tax simplification proposals in the budget process.

**Representative Saxton.** It is abundantly clear that there are two very classic approaches to economic stimulus which are being discussed in the Congress. One approach would promote the concept of pump priming, if you will, perhaps short-term tax cuts; the notion of a sales tax holiday for a month has been proposed as a short-term pump primer. Other types of short-term spending increases have been proposed. But the notion of long-term or permanent tax cuts, which have been mentioned here already, is another idea which we have seen work in the past because it gives people the ability to anticipate what the tax code will look like tomorrow, not just what it will look like in the short term and promote certain types of economic behavior that we think are important.

Would you agree that long-term tax cuts such as those contained in the middle class tax cut provided by *H.R. 168* would be important in that context or – give us your view of the short-term/long-term effect of tax cuts versus spending increases and short-term tax cuts?

**Dr. Hubbard.** It is very important for the long term to consider the right tax system for the country, and that involves a whole host of issues and capital taxation, mutual funds being one of a very important element, but many other elements. In the context of the debate over growth insurance packages, it is important in your consideration that you think about things that don't have very long-term budget consequences, but do focus a lot on the short term. That doesn't mean that you can't consider things that look like permanent tax cuts.

For example, in the President's proposal accelerating the marginal rate cuts is simply bringing forward decisions that you have already made; that is, the permanent tax cut that is embedded in the previous tax bill. Expensing, of course, is another form of bringing things forward. You are simply bringing forward capital recovery charges. So the focus on not doing long-term budget damage does not mean that you would not look at policies that have important short-term and long-term consequences.

On the issues of taxes versus spending, as with anything else economists tell you, the answer of course is it depends. Both the tax changes and the spending changes need to be the right ones for the tax issues to work. It has to be focused on consumer and business confidence, and for spending one wants to avoid the temptation for public works spending and avoid the temptation for spending changes that might become permanent, "permanent" being a code word for the need to raise taxes down the road.

In considering these changes on the tax side and the spending side, you want growth insurance in the short term but fiscal discipline in the long term.

**Representative Saxton.** Thank you very much. I now recognize Senator Reed.

**Senator Reed.** Thank you very much, Mr. Chairman, and thank you, Chairman Hubbard, for your testimony. In a recent *Washington Post* op-ed, you suggested that tax cuts for businesses would do a good job of creating jobs and stimulating new economic activity because the tax cuts would increase businesses' cash on hand. The question I think is: how can we expect firms to spend more on capital and workers when strong evidence suggests that it is a lack of demand that is causing the constraints on business today?

For example, and this might be a specialized example, the airlines have already claimed about two billion dollars of assistance from the Federal Government and laid off 95,000 workers since September 11. Just recently *The New York Times* reported that major automobile companies have gone heavily into the debt markets, raised a lot of cash, are paying some positive interest on their debt, and have thus sold cars at zero interest to get consumers into the showrooms.

So I think there is a strong issue here whether or not tax cuts will do what you propose they will do.

**Dr. Hubbard.** Let me offer three observations in answer to your question, Senator. First, your comments are predicated perhaps on the notion that there is a substantial capital overhang. As I tried to argue in the testimony that I presented, I do not think that is the case for the economy as a whole. Part of the weak demand we have seen is from exceptional weakness in business investment. That process has largely worked its way through, meaning investment incentives could have a potent impact. The support for investment incentives by most in the business community underscores that.

Your point about cash on hand related to another provision of the proposals – that is, to the elimination of the AMT. The issue I was trying to raise in that op ed is that what AMT does – the corporate AMT – is to raise the effective tax rate on businesses in a downturn. That is not good tax policy any time but it becomes especially bad tax policy during a downturn.

**Senator Reed.** Is it good tax policy to give retroactive credit for the AMT?

**Dr. Hubbard.** As you know, that was not the President's proposal.

**Senator Reed.** You would be against that?

**Dr. Hubbard.** This should be discussed in the legislative process. Our view is we wanted to focus on the core elements of the tax changes that provided the greatest bang for the buck. The elimination of the AMT helps – not blunts – investment incentives. We felt that if we did an investment incentive without making the eradication of the AMT part of the package, we would blunt that investment incentive's effect.

**Senator Reed.** Well, in terms of the capital overhang, Dr., do you have empirical data that suggest that there is or is not a capital overhang? It seems from the Chairman's questioning that there is a lot of excess capacity in manufacturing, at least.

**Dr. Hubbard.** I will say two things. There is more of this in the written testimony I gave you. I don't want to bore everybody with too much, but I will am happy to give you one. The issue of capacity utilization is not something you necessarily look at to figure out whether you have a capital overhang. Of course, business-people look not only at current demand, but future demand because these are long-lived investments.

My assessment as to what happened with the capital overhang is that the economy was roughly in equilibrium in 1999. It received a surprise in 2000 that the desired growth was about a percentage point lower. It took awhile for the capital stock to adjust through that. We saw that in quite negative rates of investment. And by early next year, that process should be, roughly speaking, unwound. Even a return to zero rates of growth of investment would be a pretty substantial improvement in the economy. So I see no reason to believe (outside certain sectors) that the capital overhang problem is persistent.

**Senator Reed.** Also in your testimony you talked about not "throwing money at a problem," but then I think you also indicated the President supports at least some spending on our unemployment benefits. I would presume you don't consider that to be throwing money at the problem.

**Dr. Hubbard.** The President's proposal is an important part of addressing the needs of displaced workers, and I will tell you what you already know. The President put that marker out at the beginning of the process before he even had his marker out on the tax package. The concern I wanted to leave you with is we do not want to use this as an occasion for radical expansions or changes in the scope of social insurance programs. That should be part of a broader debate.

**Senator Reed.** Doctor, you also talked about the need to stimulate investment and the need to respond to the immediate crisis, which raises the following question: the administration's proposals include investment incentives for two to three years, yet you are suggesting that the blue chip economists say that in six months or so the economy will be back, performing up to snuff, without the need for additional stimulus. Why would you have two or three year investment incentives in this situation?

**Dr. Hubbard.** Again, the key is to provide investment incentives or incentives generally in a package that don't have long-term budget costs. Even moving toward much more permanent investment incentives has only a modest budget cost because all that investment incentives do is pull forward capital recovery charges. So it is just a time value of money argument. We believe in the administration that the simple one year proposals make sense primarily in a world of textbooks where everything is certain and no costs of changing the capital stock and business people then don't try to play a policy game wondering what all policymakers are going to do next.

The best public finance answer to these things is to make tax changes predictable and long term. There is no magic about three years, but I think making something very temporary runs the risk simply of pulling forward investment and creating an atmosphere of uncertainty in the business community about tax policy going forward.

**Senator Reed.** You seem in one hand to be saying do you want immediate stimulus for investment to get the economy moving, but really this is about long-term incentives for investment and has very little to do about the current economic dilemma.

**Dr. Hubbard.** The point I was trying to make, Senator, was that the ability to stimulate investment depends on getting the right kind of investment incentives and people's time path of considering investment is probably going to be better served by having investment policy that is more stable and longer term even thinking about the short-term aspects of such a policy.

**Senator Reed.** There has been a lot of discussion about the cost of the terrorist attacks on businesses and households, but there is also a huge terrorism cost to this government – in fact, I think the administration estimated it at about $127 billion. How will we be able to finance that terrorism cost to the government over the next several years for functions that will not be performed by private industry or households if we don't have the revenue available to do that?

**Dr. Hubbard.** It is important to start both identifying the right kinds of spending you described and to think about reprioritizing spending. Governor Ridge from the administration will be preparing a report for the Congress on his views on needs in the homeland security spending area. Obviously in the budget process going forward it is an item of very important debate, as is frankly the reprioritization of spending. It is clear that with strong priorities in defense and homeland security, other areas of spending may have to give somewhat. But you are quite right, that is the key question.

**Senator Reed.** One final question, I think you quite rightly identified productivity in the long-run as probably the key factor in economic performance. To the extent that human capital is an important part of that productivity, when we prioritize these new investments I would hope that we would not slight education spending, health care spending – all of those items that contribute significantly to productivity through human capital.

**Dr. Hubbard.** I certainly agree with that observation. The President has been quite active in those areas and we share your views. Human capital investments are very important.

**Senator Reed.** Thank you very much.

**Representative Saxton.** Thank you, Senator Reed. Senator Bennett.

**Senator Bennett.** Thank you very much, Mr. Chairman. I appreciate the opportunity to be with you and Chairman Hubbard. Welcome. I generally agree with your testimony, but I am going to sound like I don't in some of my questions in an effort to highlight some particular issues.

You said that the economy was basically in equilibrium in 1999. I have a hard time with that. It was "tulip time" in 1999. You as an economist know what that means. I won't explain it to everybody else. They can ask somebody. But you look at the P/E ratios of some of the stocks, particularly the 100 times earnings, 200 times earnings, 10,000 times, no earnings, it was inevitable that that bubble would burst. Chairman Greenspan called it irrational exuberance. It was irrational. And we sat in these hearings and heard him and others talk about the wealth effect and how people were spending money because their stock portfolios were so great. We hear people saying my 401(k) has collapsed and isn't that terrible and you look at it in historic terms and their 401(k) has collapsed all the way back to the level that it was in 1998 after it had been growing very substantially for quite a long period of time. And you get this high spike and then it comes back down and it feels terrible, but in historic terms we are really just getting a much needed correction. And the fact that it hit us – started to hit us in mid-2000, as the Chairman's charts indicate, I think indicates we were not at equilibrium, we were – at least one sector of the economy, as I say, was in tulip time and we had to take that hit and frankly it had nothing to do with who sat in the White House or who controlled Congress. It was what was going on in the markets and the markets have a way of humbling us politicians many, many times and telling us things that we think are under our control in fact are under the control of the consumers and they always correct themselves over time.

So with that observation, I want to see where we really are, and Senator Reed poked at it and I want to poke at it a little more. I agree with you there may not be a capital overhang. I think that is probably accurate, but let us talk about whether or not there is a supply overcapacity.

Take one obvious example where the anecdotal evidence says there is, is steel. If you look at the global capacity for steel there are simply too many steel mills on line that can turn out absolutely first quality steel, which means sooner or later that some of them, either in this country or elsewhere – we all fervently hope that it is elsewhere – will have to go out of business.

The same thing was true for a while, may still be with respect to automobiles. I remember articles in the *Harvard Business Review* that said "what are the Japanese doing?" They continue to build automobile plants and never ask themselves the question who is going to buy these additional cars, and the attitude on the part of the Japanese manufacturers was, oh, we can always sell them in America. We have proven that we can out-market the Americans and we can sell these cars in America.

Well, you reach a point where there are enough cars to go around, even with those people who buy a new one every three years. We reach a point where the physical capacity is so great that while there may not be a capital overhang, there is a physical overcapacity that has to have a correction. The difference between us and the Japanese is that we are willing to take the correction. We are willing to take the pain that comes with that kind of correction and move forward. They have been mired down for 10 years now with their inability to take the pain on their bad loans and their financial structure. They won't clean up their banking system the way we cleaned up the savings and loans mess here in the United States.

So can you talk about the whole question of capacity in some basic industries and whether or not we are getting close to equilibrium or whether there is some additional capacity that has to be soaked up?

**Dr. Hubbard.** I would be delighted to try to do that, Senator. I don't think there was that much disagreement between what you had said and I said earlier. It is certainly the case in the late 1990s that there was a euphoric period. I can recall many times as a finance professor having students giving me a hard time for saying that the laws of economics don't get repealed. We had periods of time when people forgot about profits and cashflows. But I certainly share your concern. The sense in which I use equilibrium was that in 1999, given the signals that firms saw then, firms felt they were holding the right amount of capital stock. We might argue whether it is tulip time or not, but when it became apparent that those fundamentals that had been expected did not materialize the capital stock had to adjust and since it is a stock it took a while to work through. We are seeing quite similar things there, and I do believe that in general there is not a capital overhang.

Your second point about particular industries I think makes a very important point both in the case of steel and in the case of Japan. It is very hard for industries to have persistent long-term overcapacity without there being excessive intervention, and part of the problem we had in the mogul steel industry is excessive intervention, particularly in many actions that had been taken around the world that would subsidize costs of steel making, and we see the problems of that when an industry then has to go through adjustments.

So part of what we are seeing in some industries is the failure to let the market work. The Japanese case is quite constructive. You used the example of nonperforming loans, which I think is quite right. The flip side is nonperforming assets; that is, the failure of the market to allocate capital efficiently in Japan has been quite a problem. So again harkening back to where you began, I don't think there is that much disagreement and I think the capital overhang at this point is quite modest.

**Representative Saxton.** Thank you very much. We are going to go to Senator Corzine. There is a vote in the House, as everyone can tell. So Senator Reed is going to take the Chair in my absence and we will be back as soon as we can – I believe we have three votes.

Senator Corzine.

**Senator Corzine.** Thank you, Chairman Hubbard, for joining us and, Chairman Saxton, for holding this hearing on our economic outlook. I think I must have been hearing you say – and I guess I am combining this with some of the things I am reading in the press that we have a need for a growth insurance package because we may be already out of the recession that was just declared by the Bureau this week, that we don't need a stimulus package, we need an insurance package.

Is that the analysis that I am hearing, that is the preparation of what you are talking about today?

**Dr. Hubbard.** I do not mean to resort to semantics by using growth insurance instead of stimulus. That was not my point. My point was—

**Senator Corzine.** There is a difference between whether we are in a recession and you want to have a stimulus package that moves us out of that, or whether we want to ensure the fact that we continue—

**Dr. Hubbard.** That is precisely where I want to go. I think using the word "stimulus" is that it connotes an idea of fine-tuning and our ability to know exactly points in time where we want and can move the economy's aggregate demand. I think growth insurance is a better illustration. It says that if the NBER is correct and the recession began in March, a typical contraction is 11 months in the post-war period, the consensus forecasts in the private sector, as I indicated, are already consistent with recovery, but the range is quite wide and given the importance of confidence, both to the business and household side, some package that helps restore confidence is in order. I hope I didn't confuse things by using the term "growth insurance," but that is the sense in which I meant it as opposed to a fine-tuning or—

**Senator Corzine.** Do you think this is necessary or not? Do we need to add and take steps to stimulate or provide this growth insurance? Is that a necessary thing or something that is just sort of a comfortable but not necessary step?

**Dr. Hubbard.** We very much need to do it, Senator. I worry about the potential for deterioration in confidence. I worry about the effect on layoffs of a failure to act. Half a percentage of GDP growth for a year is quite a large change; so I would argue we really do need to do this.

**Senator Corzine.** Okay. I want to go back to this capital overhang issue. I think the capacity utilization, at least in the manufacturing sector, 73 percent or 74 percent, the lowest since 1983, you spoke about telecommunications. It certainly appears that the excess capacity in travel and entertainment, auto industry has got zero percent loans; so they are trying to get people there, high tech does not look all that strong. So one could argue you should make an analysis on some basis other than just a hundred billion dollars overanalysis.

What is the real physical capacity and what is its utilization relative to where you are going to go? I certainly believe that the problem in the economy is more on the demand side, and I think it gets at how do we put together an economic stimulus program or insurance policy. And I don't fully understand how, given the facts of the 73 percent and other things that I just mentioned, that we don't see a fairly substantial excess capacity in the business side that needs to be filled by demand-driven activities.

**Dr. Hubbard.** If I might, I think there are two parts to your question. And on the first of these, I would be happy to send you my more detailed calculations if you want it. I simply wrote down a simple model of investment in capital accumulation in the economy, changed the expected rate of growth that firms would see, more in line with what forecasters had changed between 1999 and 2000, calculated the difference in the capital stock, and worked through its effect on investment.

It is very hard to get a capital overhang. I would caution you not to pay as much attention to capacity utilization numbers as your question intimated. In the first place, it is one segment of the economy, and second, capacity utilization, again, ignores lumpiness in investment. You could have modest levels of capacity utilization, but still desired investment because you are looking forward. But I do take the point that we need to focus on demand, and of course, business investment is a component of demand.

**Senator Corzine.** When one speaks of demand, then we get into a question of whether spending or taxes have the kind of input. I wonder if you are familiar with the Federal Reserve Board's model, general model of the economy and whether you are familiar with the 1998 description of its model and it has a complicated title, aggregate disturbances, monetary policy, and the macro economy and are familiar with their view that income tax changes have under different circumstances, more complicated than I will be able to put into this particular question. But if you roll this out, income tax inputs have long-run implications that are much more powerful than they are in the short run, although not necessaryily overwhelming of even the short run impacts the spending.

I think the proportion is a dollar of expenditure, government expenditures worth 1.4 in the first year, if I am reading this number right, and an income tax permanent income tax is worth four-tenths. I wonder if you are familiar with these models, and whether you would agree that spending increases relative to taxes have that kind of at least tendency, relative to the kind of debate we are having now in the Congress about whether we want to have unemployment insurance benefits, health insurance benefits, and homeland defense expenditures that are being suggested, relative to accelerating tax cuts.

**Dr. Hubbard.** You asked exactly the right question on this. The Fed's model is one of many quite respectable forecasting models. When you are making these comparisons, you want to be sure not to make apples-and-oranges comparisons, that is, you have the same horizon on both and the same amounts on both. I think that the evidence, at least that I am—

**Senator Corzine.** These, by the way, run out – I put this in the record, but it goes one, two, three years and 10 years and compares both spending just so that it is comparable data.

**Dr. Hubbard.** The evidence with which I am familiar would suggest quite potent effects of tax changes. My concern in models like the Fed model is that many of these tax changes are modeled almost as if they are lump sum. There is no difference between something that gives someone $500 and equivalent amount changes in the marginal rate, and most public finance economists would say that is not accurate, so I would have that concern. There is a cross-country literature on this as well documenting the more salutary effects of tax changes than spending changes.

**Senator Corzine.** Thank you.

**Senator Reed.** [Presiding.] Senator Sarbanes.

**Senator Sarbanes.** Thank you, Mr. Chairman. First of all, we reported out yesterday the—

**Dr. Hubbard.** Thank you very much, Senator.

**Senator Sarbanes.** I would hope that we would be able to move that through the Senate in the few near future so that you will have a full complement down at the CEA. I have reference to this column you wrote in *The Washington Post* on Friday. Presumably you are familiar with it.

**Dr. Hubbard.** Yes. My memory hasn't deteriorated that fast.

**Senator Sarbanes.** I am going to quote it to you. "New spending programs are not only unlikely to make the economy grow, they are also an undesirable response to terrorism risk." How do we square that with the reports that Governor Ridge is considering asking for as much as a hundred – I was going to say 100 to 150 – I am told by my colleagues $127 billion for programs to address terrorism risk. How do I square that with they are also an undesirable response to terrorism risk?

**Dr. Hubbard.** The context of that statement, and indeed the context of the entire article, is the issue of a stimulus package and the creation of new spending programs under the guise for stimulus after a terrorist attack. There is certainly a need, as I indicated in my remarks, to focus on homeland security spending, but I don't think of that as part of a package to stimulate economic growth.

**Senator Sarbanes.** No. I am not going to take that. I want to read the whole sentence to you again. "New spending programs are not only unlikely to make the economy grow," which is your stimulus point you are making right now, "they also are an undesirable response to terrorism risk." Now, how do you square the new spending programs are an undesirable response to terrorism risk with Governor Ridge's proposal for $127 billion?

**Dr. Hubbard.** Let me repeat myself. The point of the article was to talk about responses to terrorism risks in the context of economic growth management and a stimulus package. There is, of course, a need to consider defense spending, homeland security spending, a variety of initiatives that need not, by the way, net increase Federal spending. Such spending could be a substitute for other things, but I think that is not part of a stimulus.

**Senator Sarbanes.** Do you think the new spending programs on the military are an undesirable response to the war on terrorism?

**Dr. Hubbard.** I think it is very important to consider the military front of the war and the homeland security front of the war as the Nation's key priorities.

**Senator Sarbanes.** So you think spending on new programs for terrorism risks are okay?

**Dr. Hubbard.** They are an important part of our battle against terrorism, Senator. I think that they would not be a significant part of our battle for economic stimulus.

**Senator Sarbanes.** If I said that spending programs to address terrorism risks are an undesirable response, you would say I am wrong about that, would you not?

**Dr. Hubbard.** I would say again, Senator, that the spending responses are an important part of our national security effort; they are not an important part of our need for an economic stimulus package.

**Senator Sarbanes.** What are the parameters with respect to fiscal policy within which the administration feel it is working? To develop this for a moment, do you think a Federal budget, which begins to use either because of spending programs or tax cuts the surplus attributed to the workings of the Social Security system – do you think that is acceptable, that we, in effect, should begin to use up the surplus that is gained by the extra amount that comes into the Social Security trust fund?

**Dr. Hubbard.** I would like to make two points, if I might. The first relates to the unified surplus. A healthy budget situation for the country requires a healthy economy. That is, a good budget surplus is the product of a good economy, not the other way around.

As regards the Social Security surplus, in the administration's view it would be desirable to dedicate some funds toward personal accounts. In the short term, we do have a unified surplus system of accounting and if the economy is weak we might indeed run on budget deficits.

**Senator Sarbanes.** By budget deficit you mean a budget deficit on the unified system or a deficit with respect to using the surplus attributed to the Social Security system?

**Dr. Hubbard.** Such deficits, likely in response to short-term economic weakness, would be on-budget deficits.

**Senator Sarbanes.** So you don't draw a line and say we don't want to use the Social Security system? You are prepared to do that; is that correct?

**Dr. Hubbard.** That is not what I said. I think it—

**Senator Sarbanes.** Well, do you draw the line at that point?

**Dr. Hubbard.** I think it is important to focus on the health of the economy.

**Senator Sarbanes.** I understand that, but if—

**Dr. Hubbard.** In a system in which we have unified budget concepts, a weaker economy would lead to running on-budget deficits.

**Senator Sarbanes.** Okay. So as you project tax and spending policy, if, in fact, you incur a deficit by going into the Social Security system, you don't draw the line at doing that; is that correct?

**Dr. Hubbard.** In a sense, you draw it in a very important way. One of the principles the President outlined in his call for an economic stimulus package was for long-term budget discipline, so that you do not have the sort of Social Security shortfall that you just described, Senator. In a very short term, it is very important to get the economy moving again.

**Senator Sarbanes.** I understand that. Will you use the Social Security trust fund surplus in the short run in order to do that? I mean, it is a simple question, yes or no. Presumably the answer is yes. That is certainly what your projections are showing.

**Dr. Hubbard.** Certainly in the short run.

**Senator Sarbanes.** Okay. Now having established at least that parameter, let me ask you this question: Are you prepared to go to throw – to put the unified budget into deficit through your tax and spending policies in order to address the economic situation?

**Dr. Hubbard.** I think it is important to ask a question in the sense of what is best for the long-term health of the economy. Of course, the administration would not suggest running long-term unified or on-budget deficits. The question is in the short term, what is the best interest for the economy in getting a stimulus package? The payoff to a healthy economy will redound in part to on budget and Social Security surpluses.

**Senator Sarbanes.** So you do not even then draw the line in terms of the deficits at the unified budget? You would be prepared to put the unified budget into deficit as well to address the short-run economic problem; is that correct?

**Dr. Hubbard.** What I said, Senator, was it is important to consider the economic situation at the time, come up with the right stimulus package that is in the country's long-term economic interests and then see what happens to the short-term budget situation. The President originally suggested the need for tax cuts in the range of $60-75 billion. I think, again, you want to focus on the long-term economy, not targeting the year-to-year budget deficit.

**Senator Sarbanes.** All right. But I think we have gotten an answer out of you, which is essentially that as far as placing parameters, you do not have any restraint in addressing a short-term economic situation in terms of running a deficit, either first going into the surplus produced by the Social Security trust fund, or beyond that, taking the entire unified budget into deficit? I mean, that is the conclusion I draw, and I mean, that is certainly a point of view. I just want to get it out.

**Dr. Hubbard.** If I may respond—

**Senator Sarbanes.** I have got all the red lights blinking at me—

**Dr. Hubbard.** If I might respond, your inference is not correct, Senator. I think what you can draw is that in the long term, it is long-term budget discipline that both the administration and the Congress have wisely suggested. In the short term, I think good sense of both the administration and the Congress is exactly the right economic constraint here.

**Senator Sarbanes.** Well, I don't know how you square that when you do a tax cut that projects the large deficits out into the future which have resulted in even the Chairman of the Federal Reserve telling us that is one of the reasons he thinks the long-term interest rates have not come down despite the efforts of the Federal Reserve – their constant efforts in bringing down the short-term rates, and that is your economic policy that projects those long-run deficits out in the future because of the excess of—

**Senator Reed.** Thank you, Senator Sarbanes. Chairman Hubbard, I believe Mr. Bennett would like to make a comment. We have been hearing all morning about overhanging capital, but I think we are getting a capital hangover, so—

**Senator Bennett.** Thank you, Mr. Chairman. I want to respond to my friend from Maryland that my answer would be yes, I would be happy – not happy. I would be willing to have a unified budget deficit if necessary to get us out of this situation, and I recall in history that President Herbert Hoover, in the midst of a much worse circumstance, said we cannot have a unified budget deficit, and the Democratically controlled Congress elected in 1930 as a precursor to the election of Franklin Roosevelt in 1932 agreed, and they raised taxes in an effort to see to it that there was no deficit. And I think the current orthodoxy in most schools of economics is it was exactly the wrong thing for both parties to do, and I don't want to make that mistake.

**Senator Sarbanes.** Actually, I say to my colleague for with whom I have great respect, I don't differ with him in the least. I really don't. I am trying to get the Chairman of the Council of Economic Advisers to give us a straight answer on these important questions. Now, you just put it straight. I don't really – I think it is a very respectable and responsible economic position to take, and in fact, I have argued for that position in the past under certain circumstances confronting an economic downturn, but we – it would be wonderful if we could get the same clarity and forthrightness out of the Chairman of the Council of Economic Advisers.

**Senator Bennett.** I won't speak for him, but I just spoke for myself. Thank you.

**Senator Reed.** Let me speak for the Chair and thank Chairman Hubbard for his testimony. Let me ask the next panel to come forward so that we can proceed with the hearing. Thank you, Dr. Hubbard.

Let me introduce our second panel and thank them all for joining us this morning. First, Dr. Allen Sinai is the founder, and chief global economist and president of Decision Economics, Incorporated, a global economic strategy and financial market information and advisory firm. He has a distinguished economic career, is the author of numerous articles and someone who – after earning his bachelor's degree from the University of Michigan and his Ph.D. from Northwest University – has become a preeminent economic modeler.

Next to Dr. Sinai is Dr. Margo Thorning. Dr. Thorning is the senior vice president and chief economist to the American Council for Capital Formation. Dr. Thorning also has a distinguished academic career, having received a bachelor of arts from the Texas Christian University, an M.A. in economics from the University of Texas, and a Ph.D. from the University of Georgia. She is an editor of numerous books and articles. Thank you, Dr. Thorning.

Next to Dr. Thorning is Alan S. Blinder, the Gordon R. Rentschler Memorial Professor of Economics and co-director for the Center for Economic Policy Studies at Princeton University. Dr. Blinder again is a distinguished economist. He's the co-author of 12 books, including the influential textbook *Economic Principles and Policies* with William J.

Baumol. Dr. Blinder and his wife reside in Princeton, New Jersey. Thank you, Dr. Blinder for joining us.

Finally we are joined by Dr. Janet Yellen, the Eugene E. and Catherine M. Trefethen Professor of Business and Professor of Economics at the University of California, Berkeley. She has been a faculty member since 1980. Her faculty and academic activities have been interrupted by service in the Council of Economic Advisers, and we recognize her from her appearances earlier. We thank you for joining us, and note that Dr. Yellen had the great sense to go to Brown University, which we like very much. Dr. Yellen is also joined by her husband Dr. George Akerlof, who himself is noted in the economics field, and recently recognized with the Nobel Prize. Thank you, Dr. Akerlof for joining your wife and supporting her today.

Also, for the record, I would like to indicate that Dr. Yellen and Dr. Blinder have signed a statement by numerous prominent economists with respect to the House stimulus bill, and I would ask without objection to include that statement in the record.

[The letter entitled, "Economists' Statement: An Open Letter to Senators Tom Daschle and Trent Lott appears in the Submissions for the Record on page 68.]

Let me begin with Dr. Sinai.

## OPENING STATEMENT OF DR. ALLEN SINAI, PRESIDENT AND CHIEF GLOBAL ECONOMIST, DECISION ECONOMICS, INC.

**Dr. Sinai.** Thank you very much, Senator Reed and—

**Senator Sarbanes.** If you could pull the microphone closer, I think it would help.

**Dr. Sinai.** If I turn it on it will help.

**Senator Sarbanes.** Well, turn it on and it will—

**Dr. Sinai.** I want to thank you for the opportunity to be here and for the introduction, and it is a pleasure and honor to be on a panel with such distinguished colleagues, economists. In one of the most unusual and dangerous business cycle episodes in record, the U.S. and global economy have fallen into recession. The current U.S. downturn, which began in March, on the surface seems like it might be nearing an end. It is nine months long against the 11-month average of the post World War II recessions, far along chronologically relative to the historical average, but in the aftermath of a long expansion and then excessive U.S. boom, functionally far from the point of recovery, in large part, stemming from the unusual nature of the slowdown, inability of easier monetary policy to reverse the economic slide and too little fiscal stimulus.

Most previous recessions have come from a fully employed economy with undesirable rises in price and wage inflation accompanied by excesses, and imbalances in housing, real estate and the consumer, Fed-induced sharp increases of interest rates, credit crunches and sometimes negative external shocks like the oil price shocks of the

1970's. Such a generic process has propelled the economy downward during those times mainly through reductions in housing, in consumption, inventories and capital spending, areas that later became amenable to easier monetary policy given the initial sources of the downturn.

This downturn has not been typical. Indeed, it is the only one since World War II clearly initiated from the U.S. business sector which, in 2000, retreated from a boom state to set in motion downwaves for production and inventories, a collapse in capital spending, less jobs creation and then a global slowdown through reduced trade flows and because of the multinational nature of U.S. corporations, and now, last, weakness in consumption and perhaps housing. This downturn started in the U.S. business sector, not the typical place nor from the typical sources. The slide that started the U.S. and global downturn stems from a number of reasons.

Some were inherently cyclical. Some related to an excessive boom and, in some cases, bubble in technology and telecommunications, and some from higher interest rates. But mostly the slowdown, and now recession, came from a diminution of the boom pace of growth in business activity, slowdown in the growth of business profits, disappointments to business and business expectations, and then a business sector response of cutting back on production, inventories, capital goods spending, imports, and people to maintain profits and to maximize shareholder value.

Cutbacks in production and inventories produced one down cycle. An inventory cycle is usually short-lived. A second down cycle was a downwave and retreat in the growth of capital spending. Capital spending downcycles don't happen in every recession. They are usually long-lived. Through trade flows, essentially the lifeblood of the global economy and the multinational nature now of U.S. and global business corporations, the "virus" of U.S. cutbacks spread throughout the world, Canada and Mexico, to an already recessed Japan and, directly and indirectly, through increased weakness, in a number of Southeast Asian economies heavily exposed to the U.S. in exports and in technology.

Then, the slowdown spread to Germany, a very open economy which lost exports to all of the global economy into France and Italy, heavily exposed to Germany through exports, now the whole Eurozone, Latin America, and the U.K. The business sector cutbacks in the U.S. started the global downturn. It initiated a spreading and cumulative weakness throughout the world that has reverberated back to the U.S. through reductions in exports, adding to the recessionary forces in the U.S. in an unusual way through the new economic dimension of globalization.

With this causal sequence and the aggressive reductions of interest rates by The Federal Reserve that started this past January to stem what, at first, appeared to be just an inventory cycle. Consumption and housing expenditures were supported, although less over time as increased layoffs and unemployment began taking a toll on consumer spending along with less growth in incomes, worsened household financial positions, diminished confidence, and increased uncertainty over the economy and lost jobs. A bear equity market also has hurt.

Now the U.S. and global economy are in the heart of an interactive and mutually reinforcing cumulative downturn made worse by the negative shock waves generated from the September 11 terrorist attack and its aftermath, a recessionary and disinflationary external shock coming on top of the processes already in place. The terrorist external shock has intensified the U.S. economic downturn through its negative effects on consumption, directly and indirectly on business through interruptions to production and increased security costs with the latest downward wrench in U.S. economic activity spreading now throughout the world to intensify the global recession already in place, much as the first negative demand shock did from the U.S. business sector well over a year ago.

The terrorist event, like many other external shocks in business cycle history, is serving to deepen, intensify and prolong the downturn. But if it were to leave no lingering effect or not last long, the economy could spring back to its previous position; however, this does not appear to be the case for the terrorist event and its aftermath where fundamental shifts in consumer and business behavior occasioned by the need for ongoing security and increases in costs for security – essentially a tax that weakens economic activity as well as producing some inflationary thrust in costs – also disrupts production and productivity. The increased Federal Government spending associated with the War Against Terrorism can lift GDP, but very likely will have no lasting positive effect on the supply side of the U.S. economy, indeed, probably will reduce productivity growth and the potential rate of growth of the United States.

If the diagnosis for the genesis of the 2001-02 economic downturn is roughly right. An easier monetary policy through sharp reductions of interest rates is unlikely to quickly or easily reverse the recession in the U.S. or globally. It is well known that reductions of interest rates alone, even increased availability of credit, are not the prime motivator for business sector spending, the area of activity that is undergoing the sharpest downturn. In such a situation, which is very unusual in the U.S. business cycle history, the standard medicine of easier monetary policy cannot work in its normal time span.

Such has been the case so far. We are now 11 months along since monetary policy began to be aggressively eased and the economy is continuing to decline. To the credit of the Federal Reserve, monetary policy was eased aggressively before the onset of the recession, two months before the recession as now dated. Through the contemporary central bank approach of managing the risks around economic and inflation prospects, under such a policy, the central bank need not wait for nor even expect, nor forecast, a recession before taking the appropriate easing, or in the opposite case, tightening decisions.

But given the cause and effect of this particular downturn, I think it becomes absolutely essential to employ fiscal policy stimulus, and soon in this episode, not all episodes, but this episode, along with the necessarily easier monetary policy to restart the U.S. economy and set into motion forces that can begin and build a cumulative upswing. Stakes are high in this unique business cycle downturn where both the U.S. and global economy are in recession. This is the worst global economic downturn since 1982. It is a difficult global economic downturn.

Since the U.S., in essence, started the downturn, it must be the U.S. that will have to be the catalyst to reverse it, to be the engine that gets restarted to reverse a global recession. Poor economic performance, bad business and rising unemployment are undesirable in both the U.S. and elsewhere, but even more so in these times, given the historical record of political instability that stems from bad economic times let alone to be fodder for terrorist activities. An economic stimulus package totaling 125 to $150 billion, including the increased Federal Government spending occasioned by the War on Terrorism, in addition to whatever stimulus will be forthcoming from the personal income tax reductions legislated last year would be appropriate for the next and subsequent fiscal years until the U.S. economy is back on its feet.

Already, some $60 billion to $80 billion of government spending stimulus appears committed because of the War Against Terrorism, that we have no choice about, those moneys must be spent for obvious reasons. This amount of Federal Government spending will lift aggregate GDP and growth of real GDP for a time, but will have little lasting effect in terms of permanent jobs creation, effects on the private sector in terms of raising productivity and potential growth.

Such is the case in modern economies, unless Federal Government spending is targeted to enhance productivity and efficiency, perhaps focusing on education, targeted infrastructure, or new technology development. Additional tax reductions to stimulate the economy would be appropriate, some $60 billion to $70 billion over the next fiscal year to round out the economic policy stimulus. The main objective should be to stimulate the area of the economy that is currently the most depressed, that is, the business sector, especially since last year's tax reductions were aimed almost solely at households.

In order to provide demand-side incentives for business spending and jobs creation, it is necessary to stimulate the sales of business, hence cash flow. This can be done through tax reductions for consumers in order to raise the growth in consumption spending that has markedly diminished in recent months and is next in line for recession-like tendencies. Accelerating the phase-in of the already legislated marginal income tax reductions would be stimulative and appropriate, particularly for middle and low income taxpayers. Accelerating the phase-in of legislative reductions in higher income tax brackets is more a long-run stimulus than short-run, so that a quicker phase-in of income tax reductions in what is to be the 27 percent bracket to 25, taking it to 25 percent, and through increasing the number of households eligible for the new 10 percent bracket should be considered. One advantage of the acceleration of reductions in the income tax brackets is the permanence of the tax reductions. Permanent tax cuts tend to have more beneficial effects on the economy short- and long-run than temporary tax cuts.

Of course, with rising unemployment, increased transfers through extending unemployment benefits – a temporary measure – should also be put into place. Total fiscal stimulus of around $130 billion to $150 billion, along with the 40 billion and $50 billion of tax reductions for individuals coming this year from last year's législation, is essential to assure recovery of the economy in 2002.

The forecast that we carry of recession indicates that we in the world economy are in the heart and brunt of the downturn now. The prospect of recovery in 2002 is reasonably bright, but much less so without economic policy stimulus. In our quantitative studies, and I must emphasize these are approximate, a program roughly approximating $130 billion to $150 billion stimulus, which includes the already mandated Federal Government spending and tax cuts for individuals, middle and lower income brackets and accelerated depreciation, would add something like three-quarter percentage points to one percentage point of growth to the economy next year. Without it, the economy might well not recover in 2002. The economy ultimately will recover, however.

Recessions do not stay forever, but we might have to wait until 2003. Our forecasts for this year, fourth quarter-to-fourth quarter, this fourth quarter to last fourth quarter, show a decline reflecting the recession that came into place in March. From the fourth quarter this year to the fourth quarter next year, the expectation we have with economic policy stimulus roughly the amounts for illustrative purposes that I indicated, would be growth in excess of one percent. That is not anything to write home about.

Without economic policy stimulus, we would be expecting flat or perhaps negative economic performance over the next year.

The risks in terms of pluses and minuses looking ahead, in a forecast sense, to recovery from what is now a very sharp and negative economic and business picture, reflects a lot of pluses and a lot of negatives. Certainly the amount of stimulus, monetary and potentially fiscal that is in the pipeline would be helpful. Interest rates are at the lowest levels since the 1960's, with short-term interest rates reduced, as you know, ten times by the Federal Reserve, 450 points reduction in short-term rates.

Long-term interest rates, depending which one you look at, are down by much less, about one-half point. At one time they were as much as one percentage point lower than the beginning of the year but not right now. These reductions of interest rates normally would do the trick in turning an economy around, but given the causal sequence that I have described, the genesis of this downturn, and the global nature of the recession, the worst global downturn since 1982, I don't think interest rates alone can possibly do that, and I have not thought that at all since the beginning of the cuts that the Federal Reserve put into place.

An economic stimulus package of tax reductions and increased government spending totaling around $150 billion, if roughly that, passed out of Congress is a sizable fiscal stimulus to GDP, 1.5 of GDP, one of the more stimulative fiscal packages in history.

At the moment, this package is in doubt. Its presence in the current unique business cycle downturn is an important ingredient for economic recovery for next year. Lower crude oil and energy costs, if maintained, should raise purchasing power for consumers and businesses. That is a plus. It is like a tax cut. Then you have the funds released for mortgage refinancing available to consumers to spend or save, and, of course, still very strong and positive long-run structural fundamentals of the U.S. economy, a permanently higher trend in productivity growth than previously, a strongly competitive workforce and management, and a pro-growth business environment, a pro-growth administration and a pro-growth Federal Reserve. There is no reason not to be. Inflation is not a risk at this time. Despite all these pluses, the recession has rolled on in the U.S. and global economy for quite some time, and there are no signs of any turnaround yet in the data that we watch.

Some minuses and problems: one is that lower interest rates and easier money do little to stimulate business spending in the U.S. and global economy when it is depressed and when there is considerable overcapacity. Permanently higher sales, earnings, cash flow and expansion opportunities are necessary for business to spend aggressively. Second is the reliquification of household balance sheets by consumers that is being reflected in a rising personal savings rate as households use funds released through tax cuts and mortgage refinancing to rebalance the imbalances in household financial positions that arose in the boom. Yet another impediment to recovery lies in the global downturn, intensifying now in several major regions of the world. Japan is in an intensifying recession, Southeast Asia is declining, Germany is in recession, the Eurozone might be in recession, and of course the U.S. is.

The final minus is non-economic, and it is the terrorist event and its aftermath, along with the uncertainty, the risks, and increased costs that terrorism presents to the U.S. and world economies, we do not know what lies ahead in that area.

So when will recovery come, by-and-large? The question as to when we will recover, whether and how much help we need from policy, lies in answers to two simple questions: The first is what will make business spend? How long will it take before business begins to produce more, rebuild inventories and spend for capital goods and for expansion, most importantly to hire people, not to fire people? The second revolves around the consumer and how much, if any, tax reductions or funds released in mortgage refinancing will be spent and how much will be saved. Ultimately every business sector downturn gives way to an upturn. That is simply the inherent internal mechanisms of the business cycle that produce a revival. Where policy can help and should do so is in jump starting the process of accumulative upturn. Once done to the United States given the leverage of the U.S. economy on the rest of the world, the global economy likely will be helped as well.

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The U.S. has to lead the global economy out of a global recession or the U.S. will suffer the consequences of the global recession, which might not be pleasant. In the best of circumstances, economic recovery could come in the first quarter. That is unlikely. In the worst of circumstances, economic recovery might not start until 2003, very unlikely particularly if an economic stimulus package is passed. Most likely economic recovery should begin somewhere around the middle of next year, making this recession, the tenth since World War II, one of the longest, almost as long as the 16-month episodes in each of 1973-75 and 1979-80. Thank you.

[The prepared statement of Dr. Sinai appears in the Submission for the Record on page 69.]

**Representative Saxton.** [Presiding.] Thank you very much, Dr. Sinai.

Dr. Thorning.

## OPENING STATEMENT OF DR. MARGO THORNING, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, AMERICAN COUNCIL FOR CAPITAL FORMATION

**Dr. Thorning.** Thank you, Mr. Chairman. Is this on?

**Representative Saxton.** You might want to lower it just a bit. There you go.

**Dr. Thorning.** Thank you, Mr. Chairman and Members of the Committee. I very much appreciate the chance to appear before you today to talk about the very important topic of tax stimulus and short run, and I hope long-run promotion of U.S. economic growth. I am chief economist and senior vice president of the American Council for Capital Formation, a broad-based, bipartisan group that focuses on promoting saving investment, long-term economic growth and sound regulatory and environmental policies.

Today the central themes of my testimony are that tax cuts can help stimulate the economy by providing not only a short-run stimulus, but can also lay the foundation for longer term prosperity. In conjunction with tax policy reform, we very much need to focus on regulatory reform, overhauling the procedure, and use more reliance on cost/benefit analysis for regulation of all spheres of our economy. Regulatory reform can accelerate economic growth, and I would like to point out it costs very little. There is no big negative Federal revenue impact.

The third theme is that the terrorist attacks are very real, as our previous witnesses have testified, and are going to be with us for the foreseeable future, not only imposing direct costs such as we have already borne and will bear, but also raising the risk premium for new investment. So it is going to negatively impact U.S. investment, and tax policy changes of the type I will be describing can help us bear this permanent cost of doing business, which was analogous to environmental regulations, necessary, but don't really add to productivity since we are going to have to pay the terror tax for the foreseeable future we need to look at policies that will help make it more affordable.

First, do we need the change in tax rates for the short and long run? Before answering that, I would like to walk you through, and I hope you have copies of my prepared statement, which I would like inserted in the record because really, the story I have to tell could be told just with pictures and tables rather than words.

What is our current situation in the U.S. with respect to taxation of new investment? Before I even answer that question, I would like to second what some of the previous witnesses have said, that we do need new investment particularly in the electric utility sector. Estimates are that we need $90 billion of new investment over the next three years in generation, transmission and distribution facilities. So I think I second some of the previous witnesses that we do need to focus on how to promote investments where investment is needed. But how do we tax investment in the U.S.?

I want to bring to your attention the very harsh treatment of saving and particularly investment here in the U.S. If you will look at table 1 in my testimony, data prepared by Harvard professor Dale Jorgenson, indicate that in 1982 after the *Tax Reform Act*, the *Economic Tax Reform Act of 1981*, the tax rate on new equipment investment was essentially zero, in other words, the equivalent of expensing first year write-off, but by 1996, the tax rate on new equipment was up to 36 percent. For all assets, the tax rate rose from 31 to 40 percent.

And I would also like to focus you on figure two, which shows the tax rate on foreign source investment, and that is data prepared by the Progressive Policy Institute, the Democratic policy think tank. Foreign source investment is taxed very harshly, about 43 percent here in the U.S. compared to say 24 percent in Germany. Those tax rates make it harder for our multinationals to do business abroad, to be competitive and to repatriate income, which benefits all shareholders, and I would like to point out that in that, in the U.S., half our households own equities now.

So of the approximately 90 million households, 45 million are shareholders. So what happens to multinationals as far as income does have a bearing on their eventual prosperity. Second documentation of the harsh foreign source taxation is in figure 3. That data shows how a financial service firm faces tax rates as much as 143 percent higher than its competitors in trying to sell a financial product like insurance in a third country such as Taiwan. Other countries tax foreign source income far more lightly or not at all and that gives their firms a competitive advantage.

Another way of documenting the very high taxation of new investment in the U.S. is a new study that we are releasing today, the ACCF Center for Policy Research commissioned work by Arthur Andersen to take a look at how 14 countries around the world tax investments in electricity generation, transmission, distribution facilities as well as pollution control equipment, and I am just picking one asset.

If you turn to table two in my testimony, you will see an array of countries in column – in the fifth column over you can see the tax treatment of combined heat and power facilities which allow companies to produce power for their own use and heat on their own – at their own facility or to sell it back into the grid, and you can see that after five years, a U.S. firm recovers only 29 cents of every dollar of investment whereas other countries around the world, for example, China, you recover 45 cents of every dollar; Germany, 51 cents of every dollar after five years, and some of the countries like Colombia, Malaysia, Thailand, you have gotten 90 cents back of every dollar of investment.

So trying to invest in assets that not only are important to strengthen our electricity distribution and production system as well as reduce $CO_2$ emissions and reduce other emissions, have begun to switch, is handicapped by a very slow capital cost recovery in the U.S. as well as by environmental regulations that need to be streamlined like new source review.

These two factors make it rather uneconomic to try to invest in this type of asset. And as a quick aside, I would like to point out that the Clinton administration, in its Climate Technology Initiative, supported shortening depreciable lives for combined head and power facilities to 15 years, and the Bush administration has also proposed in its national energy plan reducing depreciable lives. So this is an example of an asset that is treated very harshly under the tax code ,and, given what we saw in yesterday's paper that the terrorists are going to target our gas pipelines and our electricity facilities, it is really important to build redundancy into the system.

So I just would like to point that out as a poster child of why the U.S. tax system needs reform. Another thing that we need to focus on is repeal of the AMT, and of course, that proposal is contained in the House bill along with the proposals for accelerated depreciation.

As the previous witness said, it is procyclical. If you are already down, it forces you down further and retention of the AMT in the Tax Code is going to make it harder to claw our way out of this current downturn. It's a bad tax that raises the cost of capital. It makes it more expensive to invest and it increases uncertainty, and it definitely should be repealed.

Let me ask the question: Can any of the tax stimulus options help in the short run? I would like to focus your attention on the results of a study that the witness at the right, Dr. Allen Sinai did for the American Council for Capital Formation. If you take a look at Table 5 in my testimony, you can see that using his large general equilibrium model, Dr. Sinai modeled the impact of four different tax stimulus proposals.

As you can see, all of the options, including reducing capital gains rates for individuals and corporations; option two was corporate income tax cuts, taking the corporate income tax down from 35 percent to 23 percent; option three was accelerating depreciation by reducing depreciable lives by 25 percent for all assets and reducing real estate from 39 years to 25 years; and then option four, which is the combined impact of the other three, have very positive impacts on real GDP in both the short run and the longer term resulting – for example, Option 4, which is corporate rate cuts, accelerated depreciation, and capital gains gives, on average, $250 billion extra GDP a year as well as extra investment at a reasonable price tag of around $100 billion a year.

Accelerated depreciation alone generates about $65 billion real GDP and costs only about seven billion dollars a year, and that is because depreciation if you accelerate that means your write-offs end sooner. So it is really a timing issue as far as the revenue impact. So to answer the question, can tax policy change – can fiscal policy changes stimulate the economy in the short run, I think the answer is certainly yes, and in the long run, it is absolutely true.

The vast body of public finance scholars who have looked at tax policy from people like Dale Jorgenson at Harvard and John Shovin at Stanford and Dr. Sinai, and many others, which I will be glad to submit for the record, show that switching toward lighter taxation of investment will generate much higher growth in the long run.

And another study that we are introducing today, a new study also by Dr. Sinai, looks at the impact of what the U.S. economic picture would have looked like if we had switched to a consumed income tax in 1991 where all investment is written off in the first year, all saving is tax deductible, and no interest is deductible. That is a pure consumed income tax. And the results of his simulation are shown in table six of my testimony. If we had a consumed income tax from 1991 on through 2004, GDP growth would have been about five percent greater. The level of GDP would have been about five percent higher. Investment would have been as much as 35 percent higher. The S&P 500 would have been higher and Federal tax receipts would, over the latter part of the stimulation period, would have been higher due to the stronger growth. So it would have paid for itself.

Finally, I would like to make the point that moving toward using the legislation that is being discussed in the House and the Senate, using some of the provisions in there to move us not only toward a short-term stimulus and positive impact on some investment spending, but would enable us to build a foundation for a stronger prosperity in the long run; so if we could combine tax policy stimulus, such as I have described with regulatory reform, move those forward on two tracks, we would end up stronger than when we went into the recession.

And there is also other legislation out there to build on, such as the bill, introduced by Senators Craig and Murkowski. I think it is *1293*, which is calling for tax incentives to encourage the very type energy investment and clean coal type investments that we need to not only provide strong growth and ability in electrical generating capacity, but also a cleaner environment.

So the foundation is there and the proposals are there to work with and I urge Members of Congress to seriously look at these options and move forward. Thank you.

[The prepared statement of Dr. Thorning appears in the Submissions for the Record on page 85.]

**Representative Dunn.** [Presiding.] Thank you very much, Dr. Thorning.

**Representative Dunn.** May we hear from you, Dr. Blinder.

## OPENING STATEMENT OF DR. ALAN S. BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY

**Dr. Blinder.** Yes. Thank you very much, may I say, Madam Chairman? – I am looking at the chair you are sitting in – and Members of the Committee. As I was preparing the testimony, it occurred to me that if you reverse the word "outlook," you get "look out." That is rather the way I feel about the outlook for the U.S. economy at the moment. Forecasting the economy has always been a hazardous occupation. But today we have layered on top of the usual economic uncertainties – that we know something about – a need to cope with a host of extremely unusual geopolitical uncertainties, all of which, in my view, make forecasting nearly impossible at the moment. But frankly, they also make me worry much more about downside risk than upside risk.

There is, I hasten to say, a happy scenario leading to a sharp, v-shaped recession and recovery. But I call this the "everything goes right" scenario because, among the things that must happen to follow this sharp v are the following. First of all, Congress must pass a sensible, and I emphasize the word "sensible," stimulus bill in short order, and I emphasize "short order" as well.

Second, oil prices must remain low. Third, there must be no more serious confidence-shattering acts of terrorism in the United States. Fourth, the war in Afghanistan must continue to go well. Fifth, the war must not spread to the Persian Gulf, which could cause another oil shock or, say, destabilize Pakistan. And you can easily add other things to the list. In this "everything goes right" scenario, we might have another negative fourth quarter, the one we are living in right now, a first quarter of next year that has real GDP growth maybe slightly positive or slightly negative – a zero plus or minus – and then start registering substantially positive growth numbers by the second quarter and continuing thereafter.

The recession of 2001-02 would then be no worse than and probably milder than the recession of 1990-91. The reasons for that optimistic view are well known. Falling oil prices, monetary policy, and fiscal policy are all stimulating the economy and inventories have been drawn down to very low levels, which should lead to a strong inventory upswing once sales starts to recover.

The problem is, I don't know how to attach probabilities to the events that I just listed under the "everything goes right" scenario, and I don't think anybody else in the world does either. But I am very worried that the probability that all these things turn out favorably cannot be very high. And if one or more of the things on my list goes wrong, I fear we could be in for a severe, and perhaps lengthy, recession.

In that regard, I would like to remind you that the economy was extremely weak prior to September 11.

And only the intrepid American consumer was keeping the economy afloat at that time. In addition, the terrorist attacks were a blow not only to consumer confidence, which is what everybody speaks about, but much more importantly to jobs and to incomes. The standard cycle that we see in business cycle after business cycle – of lower spending leading to layoffs that lead to more spending – has barely begun. It is not that we are at the end of this process. I think we are really in the early stages of that part of the cycle. And the core problem here, now and in the near-term future, is a lack of demand from these sources.

And as Allen Sinai emphasized correctly, this is a worldwide event. We are not going to get help from abroad to lift the U.S. economy out of this recession. The solution is going to be made in the United States. While the Federal Reserve is doing its part, the well-known lags in the effects of monetary policy that have been mentioned here this morning several times mean that the steps that the Federal Reserve has taken since the terrorist attack on September 11 will be relevant only to the shape of the recovery. They will have nothing whatsoever to do with the severity of the recession.

There are, however, fiscal measures that can impact the economy much sooner than that, if only Congress would enact them. Many economists and other citizens are dismayed that Congress has been dithering over the stimulus for more than two months and now appears to be deadlocked. When I read in the papers about tax cuts or spending programs that may take effect in the spring or even later, I wonder what Members of Congress can be thinking about. This is not a partisan remark. Both Republicans and Democrats are to blame. But it is well past time to get beyond this partisanship and enact a genuine stimulus bill, and I mean one that really adds spending.

As you think about this subject, I would like to suggest two simple and very nonpartisan tests to determine whether some candidate proposal is really an appropriate part of the stimulus package in the current environment. And these two tests are actually rather similar to remarks Senator Reed made early on. First a look at the numbers that come out of the CBO, and see if at least 80 percent of the costs of the proposal are incurred in the first year. I would actually prefer 100 percent, but will accept 80 – we can grade this on the curve. If that is not the case, the economy is not going to get very much stimulus bang for the budgetary buck soon. I am not talking about over a five- or 10-year horizon, but within a year.

The second test is customization or tailoring, and the question to be asked here is whether people who are now advocating this policy were also advocating it a year or two ago, and will they also want it a year or two from now. If this is the case, this is probably not a policy tailored to the current situation. And we have heard many, many examples of that.

Proposals that fail to meet these two criteria may or may not be sound policy. That is the sort of thing that needs to be debated. But they cannot legitimately be considered a short-run stimulus. And I think you are all aware that most of the proposals included in the House bill and several of those under consideration in the Senate fail on one or both of these criterion.

With your indulgence, I would like to outline my own suggestion for breaking the deadlock in a bipartisan way. I made it first in an op ed-piece in *The New York Times* exactly two months ago. The original proposal was that Congress should offer to replace the revenue lost by any state that reduces its sales tax by one or two percentage points for one year. But now that time has elapsed, I can see a case for a shorter time period and a deeper tax cut, maybe two to four percentage points over six months.

Some of you may be familiar with a first cousin of this proposal which was offered by Senators Murray and Snowe. Their proposal would drive the tax rate all the way to zero, but my understanding was for only 10 days – though I did hear Chairman Saxton mention a month an hour or two ago. The spirit of this proposal is exactly right, and it passes the two tests that I offered you with flying colors, and I applaud both Senators for making this proposal. But our economy is not facing a 10-day problem. The central idea behind a temporary cut in sales taxes is to induce consumers to bring their spending forward into the low-tax period. But we are not going to shorten the recession if consumer spending booms for 10 days and then on day 11 begins to sag again; 30 days would be better; 90 days would be better yet, and so on.

A temporary sales tax cut has many virtues. You will notice, first of all, that it is strikingly nonpartisan. For Republicans, it is 100 percent tax cuts, not government spending. You have heard the debate over the virtues of those two approaches here this morning. For Democrats, it is a cut in the tax that has long been viewed as regressive.

Secondly, the proposal cuts taxes only where tax cuts will do the economy good. Every single dollar of tax cut is targeted directly on consumer spending, which is where I believe we need to concentrate our fire in the short term.

Third, making an income tax cut or a payroll tax cut temporary weakens its impact on spending, but making a sales tax cut temporary strengthens it – and that is the incentive idea beyond the proposal.

Fourth, the sales tax cut is as simple, legislatively and administratively, as can be imagined. The structure of the tax in each state is, of course, already set up, and Congress wouldn't tamper with that. At the state level, the necessary enabling legislation could be one line long. In my home state and Senator Corzine's home state of New Jersey, for example, it could read as follows: The basic rate of sales taxation is reduced from six percent to four percent for the sixth month period January 1, 2002 through June 30, 2002. End of bill.

Fifth, and related, a sales tax cut of this nature will convey a simple and intelligible message to citizens in a way that a complicated hodgepodge bill never does. Ordinary Americans will not only see that Congress has done something to help the economy, they will immediately perceive that the tax cut is designed to help them spend more money. It's something they can very easily get their arms around.

Last and certainly not least, this measure will improve the ailing fiscal positions of the states, which was mentioned earlier. If the tax cuts succeed in increasing sales volume, then the state Treasury not only gets back what it otherwise would have had, but actually comes out ahead. This feature of the proposal is not an accident. We all know that states and localities typically raise their taxes and cut their spending during recessions, which weakens the economy. More revenue into the state from whatever source – and this is an example – will cushion the blow.

Now, I have to confess that when I published this proposal on September 28, I did not expect an immediate ground swell of both parties to jump on board this bandwagon. My hope then was that, in the event of a partisan deadlock down the road, Congress might look for a way out that was acceptable to both Democrats and Republicans. Looking at this from the outside, as a citizen, it looks like we are now at that point.

Thank you, Mr. Chairman and Members of the Committee, and good luck with your deliberations.

**Representative Saxton.** Thank you very much, Dr. Blinder.

[The prepared statement of Dr. Blinder appears in the Submissions for the Record on page 98.]

**Representative Saxton.** Dr. Yellen, the floor is yours.

## OPENING STATEMENT OF DR. JANET YELLEN, EUGENE E. AND CATHERINE M. TREFETHEN PROFESSOR OF BUSINESS AND ECONOMICS, HAAS ECONOMIC ANALYSIS AND POLICY GROUP; PROFESSOR, DEPARTMENT OF ECONOMICS, UNIVERSITY OF CALIFORNIA, BERKELEY

**Dr. Yellen.** Chairman Saxton, Vice Chairman Reed, Members of the Committee, thank you for inviting me to testify on the economic outlook. In my opinion, the U.S. economy is at a critical juncture, and the decisions this Congress makes about the economic stimulus package matter both to the short-term economic outlook and also our longer-term prospects.

In my remarks I would like to summarize my views, and I would ask that the full statement I submitted be included in the record.

Before the attacks, the U.S. economy was in the midst of a growth recession, a period of growth well below the economy's potential. Such subpar performance results in greater slack in labor markets and lower capacity utilization. The terrorist attacks then dealt a substantial blow to an already weak economy. The most important economic risk now is of further retrenchment of capital and consumer spending.

Americans are naturally more uncertain and more apprehensive, and in the face of such uncertainty, deferring significant spending commitments, whether for capital expenditures or consumer outlays, is a rational response. Declines in capital goods orders suggest that just such a response is now in progress. The ripples from reduced spending will cause additional job and income losses, exacerbating the downturn. Recent signs are not unambiguously negative, but I believe most indicators are unsettling, including yesterday's decline in consumer confidence to its lowest level in seven years.

There are legitimate grounds for optimism that the economy will rebound during the coming year with growth returning to trend or possibly above, and that optimism has been reflected in stock prices since the attacks. But what actually happens depends critically both on the progress of the war on terrorism and also the decisions that Congress and the administration make now about the future course of fiscal policy.

Fiscal policy is already providing meaningful stimulus to the economy, and the question is whether additional stimulus beyond already enacted steps is needed. My answer is yes, but only if the package is properly designed. Even if the recession proves short-lived, there is no guarantee that the recovery will be strong enough to reduce unemployment and eliminate economic slack. The extra boost to demand from a stimulus package could speed the return to full employment and mitigate the considerable downside risk the economy now faces. But to stabilize rather than destabilize the economy, the stimulus must come now when it is needed and not after the economy has recovered, when it would be counterproductive.

The stimulus must also be temporary to avoid harm to the long-term budget outlook. Actions that undermine the longer-term position of the Federal budget will reduce national saving and jeopardize long-term growth. They could also drive up long-term interest rates, which would reduce interest-sensitive spending, deepening and not shortening the recession.

With fiscal policy the potential for bad policy is so great that a stimulus package could do more harm than good. I would rather see no stimulus package than a badly designed one that wastes crucial Federal dollars, provides little or no positive short-term stimulus, erodes national saving, drives up long-term interest rates and diminishes the ability of the Federal budget to meet the needs of an aging population.

As Senator Reed mentioned, Alan Blinder, George Akerlof, and I were among the 14 economists who recently signed an open letter to Senators Daschle and Lott urging them to lead the Senate in coming up with a stimulus package that would actually do more good than harm. We discussed two principles that a stimulus package should satisfy, and these principles have been endorsed on a bipartisan basis by the leaders of the House and Senate Budget Committees.

First, policies should be targeted to increase spending immediately. The purpose of a stimulus package should be to complement monetary policy in raising aggregate demand. The package should not primarily focus on raising aggregate supply, since a shortfall in demand, not a shortfall in supply, is the problem facing the U.S. economy now.

Second, the stimulus package should be temporary and phased out when the economy recovers. Unfortunately the House economic recovery bill violates both principles.

The bill is heavily directed towards business tax relief, yet the provisions of the bill, such as the repeal of the corporate AMT and refund of AMT credits and the change in subpart F regulations, will have little or no immediate impact on investment spending. These are pure windfalls for businesses. Because these provisions create no meaningful incentives for investment, they provide no stimulus. The best investment incentive under discussion, in my view, would be a temporary provision allowing partial expensing of investment. This targets new investment and could create a potent incentive due to its "use it or lose it" feature, which would speed up investment. But to stimulate the economy now, the window for that incentive, I believe, should be much less than three years.

The House bill also contains provisions for individual tax relief, but, again, with one notable exception, these provisions also violate the economists' two principles. The proposal to accelerate implementation of the 25 percent income tax rate and the cut in capital gains taxes are extremely costly and provide little or no stimulus. The attacks are no reason to accelerate the tax cuts enacted last spring. Instead, given the new demands on the Federal budget to meet security needs, I believe they are a good reason to reconsider them.

The one provision in *H.R. 3090* which meets the principles endorsed in the economists' letter and would be highly effective in a stimulus package is the proposed rebate for individuals that did not receive a full rebate last summer. The bang per buck for these payments would be substantial because the benefits go disproportionately to low- and moderate-income workers, and such workers are typically liquidity-constrained and spend a large share of extra income. A temporary rebate also avoids damage to the long-run budget.

In my view, a solid case can also be made for several stimulus measures that are not included in the House bill. I would support Professor Blinder's proposed temporary cut in state sales taxes, financed from general revenues, if the plan can be implemented quickly.

Another promising stimulus measure is to enhance the unemployment insurance system along the lines suggested by Alan Krueger and Wendell Primus, particularly to update eligibility rules for the UI program which mainly exclude part-time workers.

Temporary additional allocations for safety net programs like food stamps, WIC or housing subsidies, I believe, would also provide effective stimulus targeted towards those truly in need. I think increased Federal transfers to state and local governments whose budgets have been adversely impacted by the economic downturn are also worthy of inclusion in the stimulus package. These units are forced by balanced budget requirements to adjust through either spending cuts or tax increases, and responses of those types exacerbate the downturn.

Of course, additional spending for defense, public health, to counter bioterrorism, to beef up security or for other high-priority reasons is also effective stimulus and would help improve confidence.

Let me stop there. I welcome your questions.

[The prepared statement of Dr. Yellen appears in the Submissions for the Record on page 102.]

**Representative Saxton.** Thank you very much. I just have one final question that I would like to ask. Dr. Yellen, thank you. That was a very nice statement.

Dr. Blinder mentioned that it would appear that our legislative process has become stalemated. I hope that is only a temporary phenomenon, but if it is true, it is because those of us who are here have some beliefs that are rooted, we think, in some significant logical positions, and therefore, we put our ideas forward, and as usually happens around here, we come to some kind of an agreement through the process, usually in a conference committee, which we haven't been able to arrange to get to yet.

But let me just lay out what my beliefs are and ask each of you to respond to them. First I believe that the economy was doing very well, and then several things happened. As I mentioned earlier, we collectively became, for some reason, concerned about inflation in early 1999, and as a result, we saw significant short-term interest rate increases. That is factor number one from what I can see.

Factor number two is that very shortly thereafter, energy prices started to go up. And if you believe as I do that the economy depends on robust production and economic activity, and if you believe that those factors have a tendency slow it down, as I do, then you can see how we have started to become a troubled economy.

Thirdly, as the cost of production increased, it appears to me that because profits fell, the stock market began to suffer, and we saw the wealth factor that has been mentioned here today become more of a negative factor than it had – as it had previously been a positive factor.

All that together, it seems to me, provided for an atmosphere in which the economy would not do very well, and that is exactly what happened.

Finally, as has been mentioned here by each of you, the economic effects of the terrorist acts in terms of again increasing the costs in our economy for production and commerce, security tax and terrorist attacks has increased costs of doing business because of these factors and has added another increased cost of doing business and making profit, which is what our economy turns on. And so those are the things that I see as things that need to be fixed. Now, whether you fix them with a short-term fix or long-term fix I suppose is a matter of some discussion, but I happen to believe, as was true in the 1960s and as was true in the 1980s and 1990s, that people who are planning to make investments and people who are planning to be productive do so over the long haul and not over the short haul, and therefore, I tend to come down on the side of tax fixes which encourage long-term growth as well as short-term growth.

If you would each just take a minute or two at the most to capsulize your thoughts, starting perhaps with Dr. Sinai.

**Dr. Sinai.** The framework you presented for the downturn is due to a number of respects. I would offer that those factors, along with something outside of those factors, led to a decline in business spending across-the-board in all areas. The decline in the rate of growth from the boom, in the pace of growth – and it is somewhat technical, but when you change the growth rate, even if that growth is still positive, what comes into play is something technically called in economics accelerator effects and reverberates through shifting growth in a negative way. Business cycles begin from that source. What I am saying is that we had a negative demand shock from the U.S. business sector as a prime mover of this downturn, and the terrorist attack I view as a second negative demand shock which is reverberating through now. What you mentioned is true. It is just that quantitatively I would suggest this source was very big.

So how do you fix it? I might in this episode, this particular time, given that we started with a budget surplus, which is very important and that we worked hard to achieve – and many people at this table and in this room worked hard with political sacrifice – given that we started with a surplus, that the way out, if we have to spend money to fight the War Against Terrorism – we have no choice on that – I think is to do additional tax cuts that benefit short and long run. So I am with you on trying to kill two birds with one stone – the short-run stimulus and the long-run supply-side pluses, that once the economy is up and running from the demand side, that come into play in a very positive way.

The debate in Washington is very much over the nitty-gritty of what that is, but if I have to come down on one side or the other in this episode for this time, I would come down on the side of more tax cuts, well thought out; I think mostly permanent, because temporary tax cuts don't have the same effect as permanent tax cuts do.

**Dr. Thorning.** I would just like to add – kind of second Allen Sinai's thoughts about tax cuts. As I pointed out in my testimony, I feel that should be the largest component of any tax stimulus plan, especially tax cuts that will enhance our productive capacity not only in the short run, but in the long run where it is going to become a drag if we don't. And I would like to focus on the fact that the U.S. is losing competitiveness because of our Tax Code.

I often tell people that the U.S. business succeeds as well as it does in spite of the Tax Code, not because of it. So I would like to focus people on how other countries around the world – for example, in the European Union corporate tax rates have come down from an average of 34 percent in 1995 to 31.7 percent in 2000, and the trend is downward. Our rate is still at 35 percent. We are not keeping abreast of developments around the world where taxation on investment is being lightened, and in the long run as well as the short run, that is going to hurt.

I also would like to focus on the stepchild often in economic policy, which is regulatory reform. I think that could be a very helpful, cost-effective component to stimulate short- and long-term growth.

And finally, I would like to reiterate what Dr. Sinai said about temporary tax cuts, even those tax cuts accelerating depreciation included in the House bill, only three years, and for many type of business, three years is not long enough to get a plant or a design up and running. So I think the focus should be right now on moving this toward more or less permanent tax cuts for investment that will help in the short run to some extent, and certainly will be – have a very large bang for the buck in the long run.

**Dr. Blinder.** Mr. Chairman, I agree with your diagnosis of the causes of the slowdown very much, with just two small footnotes. One is that in addition to the stock market crash, to which you alluded, there was a real technology investment crash. There was irrational exuberance both in the financial evaluation of these assets and the amount of the stuff that our markets produced. Allen Sinai made a reference to that.

The second small footnote is that I do think that the terrorist attacks on September 11 were the real trigger. I was not convinced we were going to have a recession if that didn't happen. To me, it was 50-50. But I would not emphasize the additions to business costs, which are there and are legitimate and will continue to be a long-run concern. I agree with that completely. But I would emphasize the short run and potentially devastating effects it is having on demand, on spending and consumer confidence.

In terms of remedies, the proposal that I advanced is a tax cut, though not the sort of tax cut that you were alluding to. I don't think that is the only way to do it, but for the reasons I gave, it is a potentially very fast way to do it. And speed is of the essence here. The kinds of proposals that you are making reference to have been debated on and off in the United States – and you know this better than I – since the late 1970s, right through the 1980s, right through the 1990s. There are people on both sides. Various things have happened at various times. Most of the arguments for reductions in the taxation of capital – and there are many, many variants – have been argued on the basis that this is a way to insure more saving, not spending. But more saving is just not what we need right now. It may be what we need – and I will come back to that in a second – for the long term. But right now, we need spending, not savings. So I don't think savings incentives are the remedy for the current emergency situation that we are in.

On that last point, as part of the ongoing debate over capital taxation, one must always remember that a revenue loss reduces national saving. By contrast, the remedy that we as a nation latched onto in the 1990s was that potentially the best way to spur private saving and capital formation was to do more government saving by turning the deficit into a surplus.

We did that amazingly successfully, and I think not by coincidence we had the greatest investment boom in history.

**Dr. Yellen.** I would agree with much of what you said about the causes of the slowdown in the economy. In 1999, we had an economy that was overheating. The Fed did tighten policy. I think the energy price hike eroded consumer ability to spend on a wide range of products. And then, of course, the collapse of the NASDAQ bubble and some overinvestment in things like telecom – I believe there is some overhang of capital equipment – has diminished investment dramatically.

At the moment the economy mainly suffers from a demand shortfall and not a supply problem. I think this is very important, because to get the right prescription here, we need to understand what the malady is. And in my view, the major malady of the U.S. economy right now is a shortfall in demand.

One of the reasons that investment is sluggish and will continue to be so is because capacity utilization is so low, and that is because demand is depressed. The major thing we should be thinking about now is not supply-side incentives for long-term growth, but doing something to stimulate demand and doing it immediately. Proposals that will operate on the household side to stimulate spending, Professor Blinder's proposal or rebates for low-income consumers will all have a positive impact on investment because when consumers spend more, firms will have more orders. They will hire more people. Capacity utilization will rise, and more firms will end up spending in order to build capacity to fill new orders.

In my own view, if the focus is to raise investment spending, a better way to do it is to put more money in the pockets of consumers so they buy more goods and create more orders than by giving direct incentives of the sort under consideration to businesses to invest when you are in a downturn and firms have excess capacity.

On the issue of permanent versus temporary incentives for businesses: as I mentioned in my statement, I believe the single most effective business incentive would be a temporary investment tax credit or accelerated depreciation provision. Like Professor Blinder's proposal for a temporary sales tax holiday or reduction in the sales tax, these incentives create a window of opportunity, and for those businesses that continue to invest, and there are a lot of them, you are saying to them: "look, don't wait. I know it is desirable in uncertain times to wait, but you have an opportunity. Spend right now, right now in the next year, and you can get that tax break." Economists believe that a temporary investment tax credit is a more powerful incentive than a permanent credit.

Now, with respect to long-run tax policy, I believe you have made the point that there are distortions involved in raising taxes. This is a statement that would command broad support among economists. It is costly and distorts incentives to raise revenue. And so the notion of cutting taxes, whether it is on businesses or households, always seems attractive because you can point to distortions that would be reduced.

The reason, though, that we have those distortions is that we need to raise money in order to finance needed government spending, and to cut taxes without cutting government spending has exactly the adverse effects that Professor Blinder just explained. If we don't have needless government spending to cut – and I don't see where that needless government spending is – on the contrary, I see right now the need for more spending. When you cut taxes and don't cut spending, then you are reducing national saving, and what that means is you drive up interest rates. It is an improper analysis of business incentives to say all that only taxes matter. Interest rates matter, too, and if you cut taxes in a way that raises interest rates, at the end of the day, you may do nothing positive for growth.

**Representative Saxton.** Let me, in turning to Senator Reed, just observe that we are probably going to end up with a package that includes probably some of all of that. We have an administration that would tend to agree with Dr. Sinai and Dr. Thorning, and we have a House-passed package that does the same. We have a strong body of belief of – a position in the Senate which would agree strongly with Dr. Blinder and Dr. Yellen. We have a Minority in the Senate, which the Majority in the Senate needs to pass anything, that would agree more with Dr. Sinai and Dr. Thorning. So when we get something to the conference committee, I suspect there will be a great deal of talk and a great deal of compromise, and we will see a package that nobody will be totally happy with, but there will be some of your ideas, undoubtedly all of you, in that package.

I think this demonstrates – and I know my friend from Rhode Island will agree – that there are many ideas about how to stimulate the economy, most of which have been thoroughly discussed here today. And so we look forward sometime between now and when we leave town to having something that we will probably ask for your comments on again after we get a package.

**Dr. Sinai.** Mr. Chairman, if I might just say, that outcome wouldn't be so bad. The outcome you just described, which is some of the ideas of all of us and others, wouldn't be so bad. The bad thing would be if nothing happened before you went home for the holidays.

The combination of some of what the Democratic side of the Senate is suggesting, which involved some policies that would help consumer spending, and something like what I have discussed, cutting the tax rates for middle- to lower-income families who would spend more of that – you notice I didn't say upper-income families. I said middle- to lower-income families. That would increase consumer spending. We will get more spending out of the government whether we want it or not. That sets the backdrop for help to business. When they see better sales and better earnings, then something like accelerated depreciation will target them on capital spending, and that in turn will get the whole cycle going along with the inherent stuff that makes business cycles and recessions eventually end.

But be sure to get something done. Don't walk out of here – and I am sure it won't happen this way – going home for Christmas without giving the American people some sort of "Christmas gift."

**Representative Saxton.** Senator Reed.

**Senator Reed.** Thanks very much. And let me follow up on a couple of points that were raised previously.

Senator Corzine pointed to the Federal Reserve's model that showed Government spending in the short-run certainly has a higher multiplier than the comparable tax cuts. Dr. Sinai, does your model reflect that also?

**Dr. Sinai.** Yes, Senator Reed, it does. Government spending has a multiplier effect early on the first year of something a little over one. The Fed model might have it a little higher than that. And then it fades because of feedback effects in the economy, including expectational effects. Depending on the kind of Federal spending, if it also affects productivity, so-called supply side of the economy – and I mentioned several of those – education, certain kinds of infrastructure, types of expenditures, then it has positive and lasting long-run effects.

Tax policy actually has longer lags, both those for consumers – even the ones we are talking about today in our model – than does the government spending stimulus. So it is a tricky problem. You have to make decisions. If you only say, let's get GDP right away fast, you might say let us pump G. Guess what? G. You know who did that? Japan did that. Look at where they are now, with huge deficits and huge debt. They basically got nowhere with it. They have not done any tax cuts at all. So many of us think that if they had done that and spent their money that way, Japan would be in better shape now today than it is.

**Senator Reed.** Japan has other problems. Banks are absolutely distressed.

One other point you made in your opening remarks is that you would favor the acceleration of the 28 percent income tax cut bracket or expansion of the 10 percent bracket. But you thought that accelerating the very top marginal rate reductions would not have much effect in stimulating the economy. The administration is arguing for reduction of all levels. So you would differ with the administration on that one.

**Dr. Sinai.** Yes. I would differ with the administration on that. I think the phase-in of the higher marginal tax rates for upper-income families is a savings stimulus and not consumption stimulus, and it is more of a long-run measure. Like my colleagues on the panel, I do agree we have a demand shortfall now, and that is what we need to deal with, and taking an existing legislative policy is a little less difficult. If you accelerate the phase-in, it is just several years into lower withholding tax schedules, which looks to consumers like it is permanent, rather than rebates, which don't look permanent, you are likely to have more of a stimulator effect on spending.

The new 10 percent bracket I thought was a very creative, innovative thing to do. That is not in anybody's proposals. I thought that you could easily throw more lower-income families into that just by changing the income threshold of entry for that 10 percent bracket. And those families and those income brackets would probably spend most of the money that they got. You would have short-run stimulus, but also would have changed the marginal personal income tax rate, which provides longer-run incentive effects. So it is a "kill two birds with one stone" approach.

**Senator Reed.** Let me turn now to the points that Dr. Yellen and Dr. Blinder made, and that is the notion that permanent tax cuts take on not only an economic connotation, but a political connotation; that is, to raise them in the future is a breach of trust, faith, whatever, which makes it virtually impossible to do that. But in a situation where deficits, on a unified basis might be likely, given an underperforming economy, given increased tax cuts that are being proposed, given increased expenses due to the war – and I don't know anyone who has financed a war by cutting taxes – we are likely to be headed into a unified deficit within some quarters.

I don't know. I don't have my model available, Doctor. But this goes to the point I think you made that if we are looking for a short-run fix, the very nature of permanent tax cuts is such that you can't tamper with them down the road when, in fact, we might discover a year out, or two years out that our deficit is a drag – as it was in the late 1980s, early 1990s – and we have to change policy. So not only from an economic sense, but from a political sense, perhaps we might stick to short-run changes or changes such as those we have just talked about, Dr. Sinai, that affect lower-income Americans who are more likely to not save, but spend. And that is my final point.

**Dr. Blinder.** I agree with that 100 percent, and that is, in fact, what motivated the proposal that I made. Both in the economists' statement that Dr. Yellen alluded to and in the two tests that I mentioned in my testimony, right at the beginning is the notion that it should be hopefully either 100 percent front-loaded, but if not 100 percent, drastically front-loaded to deal with this current emergency. If you are talking about a permanent tax cut, you are going to see 10 percent of it or so in the first year. That is not what you need for a stimulus. That thing might be a policy you like or don't like, but it is not going to be a short-run stimulus to the economy.

**Dr. Yellen.** I completely agree as well, Senator, with your point. I think it is very important that we do not enact additional long-term tax relief that would worsen budget deficits in the out-years and worsen the problems that we face beyond 2011, when things begin to look really bad.

**Dr. Thorning.** I would like to disagree with respect to the ultimate impact of a permanent tax cut. I think one point that hasn't been raised here is that if we enact tax cuts that improve productivity and increase investment, the dynamic impact of those tax cuts as opposed to the static Joint Tax Committee revenue estimate impact is very different. And I think the results that I presented in my testimony, for example, of Dr. Sinai's simulation of some accelerated depreciation, corporate rate cuts, capital gains rates cuts, those revenue numbers presented in that table are dynamic. They take account of letting all factor prices change in the economy, let investment incentives work. And I think if we take a look at constructing a package that certainly will have some spending increases of the type the panelists have mentioned, but also some direct tax cuts on business, we will see the dynamic impact of those flowing through the economy in the near and the long term, and it will not be a drag and not add to the budget deficit.

**Senator Reed.** Dr. Sinai, just one final point, and not directly in response to my question, but given the assumptions that you talked about, does your model show us going into a deficit?

**Dr. Sinai.** Yes, it does, on the unified budget basis next year anywhere from 50- to $100 billion and perhaps more the year after. And so that is – I am okay with that. And I was one of the most outspoken complainers about budget deficits in the late 1980s and early 1990s. This is a cyclical deficit. The economy is really underperforming. Lots of other countries have the same problem. They are going to – if you let those deficits stop us from trying to grow the economy out of them, or do you try to grow the economy. We can accept them up to a point, which is why – one of the reasons the number I presented, 125 billion in total to 150 billion, I tried to be very careful with that. You can overdo that and then really lock yourself into some long-run structural deficit difficulties.

**Senator Reed.** Thank you, Mr. Chairman.

**Representative Saxton.** Thank you very much for being with us. This has been a long hearing, and we thank you for your patience. And I think it has been a great exchange of ideas and a good conversation and very timely for us to have it at this point. So thank you for your participation, and we appreciate it very much, and we look forward to seeing you again in the future.

[Whereupon, at 1:45 p.m., the hearing was adjourned.]

# SUBMISSIONS FOR THE RECORD

## PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It is a pleasure to welcome Chairman Hubbard before the Joint Economic Committee (JEC) to testify on the economic outlook. We appreciate your appearance here today, and look forward to your testimony.

According to the National Bureau of Economic Research (NBER), data following the terrorist attacks indicate that the weak economy had slipped into a recession earlier this year. Even before the events of September 11, the available economic data indicated that the economic slowdown that began in the middle of 2000 continued. The rate of real GDP growth has slowed quite sharply since the second quarter of 2000, actually falling in the third quarter of this year. The manufacturing sector has been hard hit, losing over one million jobs since July of 2000. Investment growth has fallen over the last several quarters, and corporate profits are weak.

On the other hand, housing and consumer spending have held up fairly well. In addition, since last January the Fed has reduced interest rates ten times, Congress has lowered the tax drag on the economy, and energy prices are declining. Many economists had expected these factors to lead to an economic rebound in the last half of 2001, but the attacks have led them to forecast a delay in the recovery.

Financial markets and the economy have been disrupted by the terrorist attacks. The attacks have increased uncertainty, and caused a widespread reevaluation of risk and security. Delays and higher shipping costs in air and ground transport, additional inventory and insurance costs, higher expenses for security personnel and equipment, fortification of buildings and facilities, and other measures will have the effect of imposing something like a "security tax" on an already vulnerable economy. This burden will undermine the economy in the short run, and could tend to adversely affect both productivity growth and the economy's potential growth rate.

Although the precise amount of the extra burden imposed by these security costs is not known, it appears to be large and growing by the day. Over the last several months, private sector economists have begun to consider this cost issue and its potential impact on an already weak economy. A logical policy response would be to offset these costs by relieving some of the tax burden on the private sector. Measures to reduce the cost of capital and address the sharp declines in business investment are particularly needed.

Monetary policy has addressed the economic situation with an easing that began last January. The Fed's policy moves so far this year have certainly provided economic stimulus, but the lags in monetary policy are long and variable. Given the lack of inflationary pressures, prudent action by the Federal Reserve could also contribute to improving the economic outlook. However, measures to offset the security tax and improve incentives for work effort and investment are also urgently needed to boost economic growth.

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# Opening Statement
## Senator Jack Reed
## Vice-Chairman, Joint Economic Committee
## November 28, 2001

Thank you, Chairman Saxton, for this opportunity to discuss and debate our economic outlook and to examine what policies are appropriate for dealing with our current economic situation. I also want to thank Chairman Hubbard and the distinguished economists who will follow him for coming to testify before us.

Two days ago, the National Bureau of Economic Research declared that this country's longest economic expansion on record came to an end back in March and that we have been in a recession since then. Of course, it was pretty clear before the NBER made it official that we had entered a period of slow economic growth, which was aggravated by the terrorist attacks on September 11.

The task before us as policymakers is to make the right decisions to get the economy out of this recession quickly and put us back on the path of strong and sustainable growth. Monetary policy is already doing its part, and we took some steps immediately after the attacks to increase funding to fight terrorism, address the needs of the areas most affected by the attacks, and maintain a viable airline industry. Yet most economists say that the economy could use a further fiscal boost, provided–and this is very important–provided it is quick and effective. A poorly designed fiscal policy could be a waste of valuable resources or it could even be counterproductive.

As I urged in our October hearing with Federal Reserve Chairman Greenspan, a fiscal stimulus package is only a good idea to the extent that it has maximum impact in the short run and does not undermine long-term fiscal discipline. We must not let the recession be an excuse to promote changes in taxes and spending that erode budget surpluses for years to come. Such an outcome would very likely produce higher interest rates that would discourage investment. This would not only limit the amount of stimulus in the short run; it would also weaken our longer-term growth prospects.

I also doubt that tax cuts are the most effective way to stimulate the economy. To be effective in stimulating new investment, business tax cuts must be sharply focused on the investment decision and must be available for only a limited amount of time. This hardly seems to be the case with the corporate AMT, especially the proposal by the House to provide rebates on past corporate AMT payments. Only about a quarter of taxpayers would benefit from accelerating income tax rate cuts and these are upper income taxpayers who are less likely than others to spend most of their tax savings. Permanent tax cuts also represent a permanent commitment of federal budget resources, at a time when the tremendous budgetary pressures associated with the retirement of the baby boomers are less than a decade away.

I am puzzled by the claim that tax cuts are stimulative but government spending is not. There are many worthy public investments that would contribute directly to GDP while addressing needs that would go unfulfilled if left to the private sector– for example, strengthening our public health, transportation, and security systems. And the primary effect of getting money into the hands of *lower*-income households–either through tax rebates or expanded unemployment benefits–would be to boost consumption spending. People who have lost their jobs and have trouble making ends meet are the ones to target if the goal is to get the most bang for the buck out of our stimulus policies.

Mr. Chairman, I am looking forward to the testimony and discussion with Chairman Hubbard and the other distinguished economists at this hearing. I hope we can clarify some of these issues and contribute to the development of a stimulus package that gets the economy back on track as quickly and effectively as possible.

**Testimony**
**of**
**R. Glenn Hubbard**
**Chairman, Council of Economic Advisers**

**before the**
**Joint Economic Committee, U.S. Congress**

**November 28, 2001**
**10:00 A.M.**

Chairman Saxton, Vice Chairman Reed, and members of the Committee, it is a pleasure to appear before you today to discuss the economic outlook for the United States.

### The Near-Term Economic Outlook

Let me begin by briefly reviewing the present state of the economy and its near-term prospects. In doing so, it is useful to organize thinking around supply conditions – the capacity of the economy to produce goods and services – and demand conditions – the ability and willingness of households, firms, and governments to purchase these services and products.

The events of September 11 had dramatic human and economic implications. As is now apparent, the terrorist attacks on the World Trade Center and the Pentagon resulted in loss of life, physical damages, damage to the financial sector, and interruption of commercial aviation that temporarily restricted the economy's ability to supply goods and services in the short run. These "supply shock" consequences of the attacks substantially reduced the growth rate of GDP during the third quarter and will adversely affect economic growth in the current quarter.

Of course, there are potentially more durable effects as well. The economic aftermath includes shocks to household and business confidence, and increased uncertainty regarding the economic environment. The effects on confidence and uncertainty give rise to a number of additional supply-side costs of transacting business deriving from enhanced security and more costly insurance which reduce output growth.

On the demand side, the attacks and their potential repercussions lowered household and business confidence about the future, and along with it household and business willingness to spend and invest. Prior to the attacks, a focus of policy was to ensure a continued flow of resources – incomes and cash flow – to households and businesses to provide a base for sustained growth in aggregate demand. If confidence effects are substantial, the attacks must necessarily shift our focus somewhat – away from simply providing temporary funds to households, for example, and toward buttressing the confidence of households to make purchases out of those dollars.

What is the outlook in this regard? The most recent Blue Chip consensus estimates of GDP growth indicate a rebound in 2002, with growth at an annual rate of 0.5 percent and 2.6 percent, respectively, in the first two quarters of 2002, and 3.9 percent in the second half of 2002. Even with this recovery, the unemployment rate is likely to rise through 2002. Underlying this outlook is an implicit current decline in confidence that rebounds early next year.

Much recent attention has focused on the possibility that the United States has entered a recession, a debate that has ended with the announcement on November 26 by the National Bureau of Economic Research that the economy reached its cyclical peak in March of this year. To my mind, this announcement is less important than looking forward and anticipating the path for economic policy best able to facilitate the economy's return to potential growth.

How would such a recovery take place? The key factors are growth of gross private domestic investment – especially business investment in equipment and software – and the strength of growth of personal consumption expenditures. The latter constituted 69 percent of aggregate purchases in the third quarter, while the former accounted for another 17 percent. In the third quarter, consumption grew at an annual rate of 1.2 percent and contributed 0.8 percentage point to GDP growth. In contrast, investment declined at an annual rate of 10.7 percent and contributed a decline of 1.8 percentage points to overall GDP growth.

Simple arithmetic shows that without changing any other aspect of economic performance – that is, holding growth in other components of aggregate demand at their third quarter values – simply having investment decline at a slower rate of 5 percent would yield a growth rate of GDP that was nearly a full percentage point higher.

In addition, raising real personal consumption growth from its recent pace of 1.2 percent to the 3.0 percent that prevailed from the second quarter of 2000 through the third quarter of 2001 would yield substantial additional GDP growth.

These are the mechanics of recovery. It is not appropriate to imagine that the future path of state and local government expenditures, federal purchases, and net exports will be the same as in the third quarter. However, this illustrative calculation places attention on the two key aspects of resuming rapid economic growth.

It is not necessary to have an immediate, robust rebound to positive growth in investment in order to have more rapid growth. Simply slowing the decline, or even stopping it, would contribute greatly. The substantial monetary easing since January will contribute greatly in this regard.

Recently, however, the notion that investment will not display even this modest improvement because businesses are burdened with significant excess capital – a "capital overhang" – has gained popularity. This seems unduly pessimistic. While there may be narrow sectors of the economy for which this characterization rings true – as, for example, in the telecommunication infrastructure sector – as a general matter any capital overhang is likely to have been eliminated by the weak investment performance in 2001.

Capital overhang represents the difference between the actual and desired amounts of capital in the form of equipment or structures. Because slower expected output growth lowers the amount of investment necessary to maintain the same capital stock relative to the output it produces, a slowdown in expected economic growth can lower the capital stock firms want to hold, generating a potential overhang and reducing investment. For example, if a near-term slowdown reduced the expecteu ` long-term growth rate by one-fourth percentage point, gross investment would fall $25 billion .. first year in which the slowdown became apparent.

Now, suppose that rapid economic growth in the late 1990s implied that firms had no excess capital in 1999, but that slower economic growth caused the growth rate of the desired capital stock to be roughly 3 percent in 2000. The capital stock in 2000 grew at a 4.2 percent rate and therefore would have created a roughly $100 billion capital overhang. Given the pace of events thus far this year, the capital stock appears to be growing more slowly than the three percent rate. This means under-investment in the capital stock for the year has largely eliminated any overhang that may have developed.

While thinking about capital overhang, it is worth noting that this is different from the conventional notion of unused capacity. During the sluggish growth in 2001, capacity utilization rates have fallen, but this does not imply a capital overhang. First, capacity utilization data focus solely on manufacturing, utilities, and mining and are not representative of the entire economy. Moreover, business capital purchases take time to plan, order, and put in place. For this reason, businesses look beyond current conditions – focusing on sales, cost of capital, and cash flow in the future – to plan investments. In a growth slowdown, the capital stock firms want to hold may continue to rise even though current capacity is not being strained.

To summarize, the basic path of economic recovery incorporates more rapid growth in consumption and a slowing in the decline in investment in the next few quarters. Thereafter, a recovery of positive investment growth would coincide with growth at or above potential.

This baseline forecast corresponds roughly to the consensus of private forecasters. However, it is associated with considerable uncertainty. To see this, consider the range of estimates that underlies the most recent available Blue Chip forecasts. The range reflects a divergence of views about both the depth of the initial decline in confidence and the persistence of that decline. For example, for the fourth quarter, the range between the average of the top ten estimates and bottom ten estimates is from a low of –0.1 percent to a high of –3.3 percent for the fourth quarter of 2001. For the first quarter of 2002, the same gap is from 2.9 percent to –1.7 percent, and 4.3 percent to 0.6 percent in the second quarter of 2002. The gap is from 2.6 percent to –0.1 percent for growth during 2002 as a whole. This range suggests the need to think seriously about downside risks and policies that address the source of the economy's vulnerability in the quarters ahead – vulnerability especially to slower growth of consumption and a continued sharp decline in investment.

**Public Policies to Promote Economic Security**

A key impact of the terrorist attacks has been to make us aware of new risks into the economic environment. One of the challenges is to develop policies that address these risks, but utilize the strengths of the private sector in doing so.

*Growth Insurance*

This perspective informs the Administration's efforts regarding economic growth insurance, or "stimulus." In the current setting, it is important to focus on the potential for downside risks, and develop policies as insurance against a slower and/or more sluggish upturn in economic growth than currently expected – that is to guard against a sustained downturn in business and household confidence or another adverse event.

Insurance, of course, has to be purchased in advance to have any value. Thus the first implication of this view is that we should move now to put into place the correct package of measures. In response to the President's leadership, the House of Representatives acted quickly to pass its stimulus legislation. It is time for the Senate to follow suit.

There has clearly been substantial debate of what should be included in a stimulus package. The growth insurance perspective provides considerable guidance. First, it should be pro-growth – it should enhance long-run incentives to work, invest, take risks, and increase our productivity.

Of course, it should also be cognizant of short-term needs. The President recognized this early on, incorporating tax relief for low-income families and targeted extensions of assistance for displaced workers. This addresses their needs and provides some demand-side insurance for businesses. As a general matter, though, throwing money at the problem does not buy meaningful growth insurance.

Over the past year, the household sector has sustained economic growth in the face of weak business investment. Because personal consumption spending is over two-thirds of aggregate purchases, negative growth in consumption is an important downside risk – declines in consumption would be at the heart of any severe contraction.

However, in part due to the tax cut proposed by the President and passed by Congress last spring, disposable income has held up quite well through the third quarter. Instead, the slowdown in household spending tracks the decline in consumer confidence. Consumer confidence is the issue.

How can public policy address confidence? One part of this response is attention to security and progress against terrorism. On the economic front, surveys of consumer sentiment indicate that individuals are less optimistic in the face of job losses and the prospect of future softening in the labor market. To address confidence, we need to focus on job creation.

One key to this is small businesses, traditionally a source of new jobs in the economy. The best policy for small businesses and entrepreneurs is to reduce their marginal tax rates. For this reason, the President wisely focused on moving forward the marginal tax rate cuts that were passed by Congress in the spring. Lower marginal tax rates both improve incentives and augment the cash flow of small businesses. Recent research by Harvey Rosen of Princeton University shows that through these channels entrepreneurs will expand their payrolls and increase their investments.

The second key is to help businesses overcome the current uncertainty and restart investment spending. At the aggregate level, the resumption of rapid economic growth requires resumption in the growth of capital expenditures. Employment losses have been concentrated in the manufacturing sector – a sector heavily dependent on the health of business investment. For this reason, the Administration has focused on investment incentives – partial expensing – and corporate cash flow – eliminating the corporation Alternative Minimum Tax (AMT), which raises effective tax rates on business in downturns. These growth incentives target the source of the problem, diminished private sector job creation that is associated with the decline in consumer confidence.

Some critics have suggested that investment incentives will not work because of a capital overhang. To the contrary, there is good reason for one to expect the Administration's economic stimulus proposals to be effective in the current setting. Investment incentives – partial expensing – lower the expected cost of capital, raising the amount of capital that firms want to hold. Elimination of the AMT reduces effective tax rates during downturns, again lifting the amount of capital that firms wish to have put in place. These incentives translate into an impetus for more investment. Investment incentives work through expected reductions in the future cost of capital and increases in corporate cash flow. The longer the investment incentives are in place, the greater the stimulus to investment.

To summarize, the Administration's approach is a growth insurance package that contains both demand-side support for purchases and incentives to expand investment and jobs. We expect that timely adoption would raise GDP growth by 0.5 percent in 2002 and help the private sector to create an additional 300,000 jobs.

Because the focus is on delivering incentives and support via the tax system, it can be put into place quite quickly. Because it contains supply-side incentives, it is not heavily dependent on precise timing and fiscal fine-tuning. Also because it is focused on using the private sector – crowding in private activity instead of crowding out – it will not harm the long-term outlook.

The notion of "crowding out" has surfaced in another aspect of the debate over the macroeconomic response to the terrorist attacks – effects of policy responses on interest rates. The right policy at the right time will not cause long-term interest rates to rise. Recent research by Douglas Elmendorf of the Board of Governors of the Federal Reserve System and N. Gregory Mankiw of Harvard University indicates that reduced surpluses for the sort of modest confidence-building package the President outlined would raise long-term interest rates by only three to five basis points. A well constructed fiscal stimulus will affect the out-year budget by only a fraction of this amount, and will have trivial effects on long-term interest rates.

This is not surprising. Bond market participants recognize that the modest tax cuts under discussion are small in the context of the global capital market. More importantly, the markets have absorbed more quickly than some observers the lesson that a strong economy is the source of Federal surpluses and not the reverse. Policies that insure against sub-par growth will also insure against sustained reductions in Federal surpluses.

The principal threat to long-term discipline is the other approach featured in the public debate – additional spending. Japan is the best example of trying to spend one's way to faster growth. It has not worked and will not work. Many such proposals are disguised special interest subsidies and pork-barrel public works proposals.

At the center of the debate, however, have been proposals to expand the scope of social insurance. The President recognized early on that there would be a need to address these aspects of the repercussions of the terrorist attacks. The Administration has proposed tax relief for lower-income families, and extension of Unemployment Insurance (UI) benefits in those areas experiencing a marked increase in unemployment, and flexible National Emergency Grants to provide funds for health insurance, reemployment services, and other needs. These approaches are timely and flexible.

An alternative is broad-based expansion of social insurance programs. This alternative does not, however, fit the perspective of growth insurance. It will not stimulate demand in a the very near-term nor provide supply side incentives. It is not timely, and does not address the underlying problem of job creation, and in some cases would serve to raise – not lower – unemployment.

Some proposals would impose substantial additional costs on businesses and states for hiring new workers – working against job creation and adding fiscal burdens for states. In the past, UI has reflected federalism principles: States determine benefits and payroll tax rates. The proposals endorsed by the Senate Finance Committee contain large benefit increases and expansions of coverage requirements for all states. The annual cost of the expansion in benefits exceeds $8 billion per year – equivalent to a UI payroll tax increase of around one percentage point. Put differently, over $8 billion annually in states' revenues would be forced into a new Federal mandate. In addition to raising the costs of doing business, these proposals would almost certainly increase the unemployment rate.

The Administration's approach is more timely – the President's proposals can be implemented quickly because they rely on existing mechanisms and permit states to target Federal funds effectively. It is a better approach to handling the needs of displaced workers.

The public policy response to the terrorist attacks rightfully includes a carefully constructed set of measures designed to address risks of prolonged and adverse shocks to business and household confidence. Again, these risks are most effectively addressed using the private sector; tax cuts crowd-in the private sector by supporting its job creation, providing



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support to demand, enhancing supply-side incentives, and doing these things in a timely fashion. Spending-oriented alternatives are both less timely and fail to exploit the creativity, flexibility, and innovation of the private sector.

*Terrorism Risk Insurance*

The terrorist attacks indicated that the probability of catastrophic property and casualty losses was higher than anticipated. In the short run, insurers face difficulties in responding; in particular, the current difficulty of evaluating the probability of more events or handling catastrophically large events has made the reinsurance industry reluctant to cover terrorist events. For example, Keith Buckley, an insurance analyst with Fitch Ratings Company, states that it is "the universally stated plan of reinsurance companies to add specific terrorism exclusions to reinsurance coverage." Without reinsurance, primary insurers will be forced to exclude terrorism coverage, charge very high premiums, or withdraw from the market entirely.

The loss of property and casualty insurance against terrorist acts eliminates a mechanism by which the economy can respond efficiently to such contingencies. In general, insurance spreads risks, converting for each business a potential cost of unknowable size and timing into a set of smaller, known premium payments. In normal circumstances, increased risks are translated into higher premiums. This serves the useful economic function of pricing risk, leading the private sector toward those activities where the risk is "worth it" – there might be losses now and then, but on average society will benefit – and away from foolhardy gambles.

For insurance markets, unfortunately, the distinction between risk – not knowing when an event will happen, but having solid knowledge of the odds of an occurrence – and genuine uncertainty about the frequency of an insured event is the key to being able to price efficiently.

Only experience with our new security environment will allow businesses to appropriately price the contingencies that businesses now face.

An interruption of coverage is an extreme, version of an increase in transactions costs as a result of terrorist-associated risks. If existing lines of coverage are renewed, it will quite likely involve substantial increases in premiums.

A withdrawal of insurance coverage would cause large costs as well. Lenders usually require businesses to insure any property they use to secure loans. The terms of terrorism coverage could diminish bank lending for new construction projects. It could as well act as a sharp impediment to transactions that permit existing commercial properties – skyscrapers, pipelines, power plants, and so forth – to change hands. It is important to point out that this "changing hands" is an important economic function. The relative efficiency with which our economy reallocates capital from less productive to more productive uses sets it apart from the economies of many other nations.

Without adequate insurance, it will be difficult to develop, operate, acquire, refinance, or sell property. While lenders may accept alternative terms for their financing, this modification simply disguises the problem. Instead of risk being borne efficiently by the insurance industry, it will be shifted to the banking sector.

In either event, the absence of insurance coverage for terrorism risks will likely raise the difficulty of financing existing commercial structures and deter the construction of new projects. The result could look like a "credit crunch." A rough estimate is an overall reduction in 2002 GDP of 0.3 percentage point if the problem is not solved, with most of the loss early in 2002. This reduced growth rate of GDP would likely be equal to 0.8 percentage point at an annual rate in the first quarter of 2002, 0.7 percentage point in the second quarter of 2002, and lower thereafter. The decline is caused by a reduction in asset values that reduces the consumption purchases of the household sector. In addition, lower valuations reduce the incentive to invest in new structures. The overall liquidity effects also reduce the path for investment in non-residential structures.

The appropriate policy response in this environment is to encourage private market incentives to expand its capacity to absorb and diversify risk. Thus we should seek an approach that recedes as the private market becomes capable of insuring losses on its own, provides customers and firms with appropriate incentives to minimize the expected costs of such an event, and reduces uncertainty about liabilities that arise from the events.

Congress and the Administration have each developed proposals in recent weeks which I hope will soon provide a catastrophic backstop for the private sector that retains market incentives. One part of these efforts has not been well understood, however. The Administration has proposed sensible litigation procedures for mass tort terrorism cases. Specifically the proposals would: (1) consolidate terrorism cases in single Federal court, (2) preserve the pool of defendant resources and provide for just plaintiff recovery by eliminating punitive damage awards, (3) prevent unfair and unnecessary bankruptcies caused by joint and several liability for non-economic damages, and (4) maintain the pool of defendant resources for just plaintiff recovery by preventing double recovery by some plaintiffs.

These proposals should not be confused with or made part of the debate over general tort reform. In fact, there should not be – and in the past has not been – political or philosophical disagreement about the need for alternative litigation procedures in mass tort cases. In fact, the Administration's litigation proposals would apply only in a modest sub-category of mass tort cases, namely, mass tort terrorism cases.

These litigation procedures will help reduce the substantial uncertainty faced by the insurance industry in pricing terrorism risk. A significant component of the terrorism risk to insurers is likely to be the liability component of property and casualty insurance. The Administration's proposed litigation procedures will help to manage that risk and crowd in the private market. Absent these procedures, the resources of liable defendants, including resources from their liability insurance policies, will not suffice to compensate the class of successful plaintiff-victims in mass tort terrorism incidents. For that reason, mass torts often are resolved through bankruptcy (where plaintiffs rarely receive full compensation) or settlement (again, where plaintiffs rarely receive full compensation). Put differently, the procedures will preserve the assets in order that successful plaintiffs are compensated fairly and equitably.

**The Longer-Term Outlook**

Turning toward the longer-term outlook, a few issues arise. The first, and most important, is that the long-term fundamentals of the U.S. economy remain sound. Even during the recent slowdown productivity growth remains strong. Productivity grew at an annual rate of 2.7 percent in the third quarter and averaged 2.5 percent since 1995. The growth in productivity is one of the most important factors determining our long run prosperity, which determines our ability to meet both public and private goals.

Second, over the longer term, one of those objectives will be to address the generalized need for greater security and to "harden" the U.S. economy against the threat of terrorism. In doing so, it is important to minimize the impact on underlying productivity growth. To date, the impact of meeting these needs appears likely to have a modest impact on productivity growth.

Our estimate is that doubling private security spending would lower the rate of productivity growth by no more than 0.1 percentage point over the next several years.

It may be the case that the Nation determines that adequately addressing these needs requires devoting more resources. One possible manifestation would be a genuine need for enhanced outlays for security in the Federal budget. If so, it is sensible to re-prioritize –not just augment – budget resources to address these needs. As with other aspects of addressing terrorism risks, we should not forget the historical lesson that private markets are resilient, efficient, and flexible in meeting new challenges. We should seek as our objective new standards for the security – and perhaps augment Federal resources – but should be wary of dictating how to achieve our objectives. Instead, we need to work to identify the range of risks and the appropriate level of security to require of the private sector. Having done so, it is in our national interest to be both vigilant in ensuring that these standards are met, but flexible in allowing the private sector to do so in an efficient fashion.

Another possibility would be an attempt to hide the costs of addressing terrorism risk by keeping expenditures off public sector budgets, instead mandating security measures in a heavy handed way. One of the success stories of the past thirty years has been the productivity growth derived from deregulation. We should be wary of losing these benefits via excessive new and burdensome regulation, even in the name of enhanced security, as there are more efficient approaches to the same problems.

To conclude, the U.S. economy is very resilient and, with prudent investments in enhancing the private sector's ability to address the risks of terrorism, we have every reason to expect a timely recovery of economic growth and a continuation of our economy's long-term progress.

Thank you again, Mr. Chairman, for the opportunity to appear before you today. I am happy to answer your questions.

# ECONOMISTS' STATEMENT

## An Open Letter
## to Senators Tom Daschle and Trent Lott

The current state of the U.S. economy justifies further fiscal stimulus by the federal government. But the stimulus package passed by the House of Representatives will do little to assist a near term recovery and is likely to undermine growth in the long term.

The basic principles in designing an economic stimulus are: (1) that it be targeted to increase spending immediately; and (2) that it be temporary, phasing out when the economy recovers.

The bill passed by the House fails on both counts. First, it mainly provides permanent tax cuts rather than the temporary measures required by prudent fiscal policy. Second, most of the benefits go to the wealthy and to large corporations.

In addition to being inequitable, tax cuts for the wealthy are less likely to be spent quickly than are benefits to low-income families and the recently unemployed. The tax cuts for large corporations are particularly inappropriate. Large retroactive rebates to a few giant companies will do little to stimulate an economy suffering from insufficient demand. Moreover, the permanent nature of these tax cuts is likely to worsen the long-term budget outlook and may keep long-term interest rates high.

The package passed by the House should be rejected by the Senate and replaced with temporary measures, such as further expanded unemployment benefits, that will increase spending now.

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Economic Downturn of 2001-02:
Recession-Recovery, the Role of Policy, and Risks

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Testimony presented to the Joint Economic Committee, Hearings on The Economic Outlook, Congress of the United States, Cannon House Office Building, Wednesday, November 28, 2001.

# Economic Downturn of 2001-02: Recession-Recovery, the Role of Policy, and Risks

by Allen Sinai*

## A Dangerous U.S. and Global Recession

In one of the most unusual and dangerous business cycle episodes on record, the U.S. and Global Economy have fallen into Recession—very difficult times for businesses and individuals now and to-come in the U.S. and around-the-world, with a severe business sector downturn, falling profits and increased losses, rising joblessness, less growth of income, increasing pressure through recession-related declines of tax receipts on the budgets of the U.S. Government, states and localities, and those of the G-7, developing, and emerging countries. Global trade is shrinking with travel, tourism, and related activities all suffering around-the-world.

The current U.S. downturn, which began in March, on the surface seems like it might be nearing an end, nine months in length against the 11-month average of nine post-W.W. II recessions, far along chronologically relative to the historical average, but, in the aftermath of a long expansion and then excessive U.S. boom, *functionally* far from the point of recovery, in large part stemming from the unusual nature of the downturn, inability of easier monetary policy to reverse the economic slide, and too little fiscal stimulus.

Most previous recessions generically have come from a fully employed economy with undesirable rises in price and wage inflation, accompanied by excesses and imbalances in housing, real estate and the consumer, Fed-induced sharp increases of interest rates, credit crunches, and sometimes negative External Shocks like the Oil Price Shocks of 1973-75 and 1979-80. Such a generic process has propelled the economy downward, mainly through reductions in housing activity, consumption, inventories and capital spending, areas that later became amenable to easier monetary policy given the initial sources of the downturn.

*This downturn has not been typical*; indeed, it is the *only* one since W.W. II clearly initiated from the U.S. business sector, which, in 2000, retreated from a boom state to set in motion downwaves for production and inventories, a collapse of capital spending, less jobs creation, then a global slowdown through reduced trade flows and because of the multinational nature of U.S. corporations, and now, last, weakness in consumption and housing.

*This downturn started in the U.S. business sector, not the typical place nor from the typical sources* of too much inflation, very tight Fed policy, high and rising interest rates, a credit crunch, residential and nonresidential real estate collapses, weakness in business, falling profits, declines in jobs, rises in unemployment, and continuing, but diminishing, negative interactions.

The slide in the U.S. business sector that started the U.S. and global downturns stemmed from a number of reasons, some inherently cyclical, some related to an excessive boom, in some cases "bubble," in technology and telecommunications, and some from higher interest rates. But, *mostly the slowdown came from a diminution of the boom pace of growth in business activity, a slowdown in the growth of profits, disappointment in business expectations, and then a business sector response of cutting-back on production, inventories, capital spending, imports, and people to maintain profits and to maximize shareholder value.*

Cutbacks in production and inventories produced one downcycle. An inventory cycle usually is short-lived. A second downcycle was a downwave and retreat in the growth of capital spending. Capital spending downcycles are usually long-lived. Through trade flows, the "lifeblood" of a global economy, and the multinational nature of U.S. and global business corporations, the "virus" of U.S. business cutbacks spread throughout the world, into our major trading partners Canada and Mexico; to an already recessed Japan, directly and indirectly through increased weakness in a number of Southeast Asian economies heavily exposed to the United States on exports and in technology; then to Germany, a very open economy which lost exports to all the global economy; into France and Italy, heavily exposed to Germany through exports; now the whole Eurozone, Latin America, and the U.K..

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The business sector cutbacks in the U.S. initiated a spreading and cumulative weakness throughout the world, in turn reverberating back to the U.S. through reductions in U.S. exports, adding to the recessionary forces in the U.S. in an unusual way through the new economic dimension of globalization.

With this causal sequence and aggressive reductions of interest rates by the Federal Reserve starting this past January, to stem what, at first, appeared to be just an inventory cycle, consumption and housing expenditures were supported, although less so over time as increased layoffs and unemployment began taking a toll on consumer spending, along with less growth in incomes, worsened household financial positions, diminished confidence, and increased uncertainty over the economy and lost jobs. A Bear Equity Market since March 2000 and less capital gains realizations also have depressed consumer spending. The most positive aspect of the sharply lower interest rates engineered by the Federal Reserve has been a wave of household mortgage refinancing that has reduced mortgage costs and released funds to households for spending, saving, and/or debt reduction off increased asset values of residential real estate collateral. This also constitutes a risk should real estate prices fall for any reason.

*Now, the U.S. and global economy are in the heart of an interactive and mutually reinforcing cumulative downturn,* made worse by the negative shock waves generated from the September 11th Terrorist Attack and its Aftermath, a recessionary and disinflationary/deflationary External Shock coming on top of the processes already in-place.

The Terrorist External Shock has intensified the U.S. economic downturn through its negative effects on consumption, directly and indirectly on business through interruptions to production and increased security costs, with the latest downward wrench in U.S. economic activity spreading throughout the world to intensify the global recession already in place, much as the first negative demand shock did from the U.S. business sector over a year ago.

This External Shock, like many other External Shocks in U.S. business cycle history, if lasting long enough can become integrated into the cyclical experience, in this case a recessionary force through its impacts on the consumer and on business, the risks and uncertainties that have arisen because of the Event, and the ripple effects out of the U.S. to around-the-world.

Financial markets are quick to react to changes in the risks surrounding the fundamentals of the economy occasioned by External Shocks, but the economy itself reacts slowly. Initially, stock prices fell and so did U.S. interest rates on the prospect of a worse downturn and increased uncertainty around next year's economy and profits. Lately, on the positive strides made in the War Against Terrorism in Afghanistan, stock prices have risen, along with interest rates, on decreased risks and the possibility that an economic recovery may occur soon.

So long as the Terrorist Event remains recessionary for the U.S. and Global Economy, inflation should show a significant disinflation thrust, with some deflation. Declines in crude oil prices are part of this process and so long as they remain significantly lower than before, an offset to the recessionary thrust of the Terrorist Event is provided.

The Terrorist Event, like many other external shocks in business cycle history, e.g., the Gulf War in 1990-91, is serving to deepen, intensify and prolong the downturn, but if it leaves no lingering effects or does not last long, the economy can spring back quickly to its previous position.

However, such does not appear to be the case for the Terrorist Event, where fundamental shifts in consumer and business behavior, occasioned by the need for ongoing security and large increases in costs for security, essentially a tax that weakens economic activity as well as producing an inflationary thrust in costs, also disrupts production and productivity. The increased federal government spending associated with the War Against Terrorism can lift GDP, but very likely will have no lasting positive effect on the supply-side of the U.S. economy; indeed, probably will reduce productivity growth and the potential rate of growth of the U.S. economy.

*If the diagnosis for the genesis of the 2001-2002 economic downturn is roughly right, then easier monetary policy, through sharp reductions of interest rates, is unlikely to quickly, or easily, reverse the recession, in the U.S., or globally.*

It is well-known that reductions of interest rates alone, even increased availability of credit, are *not* the prime motivator for business sector spending, the area of activity that is undergoing the sharpest downturn.

*In such a situation, unusual in U.S. business cycle history, the standard medicine of easier monetary policy cannot work in its normal time span. Such has been the case so far,* 11 months since monetary policy began to be aggressively eased in early January.

To the credit of the Federal Reserve, monetary policy was eased aggressively *before* the onset of the Recession, through the contemporary central bank approach of managing the "risks" around economic and inflation prospects. Under such a policy, the central bank need not wait for, nor even expect, nor forecast, a Recession, before taking the appropriate easing, or in the opposite case, tightening decisions.

Thus, *it becomes absolutely essential to employ fiscal policy stimulus, and soon, in this episode,* along with the necessary easier monetary policy, to restart the economy and set into motion forces that can begin and build a cumulative upswing.

*The stakes are high* in this unique business cycle downturn where *both* the U.S. and global economy are in recession, the worst global economic downturn since 1982.

*Since the U.S. started the downturn, it must be the U.S. that will have to be the catalyst to reverse the downturn, to be the engine that gets restarted to reverse the global recession.*

Poor economic performance, bad business, and rising unemployment are undesirable in both the U.S. and elsewhere, but even moreso in these times given the historical record of political instability that stems from bad economic times, let alone to be fodder for terrorist activities.

An economic stimulus package totaling $125 billion to $150 billion, in addition to whatever stimulus will be forthcoming from the personal income tax reductions legislated last year, would be appropriate for the next and subsequent fiscal years.

Already, *some $60 billion to $80 billion of government spending stimulus appears committed* over the next year through increased federal government expenditures relating to the War Against Terrorism.

This amount of federal government spending will lift aggregate GDP and growth of real GDP for a time, but have little lasting effect in terms of permanent jobs creation, productive activities in the private sector, rising productivity and the potential growth of the economy. Such is the case in modern economies, unless federal government spending is targeted to enhance productivity and efficiency, perhaps focusing on education, targeted infrastructure, or new technology development.

*Additional tax reductions to stimulate the economy would be appropriate, some $60 billion to $70 billion over the next fiscal year* to round out the economic policy stimulus.

The main objective should be to stimulate the area of the economy that is currently most depressed, namely the business sector, especially since last year's tax reductions were aimed almost solely at households.

Measures to enhance business capital spending should be favored, including accelerated depreciation, and/or corporate profits tax reductions. Investment tax credits can increase capital spending, but tend to displace future expenditures.

In order to *provide demand-side incentives for business spending and jobs creation*, however, it is necessary to stimulate the sales of business, hence earnings and cash flow.

This can be done through tax reductions for consumers, in order to raise the growth in consumption spending that has markedly diminished and is next in-line for recession-like behavior.

Accelerating the phase-in of the already legislative marginal income tax rate reductions would be stimulative and appropriate, particularly for middle- to low-income taxpayers. Accelerating the phase-in of legislated reductions in higher income tax brackets is more a long-run stimulus than short-run, so that a quicker phase-in of income tax reductions from the 27% to 25% bracket and through increasing the number of households eligible for the new 10% bracket should be favored.

One advantage of the acceleration of income tax reductions in lower income tax brackets is the permanence of the tax reductions. Permanent tax cuts tend to have more beneficial effects on the economy, short- and long-run, than temporary. Of course, with rising unemployment, increased transfers through extending unemployment benefits, a temporary measure, should be put into place.

The advantage of accelerated depreciation, or even full expensing of certain categories of capital spending, is that it is targeted toward the area of the economy that has tumbled the most and where there is considerable risk of delays in reversing the downturn.

Total fiscal stimulus of around $130 billion to $150 billion, along with $40 billion to $50 billion of tax reductions for individuals coming this year from legislation last year, is essential to assure recovery of the economy in 2002.

Table 3 shows the economic impacts for a policy package of about this size, comprised of increased federal government spending and tax reductions for business and individuals.

Tax policy stimulus aimed at consumers and business is assumed, a step-up in the expensing of equipment write-offs by business and lower income taxes through modest rebates in the first half of next year and an accelerated phase-in of the current 28% tax bracket to 25% ahead of what the legislation scheduled for 2006.

Without it, the U.S. economic recovery would be significantly delayed, perhaps until late next year or early 2003, considerably fewer jobs would be created, and productivity growth and potential output of the economy would be significantly less.

The program adds 0.8 percentage points of real economic growth to the U.S. economy in 2002. Without it, the decline in GDP would be about 1%, a significant recession, with economic recovery put off until 2003.

*Given the lags in the reaction of businesses and households to reductions in taxes, it is important to legislate tax reductions soon, before the end of this year, to take effect on January 1, 2002.* All tax reductions have more beneficial short- and long-run effects on the economy, both on the demand- and supply-side, if permanent, rather than temporary.

**Economic Outlook—U.S. and Global**

*The current Decision Economics, Inc. forecast* is a Recession for the U.S. economy and for the Global Economy, a 48-country aggregate, accounting for nearly 97% of total global GDP.

Tables 1 and 2 present the latest projections.

The worst of the U.S. and global downturn appears in-process now, in the U.S. moderate to severe in the *private* sector, the business sector, for consumers and in trade, but quite mild in terms of overall GDP, a poor measure of the state of the economy during times of recession or boom. GDP is propped by compensating and offsetting movements in net exports to the declines in private sector activity, as imports decline by more than exports fall. Declining trade flows, however, imports and exports, are a sure sign of ill health for a given country's economy and, if widespread throughout the world economy, the case now, is a symptom of major global economic weakness. Also, government spending, federal, state and local, a total near 17% of U.S. GDP, is rising, propping GDP, but is narrowly focused in its private sector economic impact.

The Decision Economics, Inc. expectation is for declines of real GDP in the 1% to 2% range during the current quarter and first quarter of 2002, then a modest positive by next spring, and growth in the 2-1/2% to 3-1/2% range in the second half of next year.

In the private domestic U.S. economy, however, the downturn could well last longer, depending upon how consumers react to lower interest rates, mortgage refinancing, and tax reductions, the propensity to spend of a beleaguered U.S. business sector, the rest-of-the-world economies in relation to U.S. exports, and, in particular, when the deep collapse of business capital spending gets reversed.

For 2001, fourth quarter-over-fourth quarter, real GDP is forecast at –0.2%; over a similar period in 2002, at 1.1%. Full-fledged economic recovery is expected to begin sometime around the middle of next year, extending through the second half, with a strong year in 2003, 3.2% growth, about trend potential growth for the U.S. economy.

This forecast assumes additional reductions of interest rates by the Federal Reserve, to 1-3/4% or perhaps as low as 1-1/2% in the key federal funds rate, with a long period of relatively stable, low interest rates, along with increased funding of private sector activities from financial and other intermediaries.

An economic stimulus package also is assumed in the Decision Economics, Inc. forecast, increased federal government spending of $50 billion to $70 billion over the next-year-so, mainly on defense, and through transfers, the latter including support of the airline and insurance industries, and increased unemployment benefits.

Tax reductions for individuals and business also are assumed, approximately $75 billion, consisting of tax rebates to lower income individuals who did not receive them in 2001, an acceleration in the phase-in of the 28% income bracket to 25%, and a 3-year 30% across-the-board reduction in tax lifetimes for all capital equipment.

Without the stimulus package, the expectation for 2002 on GDP would be lowered to between -0.5% and −1% instead of −0.2%. Fourth quarter-to-fourth quarter, the economy would be expected to grow only about 0.5%.

Viable and sustained economic recovery is forecast in the second half of 2002 and the recession, measured as beginning in March 2001, ends in June 2002, 14 months in length, one of the longest in post-W.W. II history.

Globally, the approximate 1% growth for the Global Economy in calendar years 2001 and 2002 constitutes the worst economic downturn for the global economy since 1981-82.

The dividing line for global recession on the global statistics is +1-1/2%.

One danger in the current recession environment lies in the uncertain nature of the global downturn and its pervasiveness and impacts on the U.S. economy. Most countries that are in recession are not able to aggressively stimulate their economies through fiscal policy, only through monetary policy.

Japan shows an intensifying downturn, with not much improvement next year. Germany is now in recession, likely to remain so for another quarter or two. Canada very probably will recess and Mexico is already now in a recession. Several countries in Southeast Asia also are declining in economic activity. And, Latin America, in the aggregate, is down.

The widespread global nature of the current economic downturn is one of the major risks going forward.

**Fiscal Policy and Tax Policy Possibilities**

Numerous candidates for tax reductions exist.

An across-the-board reduction of tax lifetimes for all equipment is one possibility. Yet another is to fully expense the 5-year tax lifetime equipment, which consists mainly of "high tech" categories of spending, basically Information Technology (IT) and Software.

The combination of tax measures that increase sales and targeted tax incentives for business to spend on capital goods and/or new technology goes to the heart of where the U.S. economy is currently most damaged.

Tables 4 to 5 present the results for several tax policies to stimulate the economy, 1) personal and corporate capital gains tax reductions, 2) accelerated depreciation, and 3) sizeable reductions in corporate profits taxes. These are meant to be illustrative of the relative impacts, not necessarily specifically programmatic.

Generally, for the long-run, capital gains tax reduction shows up most favorably. But, for various reasons, including the need to stimulate the economy soon, action to reduce capital gains taxes can be postponed to a later time.

Of the various business tax reductions examined, accelerated depreciation shows up favorably in most economic performance dimensions, particularly in terms of "bang-for-a-buck," i.e., the increase in real GDP per dollar of lost revenue, at least for the programs examined in the Sinai-Boston Macroeconometric Model simulations.

**Risks—Pluses and Minuses**

The risks around the forecast for the next year are numerous, with a number of pluses and a number of minuses.

Some pluses—

1. certainly, the amount of stimulus, monetary and potentially fiscal, in the "pipeline," which appears to be large.

   Interest rates are at the lowest level since the early 1960s, with short-term interest rates reduced 10 times by the Federal Reserve this year, a total of 475 basis points. Long-term interest rates, particularly mortgage rates, also are lower, by about one-half to one percentage point.

2. an economic stimulus package of tax reductions and increased government spending totaling around $150 billion, including increased government spending for the War Against Terrorism, represents a sizeable 1-1/2% of GDP, one of the more stimulative fiscal packages in history. This stimulus is in doubt, however, with Congress and the Administration not yet having agreed upon a package. *Its presence, in the current unique business cycle downturn, is an important ingredient for economic recovery.*

3. lower crude oil and energy costs, if maintained, should raise purchasing power for consumers and businesses, help offset real income lost through jobs losses and the inability to get new jobs, and to shore up profits.

4. then, there are the funds released for mortgage refinancing, available to spend or to save.

5. the underlying structural fundamentals of the U.S. economy appear sound—higher trend productivity growth than previously, a strongly competitive workforce and management, a pro-growth and pro-business administration.

But, despite all these pluses, the recession has rolled on in the US. and global economy for quite some time with no real signs of a turnaround yet.

Some minuses—

1. one is that lower interest rates and easier money do little to stimulate business spending in the U.S. and global economy when it is depressed and when there is considerable overcapacity. Permanently higher sales, earnings, cash flow, and expansion opportunities are necessary for business to spend aggressively.

2. a second is the reliquification of household balance sheets by consumers that is being reflected in a rising personal savings rate, as households use funds released through tax cuts and mortgage refinancing to rebalance the imbalances in household financial positions.

3. yet another impediment to recovery lies in the global downturn, intensifying now in several major regions of the world, such as Japan, Southeast Asia and Germany, and reverberating back to weaken the U.S. economy, prolonging its downturn.

4. The final minus is noneconomic, the Terrorist Event and its Aftermath, along with the uncertainty and risks that Terrorism presents to the U.S. and world economies.

Disruptions to production and increased security costs definitely impede business and prevent businesses from making expansionary decisions.

Households save more and are reluctant to spend in a troubling situation.

A possibility of more terrorist attacks that could disrupt the U.S. or other economies, or an extension of the current War Against Terrorism, is yet other potential negative.

**Concluding Perspectives—When Will Recovery Come?**

By-and-large, the question as to when the U.S. economy will recover, whether and how much help it needs from policy, lies in answers to two simple questions.

The first is what will make business spend? How long will it take before business begins to produce more, rebuild inventories, and spend for capital goods and for expansion, most importantly, for new hiring?

The second revolves around the consumer and how much of any tax reductions or funds released through mortgage refinancing will be spent and how much will be saved.

Ultimately, every business sector downturn gives way to an upturn; it is simply the inherent internal mechanisms of the business cycle that produce a revival.

Where policy can help, and should do so, is in jump-starting the process of a cumulative upturn.

Once done for the United States, given the leverage of the U.S. economy in the rest-of-the-world, the global economy likely will be helped as well.

Stimulative monetary and fiscal policies also need to be applied in Japan, Asia, and the Eurozone, since the U.S. economy alone, even as a primary engine for growth, will not be able to fully bring about global economic recovery all by itself—it can only start it.

In the best of circumstances, economic recovery could come in the first quarter. This actually is very unlikely.

In the worst of circumstances, economic recovery might not start until 2003, also unlikely, particularly if an economic stimulus package is passed.

Most likely, economic recovery should begin somewhere around the middle of next year, making this recession, the tenth since World War II, one of the longest, almost as long as the 16-month episodes in each of 1973-75 and 1979-80.

Decision Economics

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Table 1

**Decision Economics, Inc.**

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## U. S. Economic Forecast

**November 26, 2001**

**(Baseline, Most Likely)**

| | Quarters | | | | | | | Years | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2000:4** | **2001:1** | **2001:2** | **2001:3** | **2001:4** | **2002:1** | **2002:2** | **2000** | **2001** | **2002** | **2003** |
| **Economy** | | | | | | | | | | | |
| Gross Dom. Prod. (GDP) | | | | | | | | | | | |
| Bils. Chain 96 $'s | 9303.9 | 9334.5 | 9341.7 | 9333.4 | 9287.7 | 9252.7 | 9270.2 | 9224.0 | 9324.3 | 9307.0 | 9575.9 |
| Ann. % Chg. | 1.9 | 1.3 | 0.3 | -0.4 | -1.9 | -1.5 | 0.8 | 4.1 | 1.1 | -0.2 | 2.9 |
| % Chg. Yr.-over-Yr. | 2.8 | 2.5 | 1.2 | 0.8 | -0.2 | -0.9 | -0.8 | 2.8 | -0.2 | 1.1 | 3.2 |
| Consumption | 6341.1 | 6388.5 | 6428.4 | 6447.8 | 6429.2 | 6419.5 | 6454.5 | 6257.8 | 6423.5 | 6479.3 | 6653.6 |
| Ann. % Chg. | 3.2 | 3.0 | 2.5 | 1.2 | -1.1 | -0.6 | 2.2 | 4.8 | 2.6 | 0.9 | 2.7 |
| Bus. Fixed Invest. | 1374.5 | 1373.9 | 1320.9 | 1279.8 | 1235.4 | 1204.5 | 1181.1 | 1350.7 | 1302.5 | 1191.1 | 1245.1 |
| Ann. % Chg. | 1.0 | -0.2 | -14.6 | -11.9 | -13.2 | -9.6 | -7.6 | 9.9 | -3.6 | -8.6 | 4.5 |
| Res. Const. | 365.3 | 372.9 | 378.3 | 380.0 | 369.1 | 362.9 | 359.3 | 371.4 | 375.1 | 360.5 | 363.5 |
| Inven. Invest. | 42.8 | -27.1 | -38.3 | -50.4 | -52.4 | -49.7 | -47.7 | 50.6 | -42.1 | -46.8 | -35.2 |
| Net Exports | -421.1 | -404.5 | -406.7 | -395.0 | -392.5 | -388.1 | -383.4 | -399.1 | -399.7 | -383.6 | -396.5 |
| Fed. Govt. | 547.9 | 552.2 | 554.7 | 561.0 | 580.7 | 579.5 | 578.5 | 545.9 | 562.2 | 579.3 | 593.8 |
| Ann. % Chg. | 4.6 | 3.2 | 1.8 | 4.6 | 14.8 | -0.8 | -0.7 | 1.7 | 3.0 | 3.1 | 2.5 |
| State and Local Govt. | 1034.3 | 1050.5 | 1067.4 | 1068.4 | 1076.4 | 1082.3 | 1087.1 | 1026.3 | 1065.7 | 1086.7 | 1109.6 |
| Ann. % Chg. | 2.7 | 6.4 | 6.6 | 0.4 | 3.0 | 2.2 | 1.8 | 3.2 | 3.8 | 2.0 | 2.1 |
| Fed Bdgt. Surpl. | | | | | | | | | | | |
| Unified (Qtry. Rate, NSA, FY) | -2.3 | -22.5 | 193.7 | -41.8 | -45.7 | -37.2 | 66.1 | 236.9 | 127.2 | -76.2 | -94.0 |
| Trade Bal., Gds. & Servs. - Bils. $'s | -401.2 | -380.1 | -355.2 | -299.9 | -348.8 | -348.0 | -321.3 | -375.7 | -346.0 | -327.2 | -333.9 |
| **Vehicles, Housing, Production** | | | | | | | | | | | |
| Vehicle Sales (Mils. Units) | 16.3 | 16.9 | 16.6 | 16.1 | 18.0 | 15.7 | 14.9 | 17.2 | 16.9 | 15.1 | 15.4 |
| Autos - Total (Mils. Units) | 8.3 | 8.6 | 8.4 | 7.9 | 8.9 | 7.6 | 7.4 | 8.9 | 8.5 | 7.5 | 7.9 |
| Light Trucks (Mils. Units) | 8.0 | 8.3 | 8.2 | 8.2 | 9.1 | 8.1 | 7.5 | 8.4 | 8.5 | 7.6 | 7.6 |
| Hous. Starts (Mils. Units) | 1.539 | 1.627 | 1.623 | 1.597 | 1.510 | 1.455 | 1.447 | 1.575 | 1.589 | 1.478 | 1.510 |
| Indus. Prod. (1992=1.000) | 1.457 | 1.435 | 1.413 | 1.396 | 1.364 | 1.351 | 1.361 | 1.457 | 1.402 | 1.367 | 1.414 |
| Ann. % Chg. | -2.6 | -6.1 | -5.9 | -4.8 | -8.8 | -3.7 | 2.9 | 4.5 | -3.8 | -2.5 | 3.4 |
| **Inflation and Wages** | | | | | | | | | | | |
| GDP Price Defl. (% Chg.) | 1.8 | 3.3 | 2.1 | 2.1 | 1.5 | 1.6 | 1.7 | 2.3 | 2.3 | 1.7 | 1.9 |
| PCE Price Defl. (% Chg.) | 1.9 | 3.2 | 1.3 | -0.4 | -1.8 | 1.3 | 1.5 | 2.7 | 1.7 | 0.6 | 1.4 |
| CPI- All Urban (% Chg.) | 2.9 | 4.2 | 3.1 | 0.7 | -0.8 | 1.1 | 1.3 | 3.4 | 2.8 | 1.0 | 1.8 |
| PPI-Fin. Goods (% Chg.) | 4.1 | 5.3 | 1.6 | -3.6 | -6.0 | 0.5 | 0.8 | 3.7 | 2.1 | -0.8 | 2.2 |
| Hrly. Comp. (% Chg.) | 8.9 | 5.1 | 4.8 | 4.5 | 5.0 | 4.9 | 5.0 | 6.1 | 6.1 | 4.9 | 5.2 |
| **Unemployment Rate (%)** | 4.0 | 4.2 | 4.5 | 4.8 | 5.4 | 5.7 | 5.9 | 4.0 | 4.7 | 6.0 | 6.2 |
| **Profits, Income, Saving** | | | | | | | | | | | |
| Corp. Profs. Aftertax - Bils. $'s | 563.0 | 518.9 | 510.3 | 415.0 | 455.1 | 428.5 | 443.2 | 574.0 | 474.8 | 448.7 | 481.0 |
| % Chg. Yr.-over-Yr. | 1.0 | -8.6 | -12.3 | -28.9 | -19.2 | -17.4 | -13.1 | 9.7 | -17.3 | -5.5 | 7.2 |
| Real Disp. Inc. - Bils. 96 $'s | 6634.9 | 6679.0 | 6719.2 | 6923.9 | 6884.5 | 6940.3 | 7000.3 | 6539.2 | 6801.7 | 7022.0 | 7273.9 |
| Ann. % Chg. | 4.2 | 2.7 | 2.4 | 12.8 | -2.3 | 3.3 | 3.5 | 3.5 | 4.0 | 3.2 | 3.6 |
| Pers. Saving Rate (%) | 1.0 | 1.1 | 1.1 | 3.8 | 3.4 | 4.3 | 4.5 | 1.0 | 2.3 | 4.5 | 5.4 |
| **Interest Rates (%)** | | | | | | | | | | | |
| Fed. Funds | 6.50 | 5.60 | 4.19 | 3.42 | 2.16 | 1.78 | 1.79 | 6.26 | 3.84 | 2.17 | 3.23 |
| 3-Mos. Treas. | 6.01 | 4.90 | 3.70 | 3.27 | 1.96 | 1.73 | 1.80 | 5.83 | 3.46 | 2.20 | 3.39 |
| 2-Year Treas. | 5.69 | 4.67 | 4.17 | 3.64 | 2.78 | 2.65 | 2.78 | 6.21 | 3.82 | 3.09 | 3.75 |
| Prime | 9.50 | 8.62 | 7.26 | 6.87 | 5.13 | 4.75 | 4.76 | 9.23 | 6.97 | 5.23 | 5.23 |
| 10-Yr. Treas. | 5.55 | 5.04 | 5.30 | 4.97 | 4.67 | 4.52 | 4.37 | 5.99 | 5.00 | 4.54 | 4.77 |
| 30-Yr. Treas. | 5.68 | 5.45 | 5.71 | 5.52 | 5.23 | 4.98 | 4.80 | 5.91 | 5.48 | 4.95 | 5.01 |
| New AAA-Equiv. Corp. | 7.45 | 6.68 | 6.92 | 6.47 | 6.27 | 5.92 | 5.80 | 7.49 | 6.59 | 6.00 | 6.39 |
| Bond Buyer | 5.47 | 5.17 | 5.27 | 5.10 | 5.05 | 4.87 | 4.74 | 5.71 | 5.15 | 4.92 | 5.20 |
| **Stock Market** | | | | | | | | | | | |
| S&P 500 | 1364.2 | 1275.2 | 1233.0 | 1144.5 | 1128.3 | 1205.6 | 1222.5 | 1426.5 | 1195.2 | 1231.0 | 1326.2 |
| Ann. % Chg. | -27.1 | -23.6 | -12.6 | -25.8 | -5.5 | 30.4 | 5.7 | 7.5 | -16.2 | 3.0 | 7.7 |
| Div. Yld. - S&P 500 (%) | 1.17 | 1.24 | 1.27 | 1.37 | 1.42 | 1.45 | 1.49 | 1.15 | 1.33 | 1.47 | 1.55 |
| S&P 500 EPS ($'s, Rep.) | 9.07 | 9.18 | 4.83 | 10.44 | 9.14 | 10.20 | 10.55 | 50.00 | 33.59 | 42.06 | 46.88 |
| % Chg. Yr.-over-Yr. | -29.0 | -33.2 | -64.2 | -23.9 | 0.8 | 11.1 | 118.4 | 3.8 | -32.8 | 25.2 | 11.4 |
| S&P 500 EPS ($'s, Oper.) | 13.11 | 12.34 | 11.72 | 10.80 | 10.58 | 10.40 | 10.75 | 56.13 | 45.44 | 45.15 | 49.58 |
| % Chg. Yr.-over-Yr. | -4.8 | -11.7 | -21.2 | -23.8 | -19.3 | -15.7 | -8.3 | 8.6 | -19.0 | -0.6 | 9.8 |
| P-E Ratio - S&P 500 (Reported) | 37.6 | 34.7 | 63.8 | 27.4 | 30.9 | 29.5 | 29.0 | 29.3 | 39.2 | 29.3 | 28.4 |
| P-E Ratio - S&P 500 (Operating) | 26.0 | 25.8 | 26.3 | 26.5 | 26.7 | 29.0 | 28.4 | 25.4 | 26.3 | 27.4 | 26.7 |
| **Dollar** | | | | | | | | | | | |
| Trade-Wted. Exch. Rate (Index) | 1.167 | 1.167 | 1.208 | 1.189 | 1.212 | 1.247 | 1.278 | 1.123 | 1.194 | 1.279 | 1.313 |
| Ann. % Chg. | 13.0 | 0.2 | 14.9 | -6.3 | 8.0 | 12.1 | 10.3 | 4.0 | 6.3 | 7.1 | 2.7 |
| Yen/$ | 109.8 | 118.1 | 122.6 | 121.5 | 122.9 | 128.2 | 131.4 | 107.8 | 121.3 | 132.5 | 134.8 |
| DM/$ | 2.25 | 2.12 | 2.24 | 2.19 | 2.21 | 2.26 | 2.31 | 2.12 | 2.19 | 2.30 | 2.36 |
| $/Euro | 0.870 | 0.923 | 0.874 | 0.893 | 0.884 | 0.866 | 0.848 | 0.924 | 0.893 | 0.850 | 0.827 |
| C$/$ | 1.53 | 1.53 | 1.54 | 1.54 | 1.59 | 1.61 | 1.63 | 1.49 | 1.55 | 1.63 | 1.65 |
| $/Stg. | 1.45 | 1.46 | 1.42 | 1.44 | 1.43 | 1.39 | 1.37 | 1.52 | 1.44 | 1.37 | 1.35 |

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Table 2

## World Economic View

**November 26, 2001**
**(Baseline, Most Likely)**

| | Real Growth (1)§ (Percent Change) | | | | Inflation - Consumer Prices (2)§ (Percent Change) | | | | Unemployment Rate§ (Percent) | | | | Current Account (3)§ (Billions of U.S. Dollars) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001** | 2002** | 1999 | 2000 | 2001** | 2002** | 1999 | 2000 | 2001** | 2002** | 1999 | 2000 | 2001** | 2002** |
| **United States** * | 4.1 | 4.1 | 1.1 | -0.2 | 2.2 | 3.4 | 2.8 | 1.0 | 4.2 | 4.0 | 4.7 | 6.0 | -324.4 | -444.7 | -440.7 | -421.3 |
| **Canada** * | 5.1 | 4.4 | 1.1 | 0.9 | 1.7 | 2.7 | 2.5 | 2.0 | 7.6 | 6.8 | 7.0 | 7.5 | 1.2 | 18.1 | 24.5 | 20.8 |
| **United Kingdom (4)** * | 2.1 | 2.9 | 2.2 | 1.4 | 2.3 | 2.1 | 2.2 | 2.0 | 6.0 | 5.5 | 5.1 | 5.4 | -31.0 | -27.8 | -23.5 | -23.5 |
| **Europe** | 2.5 | 3.4 | 1.5 | 0.8 | 1.1 | 2.2 | 2.6 | 1.4 | 10.2 | 9.2 | 8.6 | 9.0 | 54.0 | 9.1 | 4.2 | -8.7 |
| France * | 3.0 | 3.4 | 2.0 | 1.1 | 0.6 | 1.7 | 1.6 | 0.7 | 11.0 | 9.5 | 8.9 | 9.2 | 37.5 | 17.8 | 20.0 | 17.0 |
| Germany * | 1.7 | 3.2 | 0.7 | 0.5 | 0.6 | 1.9 | 2.5 | 1.3 | 10.5 | 9.6 | 9.3 | 9.7 | -17.9 | -18.1 | -9.0 | -9.0 |
| Italy * | 1.6 | 2.9 | 1.8 | 0.5 | 1.6 | 2.5 | 2.8 | 1.6 | 11.5 | 10.6 | 9.6 | 9.9 | 8.1 | -5.6 | -7.6 | -10.0 |
| Switzerland * | 1.6 | 3.0 | 1.6 | 0.4 | 0.8 | 1.5 | 1.0 | 0.2 | 2.7 | 2.0 | 1.8 | 2.5 | 28.9 | 31.5 | 25.0 | 21.0 |
| **Asia - Pacific** | | | | | | | | | | | | | | | | |
| Japan * | 0.8 | 1.5 | -1.2 | -0.1 | -0.3 | -0.6 | -0.6 | -0.4 | 4.7 | 4.7 | 4.9 | 5.8 | 108.3 | 117.6 | 81.3 | 53.5 |
| Australia * | 4.7 | 3.3 | 2.0 | 3.5 | 1.5 | 4.5 | 5.0 | 4.1 | 7.0 | 6.3 | 6.0 | 6.4 | -22.9 | -15.4 | -8.9 | -10.9 |
| New Zealand * | 3.8 | 3.8 | 4.9 | 5.1 | 0.3 | 3.0 | 2.2 | 2.1 | 6.8 | 6.0 | 5.9 | 6.2 | -3.6 | -2.7 | -2.3 | -2.5 |
| **Newly Industrialized Countries** | 7.0 | 8.4 | -0.5 | 2.3 | -0.4 | 0.7 | 2.8 | 2.5 | 4.9 | 3.8 | 4.1 | 4.3 | 64.7 | 50.6 | 50.5 | 48.3 |
| Korea * | 10.9 | 8.8 | 2.0 | 3.3 | 0.8 | 2.3 | 4.5 | 3.8 | 6.2 | 4.1 | 4.9 | 5.1 | 24.5 | 11.1 | 16.1 | 14.6 |
| Taiwan | 5.4 | 6.0 | -2.8 | 0.7 | 0.2 | 1.3 | 2.2 | 2.0 | 2.9 | 3.0 | 3.2 | 3.4 | 8.4 | 8.9 | 15.5 | 14.2 |
| Hong Kong (5) | 3.0 | 10.5 | -0.3 | 2.7 | -4.0 | -3.5 | 0.5 | 1.0 | 6.1 | 5.0 | 4.6 | 4.9 | 10.5 | 8.8 | 7.6 | 6.0 |
| Singapore | 5.9 | 9.9 | -3.1 | 2.4 | 0.0 | 1.4 | 2.7 | 2.3 | 3.5 | 3.1 | 2.8 | 3.1 | 21.3 | 21.8 | 11.3 | 13.5 |
| **Latin America** | 0.3 | 4.4 | -0.2 | 0.3 | 7.9 | 5.1 | 5.1 | 4.9 | 7.9 | 7.7 | 8.2 | 6.1 | -45.7 | -38.7 | -41.9 | -40.4 |
| Argentina | -3.4 | -0.5 | -2.3 | -3.7 | -1.8 | -0.7 | -1.0 | 2.8 | 14.2 | 15.1 | 15.4 | 11.0 | -11.9 | -9.0 | -6.3 | -2.7 |
| Brazil | 0.8 | 4.8 | 0.6 | 0.7 | 8.6 | 4.4 | 6.6 | 4.2 | 7.6 | 7.1 | 7.6 | 5.2 | -25.1 | -24.6 | -24.1 | -23.4 |
| Mexico * | 3.9 | 6.9 | -1.1 | 1.8 | 12.3 | 9.0 | 5.7 | 5.8 | 2.5 | 2.2 | 3.1 | 2.8 | -14.2 | -17.5 | -16.6 | -14.4 |
| Venezuela | -6.2 | 4.7 | 2.8 | 1.5 | 20.0 | 13.4 | 11.8 | 14.1 | 14.2 | 13.0 | 14.0 | 14.0 | 5.5 | 13.4 | 7.1 | 1.6 |
| Chile | -1.1 | 5.4 | 2.3 | 1.6 | 2.3 | 4.5 | 3.7 | 3.6 | 9.7 | 9.2 | 7.5 | 5.0 | 0.0 | -1.0 | -2.0 | -1.5 |
| **World** | 3.0 | 3.9 | 1.0 | 0.9 | 2.7 | 3.1 | 3.1 | 2.0 | 6.5 | 6.0 | 6.1 | 6.7 | -122.4 | -222.2 | -248.7 | -303.5 |
| **OECD** | 2.9 | 3.6 | 0.8 | 0.5 | 2.4 | 3.1 | 2.9 | 1.7 | 6.4 | 5.9 | 6.1 | 6.8 | -198.6 | -333.8 | -338.4 | -368.0 |
| **EU** | 2.4 | 3.3 | 1.6 | 0.9 | 1.2 | 2.1 | 2.6 | 1.4 | 9.2 | 8.2 | 7.7 | 8.0 | 13.5 | -31.3 | -26.5 | -36.2 |
| **Eurozone** | 2.7 | 3.5 | 1.5 | 0.8 | 1.1 | 2.3 | 2.6 | 1.4 | 9.9 | 8.8 | 8.4 | 8.7 | 38.0 | -5.5 | -14.8 | -23.7 |
| **Asia-NICs, Emerging** | 6.5 | 7.4 | 3.3 | 4.7 | 0.8 | 1.2 | 2.5 | 2.9 | 4.2 | 3.9 | 3.9 | 3.9 | 114.4 | 102.1 | 93.4 | 87.7 |

(1) Real GDP.
(2) Annual averages, except for Latin American countries and Russia, which are percent change, December-over-December.
(3) Hong Kong, balance on goods and services.
(4) Retail Price Index ex-mortgage interest.
(5) Average of high-income and low-income CPI measures.
§ Regional and world totals are weighted averages of countries shown.
§ Current account totals are the sum of the countries shown.
§ Growth and inflation totals include the 7 largest Latin American economies, 11 largest industrializing Asian economies and 14 major European economies.

* OECD countries.
** Forecast.

Decision Economics

*Information for Decisions*

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Table 2 (Cont.)

# World Economic View

November 26, 2001
(Baseline, Most Likely)

| | Real Growth (1)‡ (Percent Change) | | | | Inflation - Consumer Prices (2)‡ (Percent Change) | | | | Unemployment Rate‡ (Percent) | | | | Current Account§ (Billions of U.S. Dollars) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001** | 2002** | 1999 | 2000 | 2001** | 2002** | 1999 | 2000 | 2001** | 2002** | 1999 | 2000 | 2001** | 2002** |
| **Europe** | | | | | | | | | | | | | | | | |
| Spain * | 4.1 | 4.1 | 2.6 | 1.5 | 2.3 | 3.4 | 3.7 | 2.3 | 15.9 | 14.1 | 13.2 | 13.0 | -13.7 | -17.4 | -16.5 | -17.0 |
| Portugal * | 3.4 | 3.4 | 1.7 | 1.1 | 2.3 | 2.9 | 4.3 | 2.4 | 4.4 | 4.0 | 4.0 | 4.2 | -9.6 | -10.8 | -10.6 | -13.3 |
| Netherlands * | 3.7 | 3.5 | 0.8 | 0.6 | 2.2 | 2.5 | 4.6 | 2.2 | 3.1 | 2.6 | 2.1 | 2.8 | 15.2 | 13.6 | 9.7 | 10.6 |
| Belgium * | 3.0 | 4.0 | 1.3 | 0.1 | 1.1 | 2.5 | 2.4 | 1.3 | 11.7 | 10.9 | 10.7 | 10.8 | 14.8 | 11.8 | 8.8 | 8.2 |
| Austria * | 2.8 | 3.3 | 0.8 | 0.2 | 0.6 | 2.4 | 2.6 | 1.4 | 6.7 | 5.8 | 6.0 | 6.2 | -4.4 | -5.1 | -4.4 | -4.7 |
| Greece * | 3.4 | 4.3 | 3.5 | 2.5 | 1.9 | 2.8 | 3.2 | 2.2 | 9.9 | 9.6 | 9.2 | 9.5 | -5.2 | -8.1 | -11.7 | -11.7 |
| Ireland * | 10.8 | 11.5 | 6.0 | 2.0 | 1.6 | 5.5 | 4.8 | 3.1 | 5.5 | 4.1 | 3.8 | 4.0 | 0.3 | -0.5 | 0.5 | 0.2 |
| **Scandinavia** | 2.9 | 3.5 | 1.1 | 1.0 | 1.5 | 2.4 | 2.6 | 1.6 | 5.9 | 5.6 | 5.1 | 5.3 | 25.6 | 41.9 | 37.8 | 36.0 |
| Denmark * | 2.1 | 3.2 | 1.2 | 1.1 | 2.5 | 2.9 | 2.3 | 1.6 | 5.7 | 5.4 | 5.2 | 5.4 | 2.9 | 3.2 | 5.3 | 5.0 |
| Sweden * | 3.9 | 3.5 | 1.6 | 0.9 | 0.5 | 1.0 | 2.4 | 1.4 | 5.6 | 4.7 | 3.9 | 4.2 | 8.8 | 6.9 | 6.5 | 6.0 |
| Norway * | 1.2 | 2.2 | 1.0 | 1.3 | 2.3 | 3.1 | 3.1 | 2.1 | 3.2 | 3.5 | 3.4 | 3.5 | 6.2 | 23.0 | 20.0 | 19.0 |
| Finland * | 4.0 | 5.7 | 0.0 | 0.7 | 1.2 | 3.4 | 2.6 | 1.6 | 10.2 | 9.8 | 9.1 | 9.4 | 7.7 | 8.8 | 6.0 | 6.0 |
| **Eastern Europe** | -1.4 | 5.9 | -3.8 | 2.9 | 37.3 | 33.5 | 31.2 | 23.0 | 9.0 | 8.8 | 9.4 | 9.5 | -16.1 | -23.5 | -10.3 | -11.6 |
| Poland * | 4.1 | 4.1 | 0.1 | 1.4 | 7.3 | 10.1 | 6.4 | 5.0 | 12.0 | 14.0 | 15.8 | 15.4 | -11.6 | -9.9 | -5.9 | -5.9 |
| Hungary * | 4.5 | 5.2 | 3.6 | 3.1 | 10.1 | 9.9 | 9.7 | 7.9 | 9.7 | 9.3 | 8.5 | 8.4 | -2.1 | -1.5 | -1.6 | -1.7 |
| Czech Republic * | -0.4 | 2.9 | 3.2 | 2.3 | 2.1 | 3.9 | 4.7 | 4.6 | 8.6 | 9.0 | 8.4 | 7.9 | -1.0 | -2.3 | -2.3 | -2.5 |
| Turkey * | -4.7 | 7.2 | -7.4 | 3.6 | 64.9 | 54.9 | 52.5 | 37.4 | 7.7 | 6.6 | 7.1 | 7.5 | -1.4 | -9.8 | -0.5 | -1.5 |
| **Russia** | 3.0 | 8.3 | 4.9 | 3.9 | 36.6 | 20.1 | 18.0 | 14.2 | 12.6 | 10.4 | 10.7 | 10.5 | 24.1 | 46.2 | 39.5 | 19.6 |
| **Emerging Asia** | 6.2 | 6.9 | 5.2 | 5.9 | 1.4 | 1.4 | 2.4 | 3.1 | 4.0 | 3.9 | 3.8 | 3.7 | 49.7 | 51.5 | 42.9 | 39.4 |
| China | 7.1 | 8.1 | 7.5 | 7.6 | -1.4 | 0.3 | 1.4 | 2.5 | 3.1 | 3.1 | 2.9 | 2.9 | 15.7 | 20.5 | 28.9 | 24.9 |
| India | 6.4 | 5.8 | 3.4 | 4.9 | 3.0 | 2.8 | 2.9 | 3.0 | 5.6 | 5.4 | 5.3 | 5.3 | -2.7 | -4.1 | -6.1 | -6.3 |
| Indonesia | 0.8 | 4.8 | 2.5 | 2.9 | 20.5 | 3.7 | 7.3 | 7.5 | 4.4 | 4.2 | 4.3 | 4.3 | 5.8 | 8.0 | 7.2 | 7.5 |
| Malaysia | 6.1 | 8.3 | -0.1 | 2.3 | 2.7 | 1.6 | 2.8 | 3.3 | 3.4 | 2.8 | 2.5 | 2.5 | 12.6 | 8.4 | 4.1 | 2.0 |
| Philippines | 3.4 | 4.0 | 2.4 | 3.5 | 6.6 | 4.3 | 6.8 | 6.5 | 9.8 | 11.2 | 10.8 | 9.5 | 5.8 | 9.3 | 1.8 | 2.1 |
| Thailand | 4.2 | 4.4 | 0.6 | 1.8 | 0.3 | 1.5 | 2.5 | 2.7 | 1.4 | 1.5 | 1.6 | 1.6 | 12.5 | 9.4 | 7.0 | 9.2 |
| **Middle East** | 3.1 | 5.4 | 2.3 | 3.4 | 3.4 | 1.3 | 2.8 | 3.1 | 8.9 | 8.8 | 8.3 | 8.7 | -4.1 | -2.5 | -1.2 | -1.6 |
| Israel | 3.1 | 6.4 | 0.9 | 2.7 | 5.2 | 1.1 | 2.1 | 2.4 | 8.9 | 8.8 | 8.3 | 8.7 | -3.0 | -1.4 | -0.3 | -0.6 |
| Egypt | 3.1 | 4.4 | 3.9 | 4.3 | 1.6 | 2.7 | 3.6 | 3.8 | --- | --- | --- | --- | -1.5 | -1.2 | -1.0 | -1.2 |
| Jordan | 3.1 | 3.9 | 2.1 | 2.4 | 0.6 | 0.7 | 3.2 | 3.4 | --- | --- | --- | --- | 0.4 | 0.1 | 0.1 | 0.2 |
| **South Africa** | 1.9 | 3.1 | 2.3 | 2.2 | 5.2 | 5.3 | 7.6 | 6.9 | --- | --- | --- | --- | -2.2 | -1.9 | -0.6 | -0.6 |

(1) Real GDP.
(2) Annual averages, except for Latin American countries and Russia, which are percent change, December-over-December.
‡ Regional and world totals are weighted averages of countries shown.
§ Current account totals are the sum of the countries shown.

* OECD countries.
** Forecast.

Table 3

Macroeconomic Effects of Accelerated Depreciation (30 Percent Reduction for Equipment, Temporary),
"Permament" Reduction in the Personal Income Tax Rate to 25 Percent from 28 Percent,
Personal Income Tax Rebate of $14 Billion in 2002 (Temporary -- First and Second Quarters),
$35 Billion Increase in Defense Spending, $10 Billion Increase in Unemployment Insurance
and $5 Billion Loan Guarantee for the Airline Industry*
Changes From Baseline

| | 2002 | 2003 | 2004 | 2005 | 2006 | Average 2002-06 |
|---|---|---|---|---|---|---|
| Real GDP - Level (Bils. '96 $'s) | | | | | | |
| (Diff. in Level) | 70.6 | 99.5 | 105.7 | 110.9 | 98.1 | 97.0 |
| Growth Difference | 0.8 | 0.3 | 0.0 | 0.0 | -0.2 | 0.2 |
| Business Capital Spending, Total (Bils. '96 $'s) | | | | | | |
| (Diff. in Level) | 18.1 | 60.7 | 83.6 | 83.6 | 71.3 | 63.5 |
| Plant, Base (Diff. in Level) | 0.5 | 2.9 | 5.9 | 5.7 | 3.1 | 3.6 |
| Equipment, Base (Diff. in Level) | 18.9 | 61.9 | 82.8 | 83.0 | 73.2 | 64.0 |
| Consumption (Bils. '96 $'s) (Diff. in Level) | 36.2 | 47.9 | 48.5 | 50.7 | 47.1 | 46.1 |
| Net Exports (Bils. '96 $'s) (Diff. in Level) | -14.2 | -19.9 | -21.5 | -22.8 | -20.4 | -19.8 |
| Inflation (Annual Pct. Chg) | | | | | | |
| GDP Chain Price Index Difference | -0.0 | -0.0 | -0.0 | -0.0 | -0.0 | -0.0 |
| Consumer Price Index (All Urban) Difference | -0.0 | -0.0 | -0.0 | 0.0 | -0.0 | -0.0 |
| Household Net Worth (Bils. $'s) Difference | 75.6 | 87.4 | 39.6 | 105.3 | 172.7 | 96.1 |
| Capital Gains Realizations (Bils. $'s) Difference | 3.2 | 5.1 | 4.4 | 5.5 | 5.9 | 4.8 |
| Unemployment Rate (Percent) Difference | -0.2 | -0.2 | -0.3 | -0.3 | -0.2 | -0.2 |
| Employment (Mils. Jobs) (Diff. in Level) | 0.233 | 0.388 | 0.566 | 0.568 | 0.419 | 0.435 |
| Potential Output (Bils. 1996 $'s) (Diff. in Level) | 41.6 | 73.0 | 91.8 | 118.5 | 141.0 | 93.1 |
| Productivity (Annual Pct. Chg.) Difference | 0.4 | 0.3 | 0.1 | 0.2 | 0.1 | 0.2 |
| Labor Force (Annual Pct. Chg.) Difference | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 | 0.0 |
| After-tax Profits (Bils. $'s) (Diff. in Level) | -78.0 | -70.8 | -57.5 | -12.5 | 33.1 | -37.1 |
| Real Dispos. Income (Diff. in Level) | 79.6 | 75.6 | 74.3 | 66.4 | 53.4 | 69.9 |

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy.
Policy changes effective Jan. 1, 2002.

Table 3 (Cont.)

| | 2002 | 2003 | 2004 | 2005 | 2006 | Average 2002-06 |
|---|---|---|---|---|---|---|
| Nom. Dispos. Income | | | | | | |
| (Diff. in Level) | 87.3 | 81.9 | 80.3 | 72.6 | 55.3 | 75.5 |
| Interest Rates (Percent) | | | | | | |
| Federal Funds Rate | | | | | | |
| (Diff. in Level) | -0.01 | 0.11 | 0.09 | 0.12 | 0.10 | 0.08 |
| 90-day Treas. Bill | | | | | | |
| (Diff. in Level) | 0.09 | 0.15 | 0.13 | 0.15 | 0.12 | 0.13 |
| US 10-Year Note | | | | | | |
| (Diff. in Level) | 0.19 | 0.34 | 0.19 | 0.09 | 0.00 | 0.16 |
| AAA-Equiv. Corp. New Issue | | | | | | |
| (Diff. in Level) | 0.14 | 0.27 | 0.12 | 0.02 | -0.06 | 0.10 |
| Aftertax Weighted Average Cost of Debt & Equity | | | | | | |
| (Diff. in Level) | 0.02 | 0.04 | 0.03 | 0.03 | 0.05 | 0.04 |
| S&P 500 Price Index | | | | | | |
| (Pct. Diff. in Level) | 1.0 | 1.1 | 0.5 | 0.0 | -0.3 | 0.5 |
| S&P 500 Operating Earnings per Share | | | | | | |
| Difference | 0.89 | 1.98 | 2.19 | 1.88 | 1.51 | 1.69 |
| Exchange Rate | | | | | | |
| Morgan Trade-Weighted Index | | | | | | |
| (Pct. Diff in Level) | 0.3 | 0.8 | 1.3 | 0.7 | 0.6 | 0.8 |
| Budget Surplus (Unified), FY | | | | | | |
| (Diff. in Level) | -90.6 | -66.6 | -40.8 | -19.8 | 1.6 | -43.2 |
| Budget Surplus (NIPA) | | | | | | |
| (Diff. in Level) | -98.9 | -60.1 | -34.3 | -13.9 | -1.7 | -41.8 |
| Personal Savings | | | | | | |
| (Diff. in Level) | 48.2 | 30.5 | 27.2 | 14.5 | 1.1 | 24.3 |
| Business Savings | | | | | | |
| (Diff. in Level) | 48.4 | 57.0 | 53.7 | 30.7 | 4.9 | 39.0 |
| National Savings | | | | | | |
| (Diff. in Level) | -4.4 | 26.9 | 47.7 | 35.2 | 10.0 | 23.1 |
| Personal Savings Rate | | | | | | |
| (Diff. in Level) | 0.6 | 0.3 | 0.3 | 0.1 | -0.0 | 0.3 |

Table 4
Macroeconomic Effects of Tax Policies*
Changes from Baseline

| | 2002 | 2003 | 2004 | 2005 | 2006 | Avg. 2002-06 |
|---|---|---|---|---|---|---|
| **GDP Growth (Pct. Pts.)** | | | | | | |
| Capital Gains Tax Reduction (a) | 0.4 | 0.6 | 0.3 | -0.0 | 0.0 | 0.2 |
| Accelerated Depreciation (b) | 0.1 | 0.3 | 0.2 | 0.0 | 0.0 | 0.1 |
| Corporate Profits Tax Reduction (c) | 0.0 | 0.2 | 0.3 | 0.3 | 0.1 | 0.2 |
| **GDP (Bils. '96$'s)** | | | | | | |
| Capital Gains Tax Reduction | 35.5 | 92.3 | 121.2 | 124.3 | 128.4 | 100.3 |
| Accelerated Depreciation | 9.0 | 39.7 | 64.4 | 70.2 | 74.3 | 51.5 |
| Corporate Profits Tax Reduction | 4.4 | 21.7 | 52.9 | 84.6 | 100.7 | 52.9 |
| **Consumption (Bils. '96$'s)** | | | | | | |
| Capital Gains Tax Reduction | 35.6 | 68.7 | 85.4 | 90.7 | 99.6 | 76.0 |
| Accelerated Depreciation | 2.9 | 11.2 | 20.4 | 24.3 | 28.3 | 17.4 |
| Corporate Profits Tax Reduction | 1.3 | 4.3 | 13.0 | 30.4 | 45.1 | 18.8 |
| **Business Capital Spending (Bils. '96$'s)** | | | | | | |
| Capital Gains Tax Reduction | 11.3 | 47.2 | 67.5 | 65.3 | 58.0 | 49.9 |
| Accelerated Depreciation | 9.2 | 39.1 | 62.4 | 66.3 | 65.7 | 48.5 |
| Corporate Profits Tax Reduction | 5.6 | 27.0 | 58.8 | 86.3 | 94.5 | 54.4 |
| **Net Exports (Bils. '96$'s)** | | | | | | |
| Capital Gains Tax Reduction | -14.7 | -28.1 | -35.1 | -35.0 | -34.6 | -29.5 |
| Accelerated Depreciation | -2.2 | -7.0 | -12.1 | -16.2 | -17.6 | -11.0 |
| Corporate Profits Tax Reduction | -1.3 | -4.6 | -8.9 | -20.4 | -27.4 | -12.5 |
| **Inflation (CPI-U, Pct. Pts.)** | | | | | | |
| Capital Gains Tax Reduction | -0.0 | -0.0 | -0.0 | -0.0 | -0.0 | -0.0 |
| Accelerated Depreciation | 0.0 | -0.0 | -0.0 | 0.0 | 0.0 | -0.0 |
| Corporate Profits Tax Reduction | 0.0 | -0.0 | -0.1 | -0.1 | -0.0 | -0.0 |
| **Unemployment Rate (Pct. Pts.)** | | | | | | |
| Capital Gains Tax Reduction | 0.1 | -0.1 | -0.2 | -0.2 | -0.2 | -0.1 |
| Accelerated Depreciation | -0.0 | -0.0 | -0.2 | -0.2 | -0.2 | -0.1 |
| Corporate Profits Tax Reduction | -0.0 | -0.0 | -0.0 | -0.2 | -0.2 | -0.1 |
| **Nonfarm Payrolls (Mils. Jobs)** | | | | | | |
| Capital Gains Tax Reduction | 0.083 | 0.307 | 0.617 | 0.713 | 0.704 | 0.485 |
| Accelerated Depreciation | 0.085 | 0.168 | 0.453 | 0.562 | 0.589 | 0.371 |
| Corporate Profits Tax Reduction | 0.044 | 0.088 | 0.066 | 0.377 | 0.548 | 0.225 |

a) Individuals to 10 Percent, Corporations to 17.5 Percent
b) 25 Percent Reduction in Lifetimes for Equipment, 25 Years for Structures
c) 35 Percent to 23 Percent over Three Years

* Macroeconometric model simulations with the Sinai-Boston Model of the U.S. Economy.
Policy changes effective Jan. 1, 2002.

Table 4 (Cont.)

| | | | | | | |
|---|---|---|---|---|---|---|
| | Productivity Growth (Pct. Pts.) | | | | | |
| Capital Gains Tax Reduction | 0.1 | 0.5 | 0.2 | 0.1 | 0.1 | 0.2 |
| Accelerated Depreciation | -0.0 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 |
| Corporate Profits Tax Reduction | -0.0 | 0.1 | 0.3 | 0.2 | 0.2 | 0.2 |
| | Potential Output (Bils. '96$'s) | | | | | |
| Capital Gains Tax Reduction | 13.0 | 58.8 | 83.3 | 101.0 | 118.0 | 74.8 |
| Accelerated Depreciation | -0.3 | 19.9 | 37.3 | 49.8 | 62.6 | 33.9 |
| Corporate Profits Tax Reduction | -0.3 | 10.0 | 45.4 | 74.4 | 98.3 | 45.6 |
| | New Business Incorporations (Thous.) | | | | | |
| Capital Gains Tax Reduction | 5.9 | 15.3 | 16.6 | 17.0 | 17.6 | 14.5 |
| Accelerated Depreciation | 0.2 | 0.8 | 1.2 | 1.4 | 1.4 | 1.0 |
| Corporate Profits Tax Reduction | 0.1 | 0.4 | 0.8 | 1.3 | 1.6 | 0.8 |
| | 90-Day Treasury Bill (%) | | | | | |
| Capital Gains Tax Reduction | 0.12 | 0.31 | 0.40 | 0.34 | 0.41 | 0.32 |
| Accelerated Depreciation | -0.01 | 0.05 | 0.09 | 0.08 | 0.05 | 0.05 |
| Corporate Profits Tax Reduction | -0.01 | 0.05 | 0.11 | 0.19 | 0.26 | 0.12 |
| | 10-Year Treasury Note (%) | | | | | |
| Capital Gains Tax Reduction | 0.08 | 0.19 | 0.27 | 0.20 | 0.20 | 0.19 |
| Accelerated Depreciation | 0.02 | 0.11 | 0.14 | 0.08 | 0.04 | 0.08 |
| Corporate Profits Tax Reduction | 0.05 | 0.13 | 0.20 | 0.25 | 0.22 | 0.17 |
| | S&P 500 Price Index (% Chg.) | | | | | |
| Capital Gains Tax Reduction | 1.1 | 2.1 | 2.3 | 2.1 | 1.7 | 1.9 |
| Accelerated Depreciation | 0.5 | 0.9 | 0.9 | 0.7 | 0.7 | 0.7 |
| Corporate Profits Tax Reduction | 0.2 | 0.4 | 0.5 | 0.3 | -0.1 | 0.3 |
| | S&P 500 Operating Earnings per Share | | | | | |
| Capital Gains Tax Reduction | 0.83 | 1.75 | 1.87 | 1.58 | 1.28 | 1.5 |
| Accelerated Depreciation | 0.39 | 1.11 | 1.48 | 1.36 | 1.18 | 1.1 |
| Corporate Profits Tax Reduction | 0.22 | 0.67 | 1.10 | 1.44 | 1.31 | 0.9 |
| | National Savings (Bils. $'s) | | | | | |
| Capital Gains Tax Reduction | 2.7 | -8.2 | -6.9 | -27.0 | -48.2 | -17.5 |
| Accelerated Depreciation | 8.6 | 28.7 | 44.7 | 44.9 | 40.5 | 33.5 |
| Corporate Profits Tax Reduction | 3.5 | 6.1 | 19.1 | 34.5 | 34.0 | 19.4 |
| | Personal Savings (Bils. $'s) | | | | | |
| Capital Gains Tax Reduction | 36.5 | 14.1 | 1.4 | -21.2 | -37.2 | -1.3 |
| Accelerated Depreciation | 1.9 | 7.9 | 13.2 | 12.6 | 8.9 | 8.9 |
| Corporate Profits Tax Reduction | 1.6 | 3.4 | 13.3 | 24.3 | 28.0 | 14.1 |
| | Business Savings (Bils. $'s) | | | | | |
| Capital Gains Tax Reduction | 21.7 | 35.1 | 34.2 | 31.2 | 30.2 | 30.5 |
| Accelerated Depreciation | 31.8 | 38.8 | 40.2 | 42.0 | 39.5 | 38.5 |
| Corporate Profits Tax Reduction | 24.5 | 50.0 | 75.2 | 72.8 | 67.7 | 58.1 |
| | Federal Budget Surplus (NIPA, Bils. $'s) | | | | | |
| Capital Gains Tax Reduction | -57.3 | -61.1 | -48.1 | -42.2 | -46.0 | -50.9 |
| Accelerated Depreciation | -21.8 | -15.9 | -8.5 | -9.4 | -7.8 | -12.7 |
| Corporate Profits Tax Reduction | -22.9 | -47.8 | -71.0 | -66.3 | -66.4 | -54.9 |

Table 5

Before and After Feedback "Cost" of Tax Policy Changes

Capital Gains Tax Reduction
Individuals to 10 Percent, Corporations to 17.5 Percent

| | 2002 | 2003 | 2004 | 2005 | 2006 | Avg. 2002-06 |
|---|---|---|---|---|---|---|
| Ex-Ante Cost (Bils. $'s) | -75.0 | -78.0 | -74.1 | -73.5 | -74.3 | -75.0 |
| Ex-Post Cost (Bils $'s) | -55.5 | -58.6 | -48.7 | -50.1 | -51.0 | -52.8 |

Accelerated Depreciation
25 Percent Reduction in Lifetimes for Equipment, 25 Years for Structures

| | 2002 | 2003 | 2004 | 2005 | 2006 | Avg. 2002-06 |
|---|---|---|---|---|---|---|
| Ex-Ante Cost (Bils. $'s) | -31.9 | -30.4 | -27.1 | -28.7 | -24.5 | -28.5 |
| Ex-Post Cost (Bils $'s) | -21.6 | -15.3 | -9.1 | -10.6 | -8.3 | -13.0 |

Corporate Profits Tax Reduction
35 Percent to 23 Percent over Three Years

| | 2002 | 2003 | 2004 | 2005 | 2006 | Avg. 2002-06 |
|---|---|---|---|---|---|---|
| Ex-Ante Cost (Bils. $'s) | -24.0 | -48.0 | -72.0 | -72.0 | -72.0 | -57.6 |
| Ex-Post Cost (Bils $'s) | -22.7 | -46.2 | -67.6 | -62.6 | -61.3 | -52.1 |

* Macroeconometric model simulations with the Sinai-Boston Model of the U.S. Economy.
Policy changes effective Jan. 1, 2002.

ACCF

AMERICAN COUNCIL FOR CAPITAL FORMATION

# The Role of Federal Tax Policy and Regulatory Reform in Promoting Economic Recovery and Long-Term Growth

by

Margo Thorning, Ph.D.
ACCF Senior Vice President and Chief Economist
Before the Joint Economic Committee
of the U.S. Congress
November 28, 2001

## INTRODUCTION

My name is Margo Thorning and I am senior vice president and chief economist of the American Council for Capital Formation.

The American Council for Capital Formation represents a broad cross-section of the American business community, including the manufacturing and financial sectors, Fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders, and public finance and environmental policy experts.

The ACCF is now celebrating its 28th year of leadership in advocating tax, regulatory, environmental, and trade policies to increase U.S. economic growth and environmental quality.

Mr. Chairman, we commend you for this timely hearing on the causes of the U.S. economic recession, the impact of the events of September 11, 2001, on the economy, and the impact of changes in the tax code on U.S. economic conditions. My testimony has two central themes. First, changes in fiscal policy can have both short-run stimulative impacts, and if chosen wisely, long-run positive effects that will yield dividends in terms of stronger economic growth well into the 21st century. Second, regulatory reform, especially of U.S. environmental laws, could also accelerate economic growth as well as facilitate the achievement of environmental goals by encouraging new investment and capital turnover, especially in the manufacturing and energy sectors.

## SHORT-RUN ECONOMIC OUTLOOK AND THE "TERROR TAX"

Recent data show that the U.S. economy is in a recession, and that relief may not come before the middle of 2002. Some macroeconomic forecasters predict that a global recession could slow the pace of economic activity for the next two to three years. The causes of the U.S. downturn are widely attributed to the sluggishness of the manufacturing sector that began in 2000, rising energy prices in 2000, the over-

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investment in the high-tech sector, the collapse of the Internet bubble, and the sharp drop in the value of equities during the past year. The terrorist attacks on September 11 were, according to many analysts, the factor that pushed the United States into negative growth for the third quarter of 2001. The events of September 11 and the threat of future attacks have imposed a costly burden, or "terror tax," on businesses, consumers, and federal, state, and local governments. The more recent indication that our energy infrastructure may be the next terrorist target accentuates the need for more investment in energy capacity. Since the confidence of both households and businesses has been shaken by recent events and the rising unemployment rate, restoring the "animal spirits" of both these sectors is critical to economic recovery. Fiscal policy reforms, combined with regulatory reforms (which cost little or nothing), could have both short-run stimulative effects as well as promote the long-run economic growth necessary to maintain U.S. hegemony in world affairs.

## FEDERAL TAX CODE HINDERS ECONOMIC RECOVERY AND THREATENS U.S. INTERNATIONAL COMPETITIVENESS

The U.S. federal tax code contains many provisions that hinder near-term economic recovery as well as sow the seeds for a continued erosion of U.S. international competitiveness. Congress and the Administration have an opportunity that should not be allowed to slip away to make significant tax code reforms that would encourage saving and investment in the United States. Tax reform could also remove some of the incentives for businesses to move offshore or be acquired by a foreign company and would strengthen U.S. multinationals as they attempt to compete abroad. Higher earnings on foreign investment enhance equity values for the approximately 50 million U.S. households that own stock.

### ■ High Tax Rates on New Investment

Even before the "terror tax" of September 11 imposed higher costs (including larger risk premiums for new investment) on U.S. business, investment was taxed harshly. For example, a 2001 analysis by Harvard University Professor Dale Jorgenson (a member of the board of scholars of the ACCF Center for Policy Research) and Yonsei University Professor Kun-Young Yun calculates the significant increase in the effective tax rate faced by most assets after the passage of the Tax Reform Act of 1986. Their new study finds that in 1982, after the enactment of the 1981 Economic Recovery Tax Act, producers' durable equipment had the equivalent of expensing first-year write-off (see Table 1) with a zero effective tax rate. TRA '86 raised the effective tax rate from zero to 32 percent. By 1996, the rate had risen to 36 percent due to corporate and individual income tax rate increases.

If the United States is to meet the challenges of maintaining strong productivity growth in the coming year, new investment in all types of assets, including energy supply, will be required. For example, investor-owned utilities estimate needed capital expenditures of almost $90 billion over the 2001–03 period. A new study by Arthur Andersen, LLP, commissioned by the ACCF Center for Policy Research, shows that the United States ranks in the bottom third or below in terms of capital cost recovery allowances for electricity generation and other energy assets, as well as investments in pollution control (see Table 2 and Figure 1). For example, after five years, a U.S. company recovers only 29 percent of its investment in a combined heat and power facility compared to 90 percent in Malaysia, Thailand, and Columbia, 51 percent in Germany, and 45 percent in China. Thus, investment costs are recovered much more quickly in these and other countries with which the United States competes or where U.S. business might choose to locate or expand manufacturing operations. (See previous ACCF testimony at www.accf.org for additional international comparisons.)

Corporate tax rates are also high in the United States relative to our competitors, and this tendency is worsening. As shown in Table 3, the average top corporate income tax rate in the European Union has dropped from 34.4 percent in 1995 to 31.7 percent in 2001; the top U.S. corporate income tax rate was 35 percent in 1995 and remains at that level today.

## ■ Tax Rates High on Foreign-Source Income

Tax rates on foreign-source investment, which are indicators of how much encouragement domestic firms are given to enhance their economic viability by expanding operations abroad, again show the United States falling behind. The effective U.S. tax rate on foreign-source investment is 43.2 percent versus an average of 36.7 percent in the other G-7 countries (see Figure 2).

The disadvantages that U.S. firms face when competing in global markets is further illustrated by a 1997 study sponsored by the ACCF Center for Policy Research showing that U.S. financial service firms face much higher tax rates on foreign-source income than do their international competitors when operating in a third country such as Taiwan (see Figure 3). A 12-country analysis shows that U.S. insurance firms are taxed at a rate of 35 percent on income earned abroad compared to 14.3 percent for French-, Swiss-, or Belgian-owned firms. As a result, U.S. firms face tax rates that are as much as 145 percent higher than those faced by their competitors on income earned in the same third country. Consequently, foreign financial service firms can offer products at lower prices than can U.S. firms, giving them a competitive advantage in world markets.

## ■ U.S. Companies Increasingly Bought by Foreign Companies

U.S. companies are increasingly acquired by foreign firms. Another way of assessing the impact of the U.S. tax code on the competitiveness of U.S. companies is to examine trends in cross border mergers involving U.S. and foreign firms. In recent years, the vast majority of large cross-border mergers resulted in the U.S. firm being acquired by the foreign firm, with their legal headquarters being moved abroad. As a recent analysis by PricewaterhouseCoopers shows, foreign acquisitions of U.S. companies far exceeded U.S. acquisitions of foreign companies in the 1998–2000 period, both in terms of the number of transactions and the dollar value of the transactions (see Table 4). For example, in 2000, two-thirds of all large mergers and 79.2 percent of the dollar value of the transactions resulted in a U.S. firm being acquired by a foreign firm. For financial service firms, the trend of a U.S. company being acquired by a foreign firm is even more pronounced.

## ■ Corporate Alternative Minimum Tax

Any effort to spur economic recovery must include repeal of the corporate alternative minimum tax. Because the AMT is a pro-cyclical tax, making the downturn in the business cycle more pronounced and thus requiring companies to pay higher taxes when profits are down, the need for repeal is particularly urgent now. The immediate impact of repeal is bottom-line tax relief for AMT companies. Once the corporate AMT is repealed, estimated tax payments for companies in AMT would be reduced, freeing up resources for companies to use for their business needs. The current economic slowdown will push more companies into the AMT. According to a U.S. Treasury Department study, nearly 50 percent of America's largest companies were in AMT during the last economic downturn (1989–91). Paying higher taxes, such as AMT payers do, will only further exacerbate the anticipated economic recession.

Based on results of a recent survey of the National Association of Manufacturers on behalf of the AMT Coalition for Economic Growth, 50 percent of the respondents indicated that either they were currently paying the AMT or expected to pay the AMT in near future. Importantly, the survey represents companies of all sizes and a broad cross-section of industries. Corporate AMT repeal is the necessary initial first step in any economic recovery package because it will provide immediate, bottom-line tax relief for AMT companies. Once the corporate AMT is repealed, estimated tax payments for companies in AMT would be reduced, freeing up resources for companies to use for their business needs. With company cash flow tight and profits down, repealing the corporate AMT is an important step in reviving U.S. economic growth.

## ■ Regulatory Barriers Retard U.S. Investment Spending

Reforms to federal and state regulations of all types could have a significant impact on near-term investment as well as long-run growth by removing some of the uncertainty associated with the return on new capital expenditures. According to AEI-Brookings Joint Center for Regulatory Studies scholar Robert W. Hahn, both Democrats and Republicans are placing increasing emphasis on the need for regulatory reform. And while the individuals and parties have different notions of how to implement reform, the degree of consensus is surprising. For example, politicians and the general public are becoming increasingly aware of the paperwork burden that both federal and state regulations impose. They are also growing more sensitive to the large number of counterproductive regulations. Several years ago, former senator and Democratic presidential candidate George McGovern opened an inn in Connecticut to fulfill a lifelong dream. The inn eventually went bankrupt. McGovern told his tale of woe in a *Wall Street Journal* op-ed, where he blamed part of the failure of the inn on the needless red tape and excessive costs that regulations impose.[1]

Dr. Hahn observes that we need to examine the revolution in regulation not only in terms of its impact on national economies, but also in terms of its potential international effects. For example, stringent regulation of the environment in one country may induce firms to relocate to other countries. In addition, product specifications introduced under the guise of protecting consumers may give domestic producers a competitive advantage. For example, the World Trade Organization ruled that a U.S. regulation for cleaner gasoline constituted a trade barrier that should be removed. Imposition of near-term limits on greenhouse gases as mandated by the Kyoto Protocol would also dramatically change trade and investment patterns. Thus, regulation can dramatically influence the pattern of international trade and investment.

The international ramifications of domestic regulation are likely to increase in importance as markets become more global. The growth in the size of markets is an inevitable result of the decreasing costs of transportation and communication. Capital can be now moved halfway around the world with one keystroke. Dr. Hahn notes specific examples of regulations that retard investment (as well as the development of new technology) are documented in a 2001 study by the Business Roundtable.[2] In the manufacturing and energy sector, for example, New Source Review (NSR) requirements under the Clean Air Act have reduced capital spending and prevented the adoption of energy-efficient technologies in the utility sector and in many industries; inflexible Clean Air Act regulatory requirements that prevent emissions trading or netting (emissions trades within a plant facility); and inadequate scientific and economic bases for environmental regulations.

A significant number of the proposed solutions to these regulatory barriers call for improving current regulatory and permitting requirements. The proposed solutions focus on four main points: substituting performance standards for technology-specific standards; establishing broad environmental performance standards for manufacturing plants and industry; allowing regulatory agencies to consider inherent trade-offs among competing environmental, safety, and energy-efficiency goals; and providing a consistent set of policies among the various regulatory agencies.

In sum, regulatory reform with increased reliance on cost-benefit analysis should be part of the strategy for stimulating the U.S. economic recovery.

## IMPACT OF POLICY CHANGES

### Short-Run Tax Policy Stimulus Options

According to a new analysis by Dr. Allen Sinai, president and chief global economist of Decision Economics, corporate income and capital gains tax cuts would indeed stimulate the U.S. economy, yield higher GDP and investment, and increase employment. For example, cutting top individual and corporate capital gains tax rates in half would increase real GDP by an average of $120 billion per year over the 2002–10 period and produce 621,000 new jobs per year (see Table 5).

Corporate income tax reductions (from 35 percent to 23 percent) and shortening the depreciable lives of assets (by 25 percent and reducing real estate depreciation from 39 to 25 years) also provide positive stimulus. When the dynamic impact of the various tax policy changes is factored in, the revenue losses are relatively small.

The results of Dr. Sinai's simulations on the impact of policies that reduce the cost of new investment suggest that legislation already before the 107th Congress, such as S. 1293, the Climate Change Tax Amendments of 2001, sponsored by Senators Larry Craig (R-ID), Frank Murkowski (R-AK), Chuck Hagel (R-NE), and Pete Domenici (R-NM), would provide both short-term stimulus and long-run benefits. The bill, which provides tax incentives in the form of investment tax credits, extension of R&D credits for voluntary reduction, and sequestration of greenhouse gases and technology development, would likely have positive impacts on the environment, economic growth, employment, and energy security.

### Tax Policy Options for Long-Run Economic Growth

While certain tax stimulus bills under consideration by the U.S. Congress are steps in the right direction, especially the focus on capital cost recovery, net operating loss extension, corporate alternative minimum tax repeal, and extension of subpart F exceptions, the measures fall far short of what is needed. Policymakers must move the United States forward with a viable tax code designed for the challenges of the 21st century, including globalization of business and greater use of e-commerce and the Internet to conduct operations from anywhere in the world.

A recent analysis by Dr. Allen Sinai, examining fundamental reform of the U.S. tax system by switching to a tax system where all saving is tax exempt, all new investment is written off in the first year, and interest expense is not tax deductible, shows strong increases in GDP, investment, employment, and federal tax receipts. If this tax system had been in place from 1991–2004, GDP would have been 5.2 percent higher every year, consumption and investment would have been greater, and employment higher by over 500,000 jobs per year (see Table 6).

## CONCLUSION

Dr. Sinai's research shows that progrowth tax cuts for individuals and corporations cost relatively little in terms of tax revenue but strongly promote economic growth. Regulatory reforms should be instituted at the same time to further reduce barriers to investment and technological change. As a consequence, the United States would emerge from the current economic downturn stronger and better able to promote the spread of open markets and democracy worldwide. ❖

## NOTES

1. Robert W. Hahn, *Revising Regulatory Reform: A Global Perspective* (Washington, D.C: AEI-Brookings Joint Center for Regulatory Studies, 2000), pp. 2–3.

2. The Business Roundtable, "Unleashing Innovation: The Right Approach to Global Climate Change," Washington, D.C., April 2001.

**Table 1 Effective Federal Tax Rate on Business Assets**

| | Producers' Durable Equipment | Nonresidential Structures | Residential Structures | Inventories and Land | All Assets |
|---|---|---|---|---|---|
| 1981 | 35% | 50% | 38% | 56% | 47% |
| 1982 | 0% | 27% | 28% | 56% | 31% |
| 1987 | 32% | 31% | 27% | 44% | 36% |
| 1996 | 36% | 39% | 31% | 46% | 40% |

Source: Dale W. Jorgenson and Kun-Young Yun, *Investment Volume 3: Lifting the Burden: Tax Reform, the Cost of Capital, and U.S. Economic Growth* (Cambridge, Mass.: MIT Press, 2001)

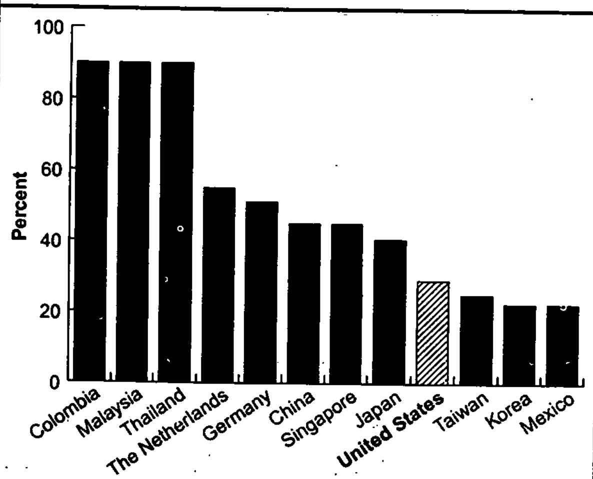
**Table 2 Percent of Investment Recovered After Five Years for Energy Investment and Pollution Control Equipment**

| | Electricity Generating Plants | | | Electricity Transmission & Distribution Lines | Combined Heat & Power Generation Facilities Using Conventional Fuel (Assumes Power for Sale) | Distribution of Industrial Steam & Electricity Generated for Self-Use | Pollution Control Equipment | |
|---|---|---|---|---|---|---|---|---|
| | Gas | Coal | Nuclear | | | | Input Modification (e.g., scrubbers) | Discharge Modification (e.g., thermal discharge control) |
| United States | 37.67 | 29.08 | 37.67 | 29.08 | 29.08 | 37.67 | 64.63 | 64.63 |
| Brazil | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| Canada | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| China | 22.50 | 22.50 | 22.50 | 45.00 | 45.00 | 45.00 | 45.00 | 45.00 |
| Colombia | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 | 100.00 | 100.00 |
| Germany | 40.95 | 40.95 | 34.09 | 34.09 | 51.11 | 40.95 | 52.26 | 52.26 |
| Japan | 11.84 | 11.84 | 11.84 | 31.91 | 40.62 | NC | NC | NC |
| Korea | 11.13 | 11.13 | 11.13 | 22.50 | 22.50 | 22.50 | 22.50 | 22.50 |
| Malaysia | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 | 100.00 | 100.00 |
| Mexico | 22.50 | 22.50 | 22.50 | 22.50 | 22.50 | 22.50 | 100.00 | 100.00 |
| The Netherlands | 55.00 | 55.00 | 55.00 | 55.00 | 55.00 | 55.00 | 55.00 | 55.00 |
| Singapore | 45.00 | N/A | N/A | 45.00 | 45.00 | 45.00 | 70.00 | 50.00 |
| Thailand | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 | 90.00 |
| Taiwan | 20.00 | 14.30 | 14.30 | 33.33 | 25.00 | 33.33 | 100.00 | 100.00 |

Notes:
- Interest rates are from IMF's *International Financial Statistics*, April 2000.
- Unless otherwise noted, the interest rates are the lending rates (period averages per annum) for December 1999.
- Korean interest rates are from latest period reported, November 1999.
- Taiwan interest rate not reported. Chinese interest rate used for this calculation.
- N/A: Data is not yet available.
- NC: Data is unclear. Further clarification necessary.

Source: Preliminary data from Arthur Andersen, LLP, November, 2001.

**Figure 1 Combined Heat and Power Facilities: Percent of Cost Recovered After Five Years**
Cumulative through five years



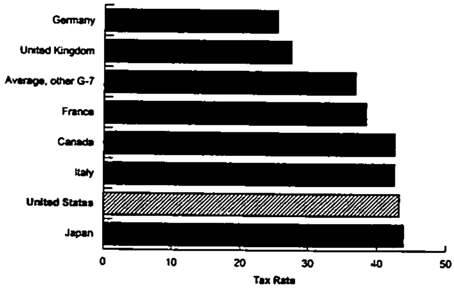

Source: Preliminary data from Arthur Andersen, LLP, November, 2001.

**Table 3 Central Government Corporate Income Tax Rates, 1995–1999**

| Country | 1995 | 2001 |
|---|---|---|
| Australia | 33.0 | 34.0 |
| Austria* | 34.0 | 34.0 |
| Belgium* | 39.0 | 40.2† |
| Canada | 29.0 | 27.0 |
| Denmark* | 34.0 | 30.0 |
| Finland* | 25.0 | 29.0 |
| France* | 33.0 | 33.33 |
| Germany* | 45.0 | 25.0 |
| Greece | 35.0 | 37.5 |
| Ireland* | 40.0 | 20.0 |
| Italy* | 36.0 | 36.0 |
| Japan | 38.0 | 30.0 |
| Luxembourg* | 33.0 | 30.0 |
| Netherlands* | 35.0 | 35.0 |
| New Zealand | 33.0 | 33.0‡ |
| Norway | 19.0 | 28.0 |
| Portugal* | 36.0 | 34.0 |
| Spain* | 35.0 | 35.0 |
| Sweden* | 28.0 | 28.0 |
| Switzerland* | 4.0–10.0 | 8.5 |
| Turkey | 25.0 | 30.0 |
| United Kingdom* | 33.0 | 30.0 |
| **United States** | **35.0** | **35.0** |
| European Union | 34.4 | 31.7 |
| **Average** | **32.4** | **30.6** |

*European Union member state.
†Effective tax rate.
‡For the year ending March 2001.

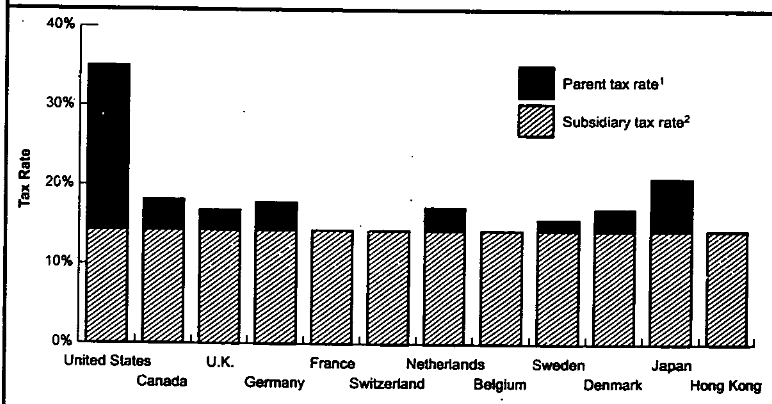
**Figure 2 Effective Tax Rates on Foreign-Source Investment**




Note: Tax rates include both the corporate and personal income tax on investment.

Source: *Enterprise Economics and Tax Reform* (Washington, D.C.: Progressive Foundation, Progressive Policy Institute, October 1994).

**Figure 3 International Comparison of Tax Rates on Foreign Income Earned by Insurance Companies Operating in a Third Country Such as Taiwan**
By country of residence of parent company




1. "Parent" means residence country income tax on parent company.
2. "Subsidiary" means local income tax on foreign subsidiary.

Source: Thomas Horst, "The Impact of the U.S. Tax Code on the Competitiveness of Financial Service Firms" (Washington, D.C.: American Council for Capital Formation Center for Policy Research, July 1997).

**Table 4 Large Cross-Border Mergers and Acquisitions, 1998–2000**
Millions of dollars

| Item | Firms | | Transaction Value | |
|---|---|---|---|---|
| | Number | Percent | Amount | Percent |
| | **1998 Mergers and Acquisitions** | | | |
| **All target firms** | 51 | 100.0 | $175,464 | 100.0 |
| *Foreign acquisition of U.S. firm* | *34* | *66.7* | *$151,283* | *86.2* |
| U.S. acquisition of foreign firm | 17 | 33.3 | $24,181 | 13.8 |
| **Financial services target firms** | 15 | 100.0 | $14,867 | 100.0 |
| *Foreign acquisition of U.S. firm* | *12* | *80.0* | *$11,316* | *76.1* |
| U.S. acquisition of foreign firm | 3 | 20.0 | $6,551 | 23.9 |
| | **1999 Mergers and Acquisitions** | | | |
| **All target firms** | 77 | 100.0 | $224,458 | 100.0 |
| *Foreign acquisition of U.S. firm* | *45* | *58.4* | *$163,579* | *72.9* |
| U.S. acquisition of foreign firm | 32 | 41.6 | $60,879 | 27.1 |
| **Financial services target firms** | 9 | 100.0 | $35,166 | 100.0 |
| *Foreign acquisition of U.S. firm* | *8* | *88.9* | *$33,796* | *96.1* |
| U.S. acquisition of foreign firm | 1 | 11.1 | $1,370 | 3.9 |
| | **2000 Mergers and Acquisitions (through November)** | | | |
| **All target firms** | 96 | 100.0 | $243,436 | 100.0 |
| *Foreign acquisition of U.S. firm* | *65* | *67.7* | *$192,793* | *79.2* |
| U.S. acquisition of foreign firm | 31 | 32.3 | $50,643 | 20.8 |
| **Financial services target firms** | 16 | 100.0 | $60,233 | 100.0 |
| *Foreign acquisition of U.S. firm* | *12* | *75.0* | *$48,093* | *79.8* |
| U.S. acquisition of foreign firm | 4 | 25.0 | $12,140 | 20.2 |

Note: Large is defined as mergers in excess of $500 million.

Source: Carl A. Dubert and Peter R. Merrill, Taxation of U.S. Corporations Doing Business Abroad" U.S. Rules and Competitiveness Issues, second edition (Financial Executives International Research Foundation. 2001), p. 77.

**Table 5 Economic Impact of Alternative Tax Stimulus Plans**
Difference from baseline, dollars in billions

| | (1) Capital Gains Rate Cuts: Individual & Corporate | | (2) Corporate Income Tax Rate Reduced From 35% to 23% | | (3) Accelerated Depreciation | | (4) Corporate Income Tax Cut, Accelerated Depreciation & Capital Gains | |
|---|---|---|---|---|---|---|---|---|
| | 2002–06 | 2002–10 | 2002–06 | 2002–10 | 2002–06 | 2002–10 | 2002–06 | 2002–10 |
| **Real GDP Level ('96$) (average)** | $100 | $120 | $53 | $69 | $52 | $65 | $196 | $253 |
| Percent change from baseline | 1.0% | 1.1% | 0.5% | 0.6% | 0.5% | 0.6% | 1.9% | 2.3% |
| **Investment ('96$)** billions of dollars | $50 | $54 | $54 | $69 | $48.5 | $61.5 | $145 | $182 |
| Percent | 3.5% | 3.5% | 3.7% | 4.3% | 3.4% | 3.9% | 13.0% | 13.0% |
| **Employment** Average, in millions | 0.485 | 0.621 | 0.225 | 0.336 | 0.371 | 0.492 | 1.100 | 1.500 |
| **Cost of Capital** | -0.33% | -0.27% | 0.24% | 0.31% | -0.01% | -0.03% | -0.10% | 0.01% |
| **S&P 500 Price** Percent difference in level | 1.30% | 1.70% | 0.30% | -0.01% | 0.70% | 0.80% | 2.80% | 2.30% |
| **Total Federal Tax Receipts** Average | -$53.0 | -$50.0 | -$52.0 | -$57.0 | -$13.0 | -$7.1 | -$114.0 | -$109.0 |
| **Bang for the Buck** Ex post,* ratio | 1.99 | 2.66 | 0.93 | 1.23 | 4.53 | 11.59 | 1.83 | 2.75 |

*Incorporates dynamic feedback from changes in tax policy.

Explanation of Simulations:

(1) **Capital gains tax reductions for individuals and corporations:** 20 percent to 10 percent for individuals and a reduction in the capital gains tax rate for corporations from 35 percent to 17.5 percent.
(2) **Profits tax reductions** from 35 percent to 23 percent, three stages of 4 percentage points per year starting in January 2002.
(3) **Accelerated depreciation of equipment and plant:** 25 percent reductions in lifetimes for all categories of equipment subject to depreciation and for plant and property to 25 years from the current 39-year tax allowable lifetime.
(4) **All of the tax incentives (1–3) combined.**

Source: Allen Sinai, Decision Economics, November 2001.

**Table 6 Economic Impact on the United States of Switching to a Consumption Tax in 1991**
Expensing business investment, removal of the business and personal interest deduction, and tax exemption of savings

| | Average 1991–1995 | Average 1996–2000 | Average 2001–2004 |
|---|---|---|---|
| **Real GDP—level (billions of 96$)** | | | |
| Base | 7,085.8 | 8,499.6 | 10,113.1 |
| Simulation of consumption tax | 7,203.2 | 8,890.0 | 10,637.7 |
| (Difference in level) | 117.5 | 390.5 | 524.6 |
| (Percent change in level) | 1.7% | 4.6% | 5.2% |
| **Business capital spending, total (billions of 96$)** | | | |
| Base | 684.2 | 1,092.0 | 1,599.6 |
| Simulation of consumption tax | 824.9 | 1,495.6 | 2,168.8 |
| (Difference in level) | 140.7 | 403.5 | 569.2 |
| (Percent change in level) | 20.6% | 37.0% | 35.6% |
| **Consumption (billions of $96)** | | | |
| Base | 4,761.7 | 5,717.2 | 6,746.3 |
| Simulation of consumption tax | 4,773.3 | 5,843.4 | 7,021.5 |
| (Difference in level) | 11.6 | 126.1 | 275.3 |
| (Percent change in level) | 0.2 | 2.2 | 4.1 |
| **S&P 500 Price Index** | | | |
| Base | 449.1 | 1081.9 | 1803.2 |
| Simulation of consumption tax | 557.4 | 1370.5 | 2123.4 |
| Difference | 108.4 | 288.6 | 320.2 |
| (Percent difference in level) | 24.1% | 26.7% | 17.8% |
| **Employment (millions of persons)** | | | |
| Total payrolls, base | 111.8 | 125.8 | 138.5 |
| Total payrolls, simulation of consumption tax | 111.8 | 129.3 | 140.9 |
| (Difference in level) | 0.0 | 3.6 | 2.4 |
| **Productivity (annual percent change)** | | | |
| Nonfarm business, base | 1.5 | 2.7 | 2.3 |
| Nonfarm business, simulation of consumption tax | 2.6 | 2.8 | 2.8 |
| Difference | 1.1 | 0.1 | 0.5 |
| **Total federal tax receipts** | | | |
| Base | 6,210.5 | 8,853.2 | 9,179.3 |
| Simulation of consumption tax | 5,745.5 | 8,821.0 | 9,607.7 |
| (Difference in level) | -465.0 | -32.2 | 428.5 |

Source: Margo Thorning, "U.S. Capital Formation: How the U.S. Tax Code Discourages Investment" (Lewisville, Tex.: Institute for Policy Innovation, forthcoming), using data from Allen Sinai, "Macroeconometric Model Simulation With the Sinai-Boston Model of the U.S. Economy," unpublished study, 2001.

Testimony of
Alan S. Blinder
Professor of Economics, Princeton University
Partner, Promontory Financial Group, LLC
Vice-Chairman, The G7 Group, Inc.

to the
Joint Economic Committee
United States Congress
Washington, DC
November 28, 2001

Thank you, Mr. Chairman and members of the Committee.

As I was preparing this testimony, it occurred to me that if you reverse the word "outlook," you get "look out!" That's a bit the way I feel about the outlook for the U.S. economy right now. Forecasting the economy's near-term future has always been a hazardous occupation; the usual uncertainties are daunting, and precision is out of the question—except by luck. But today we have, layered on top of the usual *economic* uncertainties, a host of extremely unusual, indeed unprecedented, *geopolitical* uncertainties--all of which make forecasting nearly impossible at the moment. But frankly, I'm worried about the downside risk.

There is, I hasten to say, a happy scenario leading to a sharp V-shaped recession and recovery. But I call this the "everything-goes-right" scenario because among the things that must happen are most or all of the following:

1. Congress must pass a sensible stimulus bill—one that really stimulates the economy—in short order.
2. Oil prices must remain low.
3. There must be no more serious, confidence-shattering acts of terrorism in the United States.
4. The war in Afghanistan must continue to go well.
5. The war must not spread to the Persian Gulf (e.g., to Iraq), which could cause another oil shock, or, say, destabilize Pakistan.

In this "everything-goes-right" scenario, we might have a negative fourth quarter, a first quarter of 2001 with real GDP growth either slightly positive or slightly negative, and then start registering substantially positive growth numbers in the second quarter and thereafter. The recession of 2001-2002 would then be no worse than, and probably milder than, the recession of 1990-1991. The reasons for this optimistic view are well-known: Falling oil prices, monetary policy, and fiscal policy are all stimulating the economy, and inventories have been drawn down to very low levels—which should lead to a strong inventory upswing once sales start to recover.

This is the scenario I hope for, but not the one I believe in. Quite honestly, I don't know how to attach probabilities to the various events that underlie the "everything-goes-right" scenario. But I am worried that the joint probability that *all* of them turn out favorably is not high. That's what I meant before by *downside risk.* And this downside risk is the main reason why I believe Congress should enact a stimulus bill *right now.* If one or more of the things on my list goes wrong, we could be in for a severe and perhaps lengthy recession. Remember:

-- the economy was very weak *before* September 11th, only the intrepid American consumer was keeping the economy afloat;

-- the terrorist attacks were a blow not only to consumer confidence but, much more importantly, to jobs and income;

-- the standard cycle of lower spending leading to layoffs, which in turn to lead to still lower spending has barely begun;

-- the slowdown is a worldwide event; we will not get any help from abroad.

The solution to the U.S. recession must be made in the USA. The Federal Reserve is doing its part; I tip my hat to them. But the well-known lags in the effects of monetary policy mean that the steps the Fed has taken since September 11th will be relevant only to the shape of the *recovery,* not to the severity of the *recession.* There are, however, *fiscal* measures that can impact the economy much sooner than that—if only Congress would enact them. That is why I became a strong advocate of fiscal stimulus on September 12th.

Many economists and other citizens are dismayed that Congress has been dithering over the stimulus for more than two months and now appears to be deadlocked. When I read in the papers about tax cuts or spending programs that might take effect in the spring, or even later, I wonder what Members of Congress can be thinking about. This is not a partisan remark; both Republicans and Democrats are to blame. But it is well passed time to get beyond partisanship and enact a genuine stimulus bill. I realize that the JEC has no jurisdiction in this matter. But every member of this committee is among the 535 men and women who must ultimately get something done. And Congress is already running late.

I would like to suggest two simple and nonpartisan tests to determine whether some proposal is really an appropriate part of a stimulus package in the current environment:

1. *Scorekeeping*: Is at last 80% of the cost incurred in the first year? (I'd actually prefer 100%.) If not, the economy is probably not going to get much stimulus bang for the budgetary buck.

2. *Customization:* Were the people who are now advocating the policy also advocating it a year or two ago, and will they also want it a year or two from now? If so, it is probably not tailored to the current situation.

Proposals that fail to meet these two criteria may or may not be sound policy—that will be a matter of debate, often partisan debate. But they cannot legitimately be considered short-run stimulus. And you are all aware that most of the proposals included in the House bill, and several of those under consideration in the Senate, fail one or both of these tests.

With your indulgence, I'd like to outline my own suggestion for breaking the deadlock in a bipartisan way. I first made it in an op-ed piece in *The New York Times* exactly two months ago.[1] My proposal is that Congress offer to replace the revenue lost by any state that reduces its sales tax by a certain amount for a certain, well-defined period of time. When I made the proposal originally, I suggested a cut of 1 or 2 percentage points for one year. But, especially now that time has elapsed, I can see a case for a shorter time period and a deeper cut—perhaps 2-4 percentage points over six months.

Some of you may be familiar with a first cousin of this proposal, which has been offered by Senators Murray and Snowe. Their proposal would declare a sales tax *holiday*, that is, drive the tax rate all the way to zero, but for only 10 days. The *spirit* of their proposal is exactly right, and it passes my two tests with flying colors. I applaud them for making it. But our economy is not facing a 10-day problem. The central idea behind a *temporary* cut in sales taxes is to induce consumers to bring their spending forward--into the low-tax period. But we won't shorten the recession if consumer spending booms for 10 days and then sags on day 11. If you start with their proposal, but lengthen the 10-day period and reduce the depth of the rate cut, you begin to move toward my proposal. There is plenty of room in the middle.

A temporary sales-tax cut has many virtues. Notice, first of all, that it is strikingly nonpartisan. For Republicans, it's 100% tax cut, not government spending—and it's a *marginal* tax rate reduction to boot. For Democrats, it's a cut in a tax that has long been viewed as regressive, and it delivers help to those who need it most. It is no coincidence that the co-sponsors of the Murray-Snowe proposal are one Democrat and one Republican.

Second, the proposal cuts taxes *only* where tax cuts do the economy some good. Every dollar of tax cut would be directly attached to consumer spending—which is where, I believe, we should concentrate our fire. At given income levels, people who spend more will benefit more. And those Americans who live from hand to mouth, spending every dollar they earn, will get a tax cut on every dollar.

You might well ask, "Doesn't the so-called 'Supplemental Rebate' for low-income households also deliver help to the needy?" The answer is yes, and I favor it. But we must remember that making an *income tax* cut temporary *weakens* its impact on spending (as we saw with the recent tax rebate), while making a *sales tax* cut temporary *strengthens* it (as many cities and states have recognized). This incentive effect is the third important virtue of the proposal.

Fourth, the sales-tax cut is as simple legislatively and administratively as can be imagined. The structure of the tax in each state is already set up, as is the reporting and

[1] Alan S. Blinder, "The Economic Stimulus We Need," *The New York Times*, September 28, 2001.

collection apparatus. Congress would not tamper with any of that. At the state level, the necessary legislation could be one line long. In my home state of New Jersey, for example, it might read: "The basic rate of sales taxation is reduced from 6% to 4% for the six-month period January 1, 2001 through June 30, 2002." And once the statute is enacted, the tax cut can take effect very fast.[2]

Fifth, and related, a sales tax cut of this nature will convey a simple and intelligible message to citizens in a way that no complicated, hodge-podge bill ever can. Ordinary Americans, the kind who were so heroic on September 11th, understand the sales tax in a way they will never understand the corporate AMT or Medicaid provisions. They will not only see that Congress has actually done something to help the economy, they will immediately understand that the tax cut is designed to help them spend more.

Last, but certainly not least, this measure will improve the ailing fiscal positions of the states. Suppose a state reduces its sales tax from 6% to 4%, and the tax cut actually succeeds in increasing sales volume. If the Federal government then adds 50 cents to every dollar the state collects, the state's treasury will actually come out *ahead.* This feature of the proposal is no accident, but it should not be thought of as merely government-to-government charity. The fact is that state and local government budgets are normally procyclical; states and localities typically raise their taxes and cut their spending during recessions, and do the reverse during booms (as we have just seen). There is every reason to think that most of the states will behave this way during the current recession; indeed, many are doing so already.

When I published this proposal on September 28th, I was not expecting an immediate groundswell of support from both sides of the aisle. My hope was that, in the event of a partisan deadlock, Congress might look for a way out that was acceptable to both parties. We are now at that point. So I offer this proposal to any Democrat or Republican who will champion it.

Thank you, Mr. Chairman and members of the Committee, and good luck in your deliberations.

[2] Five states do not have a general sales tax. Congress would no doubt want to make special provisions for these five. That is about the only complication that this proposal entails.

# The Current State of the U.S. Economy and the Role of Fiscal Policy

Testimony before the Joint Economic Committee

November 28, 2001

Janet Yellen

Introduction

Chairman Saxton, Vice Chairman Reed, and members of the Joint Economic Committee, thank you for inviting me to testify before you on the economic outlook. My name is Janet Yellen, and I am the Eugene E. and Catherine M. Trefethen Professor of Business and Professor of Economics at the University of California at Berkeley. I served as Chair of the Council of Economic Advisers from 1997 to 1999, and on the Board of Governors of the Federal Reserve System from 1994 to 1997. I am pleased to have the chance to share my thoughts with you today on fiscal policy and the economy because I believe that the U.S. economy is at an important juncture. The decisions this Congress makes about the economic stimulus package currently under consideration matter not only to the short-term outlook but also to our longer-term prospects.

The Economic Outlook

Over the past year, the American economy has been suffering the fallout from a collapse of stock prices and an unwinding of the hi-tech investment boom that had propelled growth at accelerating rates after 1995. Capital spending turned sharply downward this year, and steep cutbacks in inventory accumulation further depressed production. The slowdown has not been confined to the United States. It has been global—with weakness abroad exacerbated by diminished U.S. spending on foreign goods and services. The downturn in IT spending especially impacted countries such as Taiwan, Singapore, Malaysia, and Thailand, which rely on hi-tech exports. I consider Japan's situation bleak: it has again tipped into recession and may be undergoing an intensifying deflationary spiral. European growth has also slowed substantially. Weak global growth, in turn, is depressing American exports.

A major offsetting positive is that consumer spending has kept growing, although it has slowed considerably in the face of a weakening labor market, high debt burdens, rising bankruptcies, and, importantly, declines in equity prices.. Housing has also held up well thus far. But both are vulnerable to setbacks. Housing already shows signs of weakening.

Before the attacks, the U.S. economy was in the midst of a growth recession–a period of growth well below the economy's potential. Such sub-par performance results in greater slack in labor markets and lower capacity utilization. Even before the attacks, employment had declined, unemployment had increased substantially, and capacity utilization had fallen to levels last seen in 1983. The economic pain resulting from the slowdown in economic growth has been widely shared: corporate profits have declined about 20% over the past year; state and local governments have seen surpluses erode, forcing cutbacks in spending on a broad range of public goods and services; and American families have lost work, wages, benefits and the economic security that access to a job provides.

The terrorist attacks dealt a substantial blow to an already weak economy, tipping it into outright recession. Economic growth in the third quarter was slightly negative, at -0.4%, according to the Commerce Department's first estimate of real GDP growth. Economic activity seems likely to decline at a much faster pace during the remainder of this year. Unemployment spiked upward, from 4.9% in September to 5.4% in October; employment shrank by 415,000 jobs in a single month–about 0.75 million over the past six months. Like most observers, I anticipate that unemployment will edge yet higher in the coming months.

The direct and immediate impact of the attacks in the form of loss of life, property destruction, and disruption of production, distribution, and transportation has been substantial. In total, September 11th surely ranks as the most devastating single catastrophe in U.S. history. The most important economic risk now, however, is of further retrenchment in capital and consumer spending. Americans are naturally more uncertain and apprehensive. In the face of uncertainty, deferring significant spending commitments–whether for capital expenditures or consumer outlays–is a rational response. Declines in capital goods orders suggest that just such a response is now in progress. The ripples from reduced spending will cause additional job and income losses, exacerbating the downturn. Heightened uncertainty has also translated into larger risk spreads in borrowing costs and tighter lending standards by banks. Recent signs are not unambiguously negative–for example, October saw a strong rebound in retail sales, a decline in new claims for unemployment insurance, and a slight increase in consumer confidence readings. Still, most indicators remain unsettling: aggregate hours of work continue to decline; unemployment insurance claims, although down from their post-attack highs, stand at recessionary levels. Housing sales and starts have slipped noticeably. And industrial production continues to decline, suggesting that the manufacturing sector has not yet hit bottom.

The track record of economists at predicting turning points is not good. Even so, there are legitimate grounds for optimism that the economy will rebound during the coming year with growth returning to trend or above. This optimism is reflected in a rebound in stock prices since the attacks. What actually happens, though, depends critically on both the progress of the war on terrorism and the decisions that Congress and the Administration make now about the future course of fiscal policy. Without meaningful stimulus, unemployment could remain at unacceptably high levels for an extended time, even if a rebound occurs. With inflation well contained, the case for fiscal stimulus is strong.

The reasons for optimism can be briefly summarized. First, the inventory downturn is arguably nearing its end. During each of the last five quarters, the level of inventory investment has declined, holding growth down. In the third quarter, inventory disinvestment reached a record $50 billion in real terms. Inventory disinvestment could rise yet further this quarter; even so, there is good reason to project a rebound next year to more normal positive levels. The consequence would be a noticeable uptick in production and growth. A second reason for optimism relates to spending on high-tech equipment. Many forecasters predict progress in working off the overhang of excess investment in this sector, which would pave the way for some rebound in equipment spending. A third reason for optimism is that the global downturn is pushing oil prices down. Declines in energy costs give households extra income to spend on a broad array of products and services. Lower energy costs also decrease business costs, raising profits.

The most important reasons for a positive economic outlook, however, relate to policy. Current monetary policy is extremely conducive to recovery. The Fed had cut its key interest rate by 300 basis points before the attacks. In response to September 11th, the Federal Reserve immediately threw open its discount window to counter disruption and inject liquidity. In three separate moves since the attacks, it has lowered the federal funds rate by 150 basis points to 2.0%. In real or inflation-adjusted terms, the federal funds rate is now very low as well (maybe even negative)--so the Fed has its foot on the accelerator. Monetary policy works with a lag but we have already seen some payoffs: low short-term rates helped automakers introduce 0% financing schemes that boosted auto sales last month. Mortgage rates have declined, triggering a great surge in mortgage refinancing during the past month.

Under normal conditions, the Federal Reserve can keep the economy on track without help from fiscal policy. There are reasons for concern, however, that the Fed's medicine is less potent now than normally. Fed policy typically operates through at least four distinct channels: short-term interest rates; longer-term interest rates; equity values; and the value of the dollar. A cut in the federal funds rate typically impacts each of these financial variables, in turn stimulating spending through several distinct mechanisms. Broad indices of "financial conditions," constructed to track the combined movements of these financial variables, reveal that overall financial conditions are not as "loose" as would be suggested by the low federal funds rate—the dollar has remained strong; stock prices have fallen, not risen, on net, over the last year; long-term interest rates have declined much less than is typical, with the yield on 10-year Treasuries down less than 1 percentage point since the Fed's easing cycle began; and credit spreads have risen. Unlike Japan, the U.S. is not now in a liquidity trap; nor is the U.S. experiencing deflation—just disinflation. Still, the scope for additional monetary policy has diminished.

Fiscal policy is already providing meaningful stimulus to the economy as well. In addition to the $38 billion of rebates that went out last summer, around $70 billion of tax cuts are scheduled to take effect in 2002. The emergency package passed by Congress, moreover, authorizes $40 billion for rebuilding and disaster relief. The question is whether additional stimulus beyond these steps is needed. My answer is yes, but only if the package is properly designed. Even if the recession proves short-lived, there is no guarantee that the recovery will be strong enough to reduce unemployment and eliminate economic slack. The extra boost to demand from a stimulus package could speed the return to "full employment." But to stabilize rather than destabilize the economy, the stimulus must come now, when it is needed—not after the economy has recovered, when it would be counterproductive. The stimulus must also be temporary, to avoid harm to the long-term budget outlook. Actions that undermine the longer-term position of the federal budget jeopardize long-term growth. They also reduce interest-sensitive spending by driving up long-term interest rates, deepening, not shortening, the recession.

The biggest challenge our economy faces in the longer-run remains exactly the same as prior to September 11th: preparation for the tremendous pressures that an aging population will place on the federal budget and national saving. Those pressures have not gone away. They have worsened, since other priorities for the federal budget-associated with recovery and the war against terrorism-have surely increased. With fiscal policy, the potential for *bad* policy is so great that a "stimulus package" could do more harm than good. I would rather see *no* stimulus package at all than a badly designed one that simply wastes crucial federal dollars, provides little or no positive short-run stimulus, erodes national saving, drives up long-term interest rates, and diminishes the ability of the federal budget to meet the needs of an aging population.

Before turning to a more detailed discussion of what more fiscal policy can and should do, I would like to comment briefly about the longer-term outlook for the U.S. economy. Here I agree with the current CEA Chairman, Glenn Hubbard, that the longer-term outlook for the U.S. economy remains favorable. The 1990s, particularly the second half of the decade, was a fabulous period for the United States because productivity growth, which ultimately determines how fast living standards improve, perked up substantially. Productivity growth averaged 1.4% from 1973 to 1995. Over the next five years, it averaged 2.5%. Firms invested heavily in IT. But they innovated in other ways too: they altered relationships with suppliers and customers, changed production methods, and reengineered jobs, hierarchies, and organizations. Faster productivity growth held inflation down in the face of extraordinarily low unemployment. It also improved budget outlooks for federal, state, and local governments. In the near-term, three separate factors are likely to depress productivity growth. First, productivity growth commonly slows in recessions and rebounds in recoveries. Second, the downturn in investment spending will depress productivity growth for a time. And finally, as Chairman Greenspan and others have emphasized, the level of productivity will suffer for a time due to the additional costs associated with increased levels of security: the terrorist attacks constituted a negative supply shock. In a recent op-ed, Chairman Hubbard emphasized that "the attacks did not undermine long-term productivity growth." This assessment accords with calculations by the forecasting firm, Macroadvisers, which suggest that any long-term quantitative impact on productivity growth from the attacks is likely to be "immeasurably small." There are no certainties when it comes to forecasting future productivity growth; but my hunch, based on recent studies and data, is that productivity growth will rebound to a healthy pace during the next expansion. An implication is that the U.S. economy does not currently face any serious "supply-side" or productivity-related problem that necessitates a change in tax policy. The most important contribution that fiscal policy can make to assure healthy productivity growth is continued fiscal discipline, to provide an adequate level of national saving and low long-term interest rates. Tax cuts in the name of long-term growth are more likely to harm than boost productivity if they erode the budget surplus.

What More Can Fiscal Policy Do?

I was one of 14 economists who recently signed an open letter to Senators Daschle and Lott, urging them to lead the Senate in coming up with a stimulus package that would actually do more *good* than harm. We discussed two principles that a stimulus package should satisfy—principles that have also been endorsed on a bipartisan basis by the leaders of the Senate and House Budget Committees. First, policies should be targeted to increase spending immediately. The purpose of a stimulus package should be to complement monetary policy in raising aggregate demand. The package should not primarily focus on raising supply since a shortfall in demand, not a shortfall in supply, is the problem currently facing the U.S. economy. Second, the stimulus package should be temporary, phasing out when the economy recovers. As I have already emphasized, this second feature is important not only for productivity growth but also to insure that long-term interest rates do not rise now, choking off recovery. Unfortunately, the House Economic Recovery Bill violates both principles.

The House bill is heavily directed toward business tax relief, yet the provisions of the bill would have little or no immediate impact on investment spending. For example, repeal of the corporate AMT and refund of AMT credits provide a pure, and unconscionable, windfall for businesses. The payments are based on past investments, not current investment decisions. Because this provision creates no meaningful incentive for investment, it provides no stimulus. The proposed relaxation of subpart F regulations is a similarly expensive windfall for old capital. Among the various business tax incentives that have been discussed for inclusion in a stimulus package, a temporary provision for partial expensing of investment, or, alternatively, a temporary investment tax credit, deserves serious consideration. Temporary investment incentives are attractive because they are targeted at new, not old investments (although they reward investment that would have occurred even without the incentive); and they create potent incentives due to the "use it or lose it" opportunity they entail. In the current downturn, many firms are suffering from substantial excess capacity and will likely be immune to this incentive. But even in a recession, many firms invest and temporary investment incentives encourage these firms to speed up their purchases. From the standpoint of immediate stimulus, however, the three-year period allowed for partial expensing in H.R. 3090 is far too long. The extra spending is needed now, not two or three years from now. In my view, the time horizon for such a temporary investment incentive should be far shorter, as in the Senate Democratic plan, which makes it available only over the next 12 months.

The House Bill contains provisions for individual as well as business tax relief, but again, with some exceptions, the provisions violate the two main principles enunciated in the economists' letter. The proposal to accelerate implementation of the 25% income tax rate, now scheduled to take effect in 2006, provides very little stimulus "bang per buck" because its benefits are targeted to the top 25% of households, whom studies show are not heavily "liquidity constrained" and spend a lower fraction of extra income than low-income households.[1] In addition, the provision is extremely costly.

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[1] In a recent *Washington Post* op-ed, Glenn Hubbard ("Tax Cuts Are the Best Stimulus, November 16, 2001, page A47) states that "despite the repeated claim that only poor

Given the new burdens on the government budget resulting from the attacks, the tax cut that passed last spring is now, in my view, unaffordable. It would probably never have become law had we known that September 11[th] would happen. The attacks are no reason to accelerate the tax cut; instead, they are a good reason to reconsider them.

The capital gains tax cut included in the House Bill is especially problematic. Proponents of such cuts argue that they raise saving, not spending. As Chairman Greenspan has explained to this committee, such policy therefore has almost no short-run stimulus potential: a recession is not the right time to use tax policy to stimulate private saving. Such tax reductions are also expensive for the government budget over the longer term. To consider such a tax change in the current economic climate and in the name of stimulus, at a time when there are more pressing demands on the budget that cannot wait, strikes me as totally irresponsible. It reduces the funds available to help those truly in need while wasting money on windfall gains that do nothing to spur new spending. And it abandons the fiscal discipline that we should be maintaining for the long-run challenges that remain.

The one provision of H.R. 3090 that meets the principles endorsed in the economists' letter and would be highly effective in a stimulus package is the proposed rebate for individuals that did not receive a full rebate last summer. The "bang per buck" of these payments would be substantial because the benefits would go disproportionately to low and moderate-income workers. Such workers are typically liquidity constrained and spend a large share of extra income. Also, a temporary rebate avoids damage to the long-run budget.

In my view, a solid case can be made for several stimulus measures not included in the House bill. For example, Alan Blinder has proposed a temporary cut in state sales taxes, financed from federal government general revenues. This plan, if it can be implemented quickly, has considerable merit

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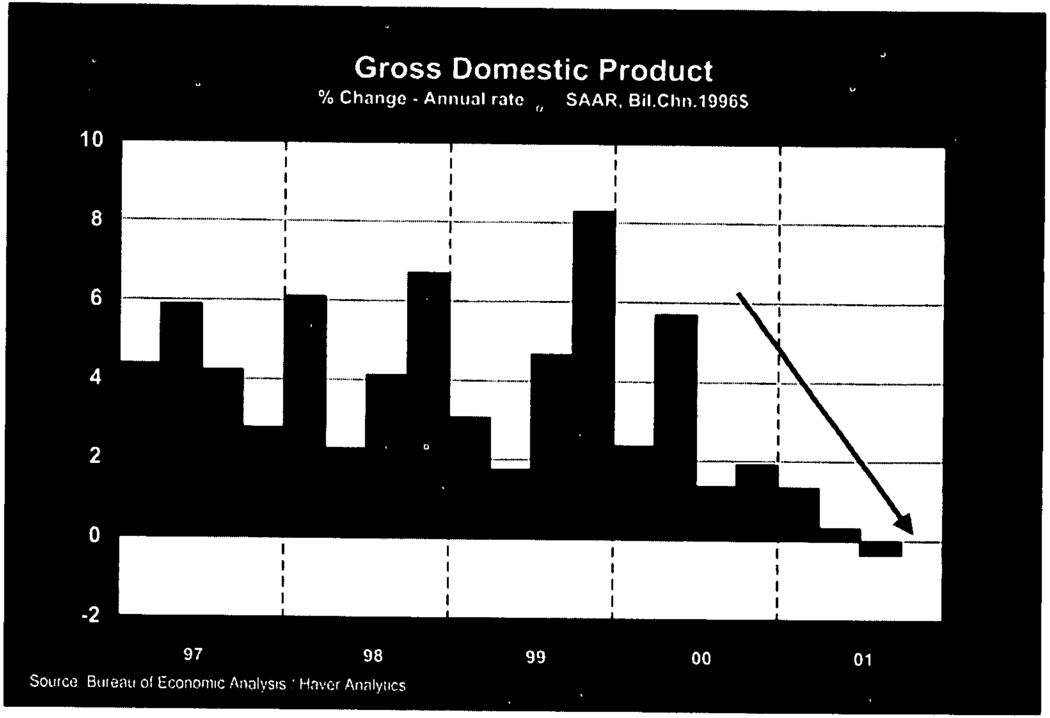
households will spend additional income, evidence indicates almost all households spend about the same percentage of their tax cuts." In fact, a recent study by Karen Dynan, Jonathan Skinner, and Stephen Zeldes (Do the Rich Save More? NBER Working Paper No. 7906) finds that saving rates rise with income, ranging from less than 5 percent for the bottom quintile of the income distribution to more than 40 percent of income for the top 5 percent. A recent study by Joel Slemrod & Matthew Shapiro ("Consumer Response to Tax Rebates," October 10, 2001) examined questions about this summer's tax rebates included on the Michigan survey of consumer sentiment and found surprising results. When people were asked how they planned to use their rebate, the responses indicated that on average only about 20% of the rebates would be spent and this fraction did not differ much across income groups. The authors note, however, that these results are surprising and anomalous. The rebates did not go to the lowest-income households, and actual behavior may differ from the intentions reported in the survey.

as a stimulus measure: it could give a quick boost to consumer spending. Alan Krueger, Wendell Primus and others have argued for improvements in the unemployment insurance system, and such measures are included in the Senate Democratic bill. Krueger and Primus advocate changing the eligibility rules of the UI program, which mainly exclude part-time workers and have become outdated. Only 40% of the unemployed now receive UI benefits. A case can also be made for a temporary increase in the level of UI benefits and an extension of the duration of benefits should the recession turn out to be long-lasting and should unemployment reach sufficiently high levels. The case on equity grounds for directing benefits to unemployed workers is extremely strong; and from the standpoint of stimulus, such expenditures are highly effective, since they assist individuals who are especially liquidity constrained. Temporary additional allocations for foodstamps, WIC, housing subsidies, and other safety net programs also would provide effective stimulus targeted toward those in need. Increased federal transfers to state and local governments whose budgets have been adversely impacted by the economic downturn are also worthy of inclusion in a stimulus package. These governments are forced, by balanced budget requirements, to react to the downturn with spending cuts or tax increases; but such responses exacerbate the downturn. Additional federal support could alleviate such destabilizing policy shifts and mitigate potential cuts in social services to the needy. One promising possibility would be to temporarily raise the federal matching rate for Medicaid.

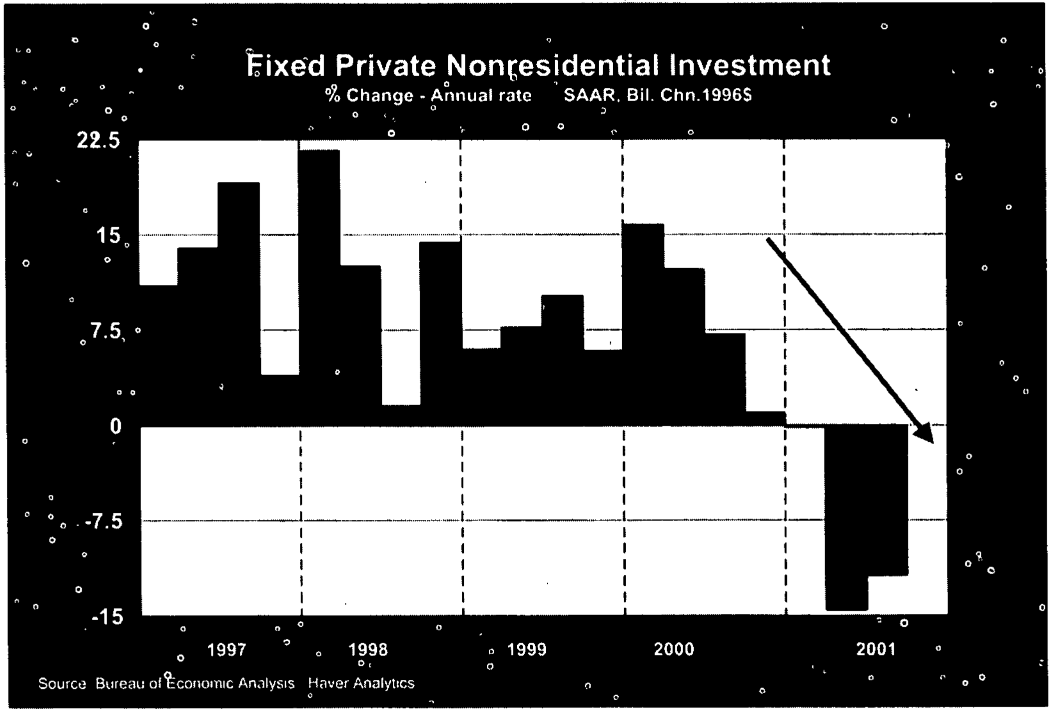
In his recent Washington Post op-ed, CEA Chairman Hubbard argued against spending as a means to revive the economy. He wrote that "it is a major fallacy to praise new spending plans as 'stimulus.' This ignores the fact that a dollar spent by the government is one fewer that can be spent by private businesses." Hubbard's argument wrongly contradicts a basic macroeconomic principle, enshrined in textbooks for the last 40 years. When an economy is operating at full tilt, with no slack in the labor market, a tradeoff between government and private spending exists, as Hubbard asserts. Additional spending by the government "crowds out" an equal amount of private spending, through the channel of higher interest rates. But when an economy is operating with slack, as ours is now, the tradeoff not only disappears, it reverses, so that greater spending by the government raises, not lowers, spending by private businesses. In an economy plagued by slack, extra spending means more business orders, more jobs, and less spare capacity. New jobs raise household incomes, further boosting private spending via the "multiplier." When firms see sales rise and excess capacity decline, they have the incentive—likely a more powerful incentive than any business tax incentive now under consideration—to invest more: to satisfy customer orders. A temporary spending boost thus raises both government spending and private business spending. Whereas trickle-down economics boosts employment indirectly by stimulating investment and saving, trickleup economics spurs investment by boosting government and/or consumer spending. Assuming that long-run fiscal discipline is maintained, there is no reason whatsoever for short or long-term interest rates to rise, choking off the recovery.

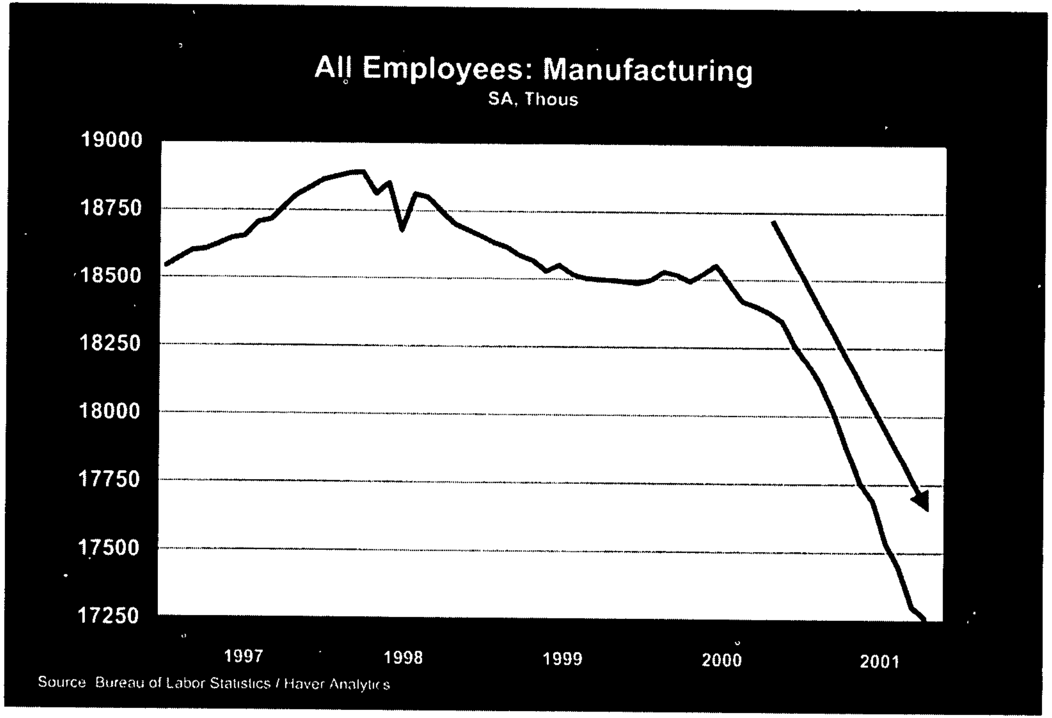
Conclusion

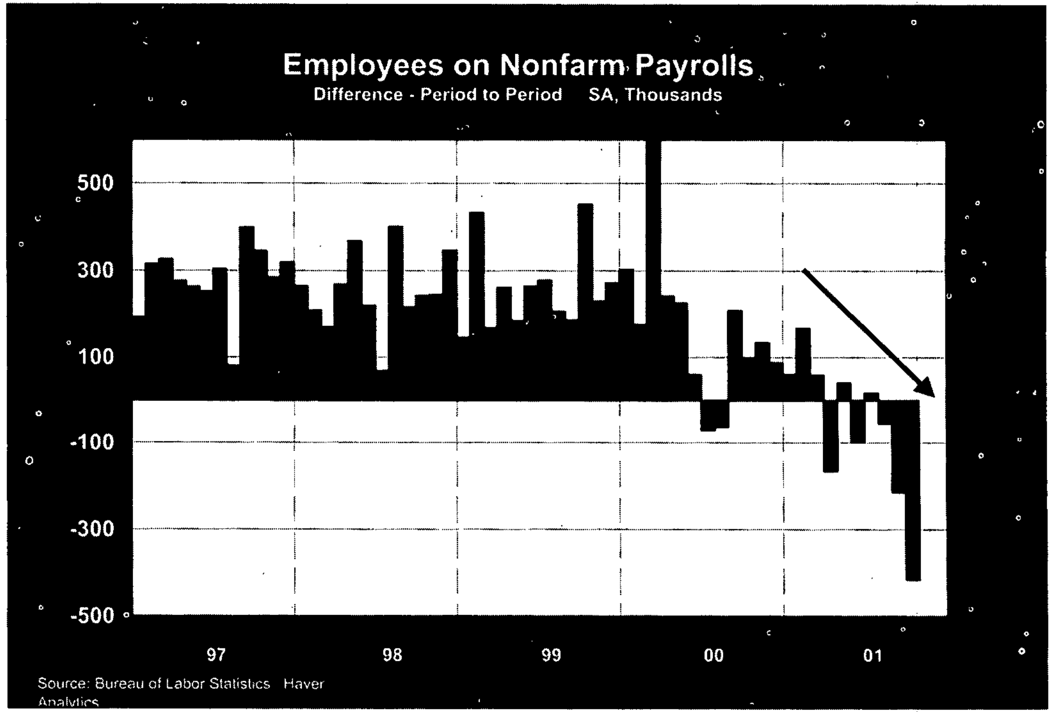
The U.S. economy stands at a critical juncture. Fiscal policy has an excellent opportunity to play a supportive role in getting the U.S. economy back on track. But the House "stimulus package" does little to boost spending and severely undermines the long-term federal budget outlook, an outcome America can ill afford with the retirement of the baby boomers looming just beyond the ten-year budget horizon. Numerous practical and effective options are available to strengthen the stimulus while reducing the long-term budget damage.

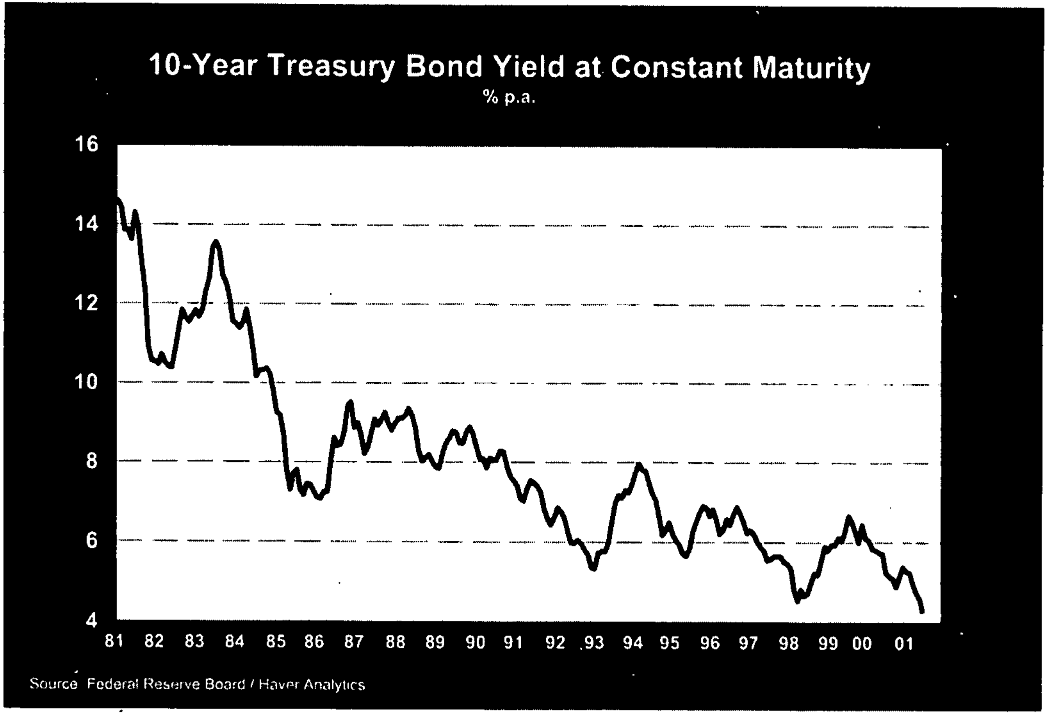


Gross Domestic Product
% Change - Annual rate
SAAR, Bil.Chn.1996$
10
8
6
4
2
0
-2
97
98
99
00
01
Source Bureau of Economic Analysis / Haver Analytics


Fixed Private Nonresidential Investment
% Change - Annual rate    SAAR, Bil. Chn.1996$
22.5
15
7.5
0
-7.5
-15
1997
1998
1999
2000
2001
Source Bureau of Economic Analysis Haver Analytics


All Employees: Manufacturing
SA, Thous
19000
18750
18500
18250
18000
17750
17500
17250
1997
1998
1999
2000
2001
Source Bureau of Labor Statistics / Haver Analytics


Employees on Nonfarm Payrolls
Difference - Period to Period SA, Thousands
500
300
100
-100
-300
-500
97
98
99
00
01
Source: Bureau of Labor Statistics Haver Analytics



10-Year Treasury Bond Yield at Constant Maturity
% p.a.
16
14
12
10
8
6
4
81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01
Source Federal Reserve Board / Haver Analytics